SONOSITE INC
Form 8-K
February 11, 2010

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 8-K

CURRENT REPORT
Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

February 11, 2010
Date of Report
(Date of Earliest Event Reported)

SONOSITE, INC.

(Exact Name of Registrant as Specified in Charter)

Washington	0-23791	91-1405022
(State or Other Jurisdiction of Incorporation)	(Commission File No.)	(IRS Employer Identification No.)

21919 30th Drive S.E., Bothell, Washington 98021-3904
(Address of Principal Executive Offices) (Zip Code)

(425) 951-1200
(Registrant's Telephone Number, Including Area Code)

None
(Former Name or Former Address, if Changed Since Last Report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

[ ] Written communication pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

[ ] Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

[ ] Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

[ ] Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e4(c))

Item 2.02 Results of Operations and Financial Condition.

On February 11, 2010, SonoSite issued a press release announcing its financial results for the fourth quarter and year ended December 31, 2009. A copy of this press release is attached hereto as Exhibit 99.1 and is incorporated into this current report by reference.

Item 9.01 Financial Statements and Exhibits.

(c) Exhibits

99.1	SonoSite, Inc. press release issued February 11, 2010, announcing its financial results for the fourth quarter and year ended December 31, 2009.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, SonoSite, Inc. has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

SONOSITE, INC.

Dated:	February 11, 2010	By:	/s/ MICHAEL J. SCHUH Michael J. Schuh Chief Financial Officer

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EXHIBIT INDEX

Exhibit Number	Description
99.1	SonoSite, Inc. press release issued February 11, 2010, announcing its preliminary financial results for the fourth quarter and year ended December 31, 2009.

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Pre-Tax Operating Earnings

$265.0 $120.9 $82.6

Totals may not add due to rounding

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Consolidated revenues in 2006 increased $316.6 million, or 50% from 2005, while consolidated Operating Expenses increased $172.5 million or 34% from 2005. Overall, Consolidated Pre-Tax Operating Earnings increased $144.1 million, or 119% from 2005.

The changes in our Pre-Tax Operating Earnings by segment from 2005 to 2006 are summarized as follows:

Asset Management Our 2006 Pre-Tax Operating Earnings from Asset Management were up $48.3 million, or 182% from 2005, primarily due to higher incentive fees as a result of increased fund returns and higher assets under management.

Global Markets Our 2006 Pre-Tax Operating Earnings from Global Markets were up $113.7 million or 252% from 2005, primarily due to the expansion of our electronic trading effort and automated execution of most of our broker-dealer order flow, increased revenue capture and volumes, and improved market conditions.

Corporate The results from our Corporate segment were positively impacted in 2006 by realized gains from the sales of our corporate equity investment in the International Securities Exchange, Inc. (ISE), as well as higher returns on our corporate investment in the Deephaven Funds. The decrease in our 2006 Pre-Tax Operating Earnings compared to 2005 is primarily related to the sale of our investment in the Nasdaq Stock Market, Inc. (Nasdaq) in 2005.

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 pre-tax profit margins, 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 continue the rates of revenue growth that we have experienced in the past or that we will be able to improve our operating results.

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Trends

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

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. Over the past several years, the greater focus on execution quality has resulted in greater competition in the marketplace, which, along with market structure changes and market conditions, has negatively impacted the revenue capture metrics of the Company and other market-making firms.

Retail equity transaction volumes executed by broker-dealers have fluctuated over the past few years due to investor sentiment, market conditions and a variety of other factors. Retail equity transaction volumes may not be sustainable and are not predictable.

There has been consolidation among market centers over the past several years, 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. In addition, many broker-dealers are offering their own internal crossing networks creating further fragmentation in the marketplace.

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 charge explicit fees in the form of commissions or commission equivalents. 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 market-makers, specialists, 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 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 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 Direct Trading, Direct Edge, Hotspot and ValuBond and the growth of our soft dollar and commission recapture activity.

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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, 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 as well as fees earned from separately managed accounts. These fees consist of annual management fees, calculated as fixed percentages of assets under management, and incentive fees, generally calculated as a percentage of the funds and managed accounts year-to-date 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 level of 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 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 Net trading revenue and Commissions and fees 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 on the New York Stock Exchange (NYSE) and other exchanges, 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 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 primarily 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

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and incentive compensation paid to all other employees based on our profitability. Compensation for employees engaged in sales activities is determined primarily based on a percentage of their gross revenues net of certain transaction-based expenses. The majority of compensation in Asset Management is determined by formulas based upon the profitability of the Asset Management segment, 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,		
	2006	**2005**	**2004**
Revenues			
Commissions and fees	42.6%	46.7%	44.1%
Net trading revenue	25.6%	26.1%	40.1%
Asset management fees	22.5%	14.1%	12.4%
Interest and dividends, net	1.7%	1.4%	0.8%
Investment income and other	7.6%	11.7%	2.6%
Total revenues	100.0%	100.0%	100.0%
Transaction-based expenses			
Execution and clearance fees	11.2%	15.7%	17.9%
Soft dollar and commission recapture expense	6.9%	10.0%	9.6%
Payments for order flow and ECN rebates	4.4%	3.3%	5.9%
Total transaction-based expenses	22.6%	29.0%	33.3%
Revenues, net of transaction-based expenses	77.4%	71.0%	66.7%
Other direct expenses			
Employee compensation and benefits	37.0%	36.2%	39.1%
Communications and data processing	3.5%	5.1%	4.6%
Depreciation and amortization	2.2%	2.6%	2.3%
Professional fees	2.2%	3.1%	2.4%
Business development	1.5%	1.0%	1.3%
Occupancy and equipment rentals	1.4%	2.1%	2.7%
Writedown of assets and lease loss accrual	0.9%	1.6%	0.6%
Regulatory charges and related matters	0.0%	0.9%	12.7%
Other	1.8%	1.8%	1.1%
Total other direct expenses	50.5%	54.4%	66.8%
Income (loss) from continuing operations before income taxes	27.0%	16.6%	0.1%

Income tax expense	10.3%	6.1%	1.5%
Net income (loss) from continuing operations	16.6%	10.5%	1.6%
Income (loss) from discontinued operations, net of tax	0.0%	0.0%	16.1%
Net income	16.6%	10.5%	14.6%

Percentages may not add due to rounding.

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Years Ended December 31, 2006 and 2005

Continuing Operations

Revenues

Asset Management

	For the years ended December 31, 2006	2005	Change	% of Change
Total Revenues from Asset Management (millions)	$ 214.9	$ 89.8	$ 125.1	139.3%
Average month-end balance of assets under management (millions)	$ 3,420.4	$ 3,291.1	$ 129.3	3.9%
Annual fund return to investors*	22.8%	7.2%	15.6%	218.4%

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

Total revenues from the Asset Management segment, which primarily consists of Asset management fees, increased 139.3% to $214.9 million in 2006, from $89.8 million in 2005. The increase is primarily due to higher incentive fees as a result of increased fund returns and higher assets under management. The average month-end balance of assets under management increased to $3.4 billion in 2006, from $3.3 billion in 2005. The blended annual fund return across all assets under management for 2006 was a gain of 22.8%, up from a gain of 7.2% in 2005.

Global Markets

	For the years ended December 31, 2006	2005	Change	% of Change
Commissions and fees (millions)	$ 405.3	$ 296.2	$ 109.1	36.8%
Net trading revenue (millions)	243.8	165.6	78.1	47.2%
Interest and dividends, net (millions)	12.2	6.6	5.5	83.6%
Investment income and other (millions)	8.4	2.2	6.2	283.2%
Total Revenues from Global Markets (millions)	$ 669.7	$ 470.7	$ 199.0	42.3%
U.S equity dollar value traded ($ billions)	2,033.6	1,882.2	151.4	8.0%
U.S. equity trades executed (millions)	225.5	204.1	21.4	10.5%
Nasdaq and Listed equity shares traded (billions)	94.3	106.3	(12.0)	11.3%
OTC Bulletin Board and Pink Sheet shares traded (billions)	1,063.1	718.8	344.3	47.9%
Average revenue capture per U.S. equity dollar value traded (bps)	2.1	1.8	0.4	21.6%

Total revenues from the Global Markets segment, which primarily comprises Commissions and fees and Net trading revenue from our domestic businesses, increased 42.3% to $669.7 million in 2006, from $470.7 million in 2005. Revenues in 2006 were positively impacted by improved market conditions, higher dollar volumes, an increase in revenue capture per U.S. equity dollar value traded, the expansion of our electronic trading effort and the automation of executions of most of our broker-dealer order flow. Revenues in 2006 were also positively impacted by the addition of Direct Trading, Direct Edge, Hotspot and ValuBond, which were acquired in June 2005, October 2005, April 2006 and October 2006, respectively. Excluding the impact of these acquisitions, total revenues from Global Markets would have increased 26.6% to $563.2 million in 2006, from $444.9 million in 2005. Revenues were also positively impacted by new fees charged to clients in connection with certain transaction-based regulatory costs incurred by the Company. These fees increased Commissions and fees by $19.2 million in 2006. Approximately $9.4 million of these fees related to client transaction activity in 2006 while the remaining $9.8 million related to client transaction activity in 2005 and prior years.

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Average revenue capture per U.S. equity dollar value traded was 2.1 basis points (bps) in 2006, up from 1.8 bps in 2005. Average revenue capture per U.S. equity dollar value traded is calculated as the total of net domestic trading revenues plus U.S. institutional commissions and commission equivalents (included in Commissions and fees), less certain transaction-related regulatory fees (included in Execution and clearance fees), (collectively Core Equity Revenues) divided by the total dollar value of the related equity transactions. Core Equity Revenues were $434.6 million and $330.4 million in 2006 and 2005, respectively. Core Equity Revenues do not include revenues from KEMIL s European institutional business, Donaldson, Direct Trading, Direct Edge, Hotspot and ValuBond.

Corporate

	For the years ended December 31, 2006	2005	Change	% of Change
Total Revenues from Corporate (millions)	$ 66.6	$ 74.2	$ (7.5)	10.1%
Average corporate investment balance in the Deephaven Funds (millions)	$ 230.2	$ 272.6	$ (42.5)	15.6%

Total revenues from the Corporate segment, which primarily represents income from our corporate investments in the Deephaven Funds and other strategic investments, decreased 10.1% to $66.6 million, from $74.2 million in 2005. Included in 2006 is a pre-tax gain of $30.1 million related to the sale of the remaining portion of the Company s equity investment in the ISE. In 2005, the Company sold 70% of its original equity ownership of the ISE and its entire Nasdaq equity investment which resulted in pre-tax gains of $34.2 million and $21.7 million, respectively. Excluding these gains on our strategic investments, total revenues from the Corporate segment were $36.5 million in 2006, up 99.9% from $18.3 million in 2005. Income from our corporate investments in the Deephaven Funds rose 109.4% to $34.2 million in 2006 from $16.3 million in 2005. This increase was due to a higher average return on investment, offset in part by a lower average investment balance.

Transaction-based expenses

Execution and clearance fees increased 7.5% to $106.9 million in 2006, from $99.4 million in 2005. As a percentage of total revenue, Execution and clearance fees decreased to 11.2% in 2006, from 15.7% in 2005. Excluding gains on the sales of our strategic investments, Execution and clearance fees as a percentage of total revenue were 11.6% in 2006 and 17.2% in 2005. Execution and clearance fees fluctuate based on changes in transaction volumes, regulatory fees and efficiencies in processing the transactions.

Soft dollar and commission recapture expense increased 2.8% to $65.5 million in 2006, from $63.7 million in 2005, primarily due to the inclusion of a full year s results from Direct Trading in 2006, which was acquired in the middle of 2005.

Payments for order flow and ECN rebates increased to $42.2 million in 2006, from $21.2 million in 2005. As a percentage of total revenue, Payments for order flow and ECN rebates increased to 4.4% in 2006, from 3.3% in 2005. This expense increased primarily due to increased profitability-based rebates paid to broker-dealers and the full year inclusion of, and higher volumes within, the Direct Edge business which was acquired in October 2005.

Other direct expenses

Employee compensation and benefits expense increased 53.6% to $352.4 million in 2006, from $229.5 million in 2005. The increase was primarily due to stronger overall results, which led to higher profitability-based compensation, as well as additional compensation related to Direct Trading, Direct Edge, Hotspot and ValuBond. As a percentage of total revenue, Employee compensation and benefits increased slightly to 37.0% in 2006 from 36.2% in 2005. Excluding gains from the sales of our ISE and Nasdaq investments, Employee

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compensation and benefits as a percentage of total revenues decreased slightly to 38.3% in 2006 from 39.6% in 2005. The number of full time employees in our continuing operations increased to 844 employees at December 31, 2006, from 720 employees at December 31, 2005, primarily due to the acquisitions of Hotspot and ValuBond.

Communications and data processing expense increased 1.9% to $33.1 million in 2006, from $32.5 million in 2005, due to technology costs incurred relating to our new businesses within Global Markets segment in 2005 and 2006. Depreciation and amortization expense increased 26.2% to $20.6 million in 2006, from $16.4 million in 2005, due to the purchase or acquisition of fixed assets and the amortization of intangible assets in connection with our acquisitions. Occupancy and equipment rentals expense decreased slightly to $13.5 million in 2006, from $13.6 million in 2005.

Professional fees increased 5.2% to $20.6 million in 2006, from $19.6 million in 2005. The increase in 2006 was primarily due to increases in legal expenses, which fluctuate based on the activity relating to various legal and regulatory proceedings, and consulting expenses.

Business development expense increased to $14.3 million in 2006, compared to $6.4 million in 2005. The primary reason for the increase was higher expenses related to the corporate brand campaign, marketing and travel and entertainment costs.

Other expenses increased to $17.1 million in 2006, compared to $11.5 million in 2005. Other expenses in 2006 include a short swing profit settlement of approximately $2.8 million relating to trading by two Deephaven funds in the shares of a company while the funds owned in aggregate more than 10% of the outstanding shares of the stock of that company. Additionally, employee recruitment costs increased to $3.4 million in 2006, compared to $1.5 million in 2005.

During 2006, the Company incurred charges of $8.5 million in writedowns of assets and lease loss accruals primarily relating to costs associated with excess real estate capacity in Jersey City, N.J. During 2005, the Company incurred charges of $15.8 million, consisting of $10.1 million of writedowns of assets and lease loss accruals primarily related to the costs associated with excess real estate capacity in our Jersey City, N.J. facilities, and $5.7 million related to charges for regulatory and related matters.

Our effective tax rate for 2006 from continuing operations of 38% differed from the federal statutory rate of 35% primarily due to state income taxes and non-deductible charges.

Years Ended December 31, 2005 and 2004

Continuing Operations

Revenues

Asset Management

	For the years ended December 31, 2005	2004	Change	% of Change
Total Revenues from Asset Management (millions)	$ 89.8	$ 78.2	$ 11.6	14.9%
Average month-end balance of assets under management (millions)	$ 3,291.1	$ 2,963.5	$ 327.7	11.1%
Annual fund return to investors*	7.2%	6.5%	0.6%	9.6%

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

Total revenues from the Asset Management segment, which primarily consists of Asset management fees, increased 14.9% to $89.8 million in 2005, from $78.2 million in 2004. The increase is due to higher incentive fees as a result of an increase in fund returns as well as higher management fees due to the growth in the average

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month-end balance of assets under management. The average month-end balance of assets under management increased to $3.3 billion in 2005, from $3.0 billion in 2004. The blended annual fund return across all assets under management for 2005 was 7.2%, up from 6.5% in 2004.

Global Markets

	For the years ended December 31, 2005	2004	Change	% of Change
Commissions and fees (millions)	$ 296.2	$ 276.0	$ 20.2	7.3%
Net trading revenue (millions)	165.6	251.0	(85.4)	34.0%
Interest and dividends, net (millions)	6.6	3.8	2.8	74.1%
Investment income and other (millions)	2.2	0.2	2.0	1180.8%
Total Revenues from Global Markets (millions)	$ 470.7	$ 531.0	$ (60.3)	11.4%
U.S equity dollar value traded ($ billions)	1,882.2	1,730.7	151.5	8.8%
U.S. equity trades executed (millions)	204.1	205.9	(1.8)	0.9%
Nasdaq and Listed equity shares traded (billions)	106.3	125.5	(19.2)	15.3%
OTC Bulletin Board and Pink Sheet shares traded (billions)	718.8	1,349.6	(630.8)	46.7%
Average revenue capture per U.S. equity dollar value traded (bps)	1.8	2.5	(0.7)	28.2%

Total revenues from our Global Markets segment, which primarily comprises Commissions and fees and Net trading revenue from the domestic businesses, decreased 11.4% to $470.7 million in 2005, from $531.0 million in 2004. Revenues in 2005 were negatively impacted by lower revenue capture per U.S. equity dollar value traded, offset by new revenues from Direct Trading and Direct Edge, which were acquired in June 2005 and October 2005, respectively, and higher dollar volumes. Our revenue capture was impacted during 2005 by greater competition, regulatory changes and market conditions. Excluding the impact of Direct Trading and Direct Edge, total revenues from Global Markets would have decreased 16.2% to $444.9 million in 2005, from $531.0 million in 2004. In 2004, the Company recorded a reserve of $6.5 million against the amount the Company believes it is owed by a counterparty in a trading dispute (the Dispute Reserve). This reserve reduced net trading revenues by $6.5 million in 2004.

Average revenue capture per U.S. equity dollar value traded was 1.8 bps in 2005, down 28.2% from 2.5 bps in 2004. We removed the impact of the Dispute Reserve of $6.5 million from our revenue capture calculation for 2004. Core Equity Revenues were $330.4 million and $424.7 million in 2005 and 2004, respectively. As previously noted, Core Equity Revenues do not include revenues from KEMIL s European institutional business, Donaldson, Direct Trading and Direct Edge.

Corporate

	For the years ended December 31, 2005	2004	Change	% of Change
Total Revenues from Corporate (millions)	$ 74.2	$ 16.6	$ 57.5	346.4%
Average corporate investment balance in the Deephaven Funds (millions)	$ 272.6	$ 216.9	$ 55.7	25.7%

Total revenues from the Corporate segment, which primarily represents income from our corporate investments in the Deephaven Funds and other strategic investments, increased to $74.2 million. In 2005, the Company sold 70% of its original equity ownership of the ISE and its entire Nasdaq equity investment which resulted in pre-tax gains of $34.2 million and $21.7 million, respectively. Excluding these gains on our strategic

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investments, total revenues from the Corporate segment were $18.3 million in 2005, up 10% from 2004. Income from our corporate investments in the Deephaven Funds rose 28.0% to $16.3 million in 2005 from $12.8 million in 2004. This increase was due to a higher average investment balance and higher average returns on such investment.

Transaction-based expenses

Execution and clearance fees decreased 11.1% to $99.4 million in 2005, from $111.8 million in 2004. As a percentage of total revenue, execution and clearance fees decreased to 15.7% in 2005, from 17.9% in 2004. Execution and clearance fees were 17.2% of 2005 total revenues excluding gains on the sales of our strategic investments. Execution and clearance fees fluctuate based on changes in transaction volumes, regulatory fees and efficiencies in processing the transactions.

Soft dollar and commission recapture expense increased 5.9% to $63.7 million in 2005, from $60.1 million in 2004, primarily due to the addition of the Direct Trading business in the middle of 2005.

Payments for order flow and ECN rebates decreased 42.1% to $21.2 million in 2005, from $36.6 million in 2004. As a percentage of total revenue, Payments for order flow and ECN rebates decreased to 3.3% in 2005, from 5.9% in 2004. The decrease on a dollar basis is primarily due to changes in our payment for order flow policies initiated in the second quarter of 2005.

Other direct expenses

Employee compensation and benefits expense decreased 6.2% to $229.5 million in 2005, from $244.5 million in 2004. As a percentage of total revenue, employee compensation and benefits decreased to 36.2% in 2005 from 39.1% in 2004. Excluding gains from the sales of our ISE and Nasdaq investments, Employee compensation and benefits as a percentage of total revenues increased slightly to 39.6% in 2005 from 39.1% in 2004. The number of full time employees in our continuing operations increased to 720 employees at December 31, 2005, from 683 employees at December 31, 2004, primarily due to the acquisitions of Direct Trading and Direct Edge.

Communications and data processing expense increased 12.5% to $32.5 million in 2005, from $28.9 million in 2004. This increase was attributable to additional costs from Direct Trading and a general increase in technology and market data costs.

Depreciation and amortization expense increased 14.8% to $16.4 million in 2005, from $14.2 million in 2004. This increase was primarily due to purchases of fixed assets and leasehold improvements at our new facility at 545 Washington Boulevard, Jersey City, N.J., as well as depreciation and amortization related to Direct Trading and Direct Edge. Occupancy and equipment rentals expense decreased 19.6% to $13.6 million in 2005, from $16.9 million in 2004, primarily due to lease loss accruals related to our Jersey City, N.J. office locations.

Professional fees increased 31.1% to $19.6 million in 2005, from $14.9 million in 2004. The increase in 2005 was primarily due to an increase in legal expenses, which have fluctuated based on the activity relating to various legal and regulatory proceedings, and consulting expenses.

Business development expense decreased to $6.4 million in 2005, compared to $8.3 million in 2004. The primary reason for the decrease was lower travel and entertainment costs.

Other expenses increased to $11.5 million in 2005, compared to $6.8 million in 2004. Other expenses in 2004 included a benefit of approximately $3.0 million related to an adjustment to legal reserves established during 2003. Excluding the impact of this one-time adjustment in 2004, Other expenses increased 17% due to costs associated with the move of our corporate headquarters, as well as higher general and administrative costs.

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During 2005, the Company incurred charges of $15.8 million, consisting of $10.1 million of writedowns of assets and lease loss accruals primarily related to the costs associated with excess real estate capacity in our Jersey City, N.J. facilities, and $5.7 million related to charges for regulatory and related matters.

During 2004, the Company incurred charges of $83.2 million, consisting of $79.3 million related to charges for regulatory and related matters and $3.8 million of writedowns of assets and lease loss accruals primarily related to the costs associated with excess real estate capacity in Jersey City, N.J. For a discussion of the $79.3 million charge for regulatory and related matters, refer to Footnote 12 Regulatory Charges and Related Matters included in Part II, Item 8 Financial Statements and Supplementary Data of our 2005 Form 10-K.

Our effective tax rate for 2005 from continuing operations of 37% differed from the federal statutory rate of 35% primarily due to non-deductible penalties related to charges for regulatory and related matters and state income taxes.

Reconciliation of Total GAAP Expenses and Pre-Tax GAAP Income to Operating Expenses and Pre-Tax Operating Earnings, Respectively

In an effort to provide additional information regarding the Company s results as determined by GAAP, the Company also discloses certain non-GAAP information which management believes provides useful information to investors. Within this Form 10-K, the Company has disclosed its Operating Expenses and its Pre-Tax Operating Earnings to assist the reader in understanding the impact of Writedown of assets and lease loss accrual and Regulatory charges and related matters on the Company s annual results for 2006, 2005 and 2004 by segment, thereby facilitating more useful period-to-period comparisons of the Company s continuing businesses. For additional information related to segments, see Footnote 20 Business Segments included in Part II, Item 8 Financial Statements and Supplementary Data included in this document. Charts are presented in millions.

Total GAAP Expenses to Operating Expenses

	For the year ended December 31, 2006			
	Asset Mgmt	**Global Markets**	**Corporate**	**Total**
Transaction-based Expenses	$	$ 214.6	$	$ 214.6
Other Direct Expenses	140.0	304.8	35.3	480.1
Total GAAP Expenses	140.0	519.4	35.3	694.7
Writedown of assets and lease loss accrual		(8.5)		(8.5)
Operating Expenses	$ 140.0	$ 510.9	$ 35.3	$ 686.2

	For the year ended December 31, 2005			
	Asset Mgmt	**Global Markets**	**Corporate**	**Total**
Transaction-based Expenses	$	$ 184.3	$	$ 184.3
Other Direct Expenses	69.0	251.3	24.9	345.2
Total GAAP Expenses	69.0	435.6	24.9	529.5
Writedown of assets and lease loss accrual		(10.0)		(10.0)
Regulatory charges and related matters	(5.7)			(5.7)

Operating Expenses	$ 63.2	$ 425.6	$ 24.9	$ 513.7

	For the year ended December 31, 2004			
	Asset Mgmt	Global Markets	Corporate	Total
Transaction-based Expenses	$	$ 208.5	$	$ 208.5
Other Direct Expenses	48.6	335.7	33.5	417.7
Total GAAP Expenses	48.6	544.2	33.5	626.3
Writedown of assets and lease loss accrual		(3.8)		(3.8)
Regulatory charges and related matters		(79.3)		(79.3)
Operating Expenses	$ 48.6	$ 461.1	$ 33.5	$ 543.2

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Pre-Tax GAAP Income to Pre-Tax Operating Earnings

	For the year ended December 31, 2006			
	Asset Mgmt	Global Markets	Corporate	Total
Pre-Tax GAAP Income	$ 74.8	$ 150.3	$ 31.4	$ 256.5
Writedown of assets and lease loss accrual		8.5		8.5
Pre-Tax Operating Earnings	$ 74.8	$ 158.8	$ 31.4	$ 265.0

	For the year ended December 31, 2005			
	Asset Mgmt	Global Markets	Corporate	Total
Pre-Tax GAAP Income	$ 20.8	$ 35.1	$ 49.3	$ 105.2
Writedown of assets and lease loss accrual		10.0		10.0
Regulatory charges and related matters	5.7			5.7
Pre-Tax Operating Earnings	$ 26.5	$ 45.1	$ 49.3	$ 120.9

	For the year ended December 31, 2004			
	Asset Mgmt	Global Markets	Corporate	Total
Pre-Tax GAAP Income	$ 29.6	$ (13.2)	$ (16.9)	$ (0.5)
Writedown of assets and lease loss accrual		3.8		3.8
Regulatory charges and related matters		79.3		79.3
Pre-Tax Operating Earnings	$ 29.6	$ 69.9	$ (16.9)	$ 82.6

Liquidity and Capital Resources

Historically, we have financed our business primarily through cash generated by operations, as well as the proceeds from our stock issuances and, in 2004, from the proceeds of the sale of our Derivative Markets segment. As of December 31, 2006, we had $2.0 billion in assets related to our continuing operations, 70% of which consisted of cash or assets readily convertible into cash, principally receivables from brokers and dealers, asset management fees receivable and securities owned. Asset management fees receivable includes incentive and management fees earned for sponsoring and managing the Deephaven Funds. Receivables from brokers and dealers include interest bearing cash balances held with clearing brokers, including, or net of, amounts related to securities transactions that have not yet reached their contracted settlement date, which is generally within three business days of the trade date. Securities owned principally consist of equity securities that trade in Nasdaq, on the OTC Bulletin Board and on the NYSE and AMEX markets. At December 31, 2006, the Company had net current assets, which consists of net assets readily convertible into cash, of approximately $345.9 million. Our corporate investment in the Deephaven Funds was $187.6 million at December 31, 2006. The majority of this investment can be liquidated upon request to Deephaven subject to a ninety-day written notification period and monthly redemption limits.

The Company has previously disclosed its intent to pursue selective acquisitions of (or possible joint ventures with) complementary businesses primarily in the markets in which our Global Markets and Asset Management segments operate. We expect to fund the purchase price of any such acquisition with our current cash position or, in some cases, through the issuance of the Company s stock or debt.

In June 2005, the Company acquired, for cash, the business of Direct Trading Institutional, Inc. (now operating as Direct Trading). In October 2005, the Company acquired, for cash, the business of the ATTAIN ECN. This business currently operates under the name Direct Edge. In 2006, the Company paid $15.5 million relating to contingent payment obligations incurred in the acquisition of these two businesses. The acquisition of the business of Direct Trading contains an additional contingent payment due in the third quarter of 2007 based

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on the profitability of that business during the second year of operation post-acquisition and the acquisition of Direct Edge contains three additional annual contingent payments based on meeting certain revenue and client retention metrics. In April 2006, the Company acquired Hotspot for $77.5 million in cash. In October 2006, the Company acquired ValuBond for $18.2 million in cash. No assurance can be given with respect to the business effect of these transactions or the timing, likelihood or business effect of any other possible transactions.

As discussed elsewhere in this document, we sold our Derivative Markets business for approximately $237 million in cash in December 2004. The final purchase price was subject to adjustment based on the final determination of the book value of the Derivative Markets business at the time the deal closed. In 2005, the result of this adjustment and other expenses related to the sale resulted in a gain of $122,000, net of tax.

Income (loss) from continuing operations before income taxes was $256.5 million, $105.2 million and ($514,000) for 2006, 2005 and 2004, respectively. Included in these amounts were certain non-cash expenses such as depreciation and amortization and certain non-cash writedowns. Depreciation expense from continuing operations was $15.8 million, $14.6 million, and $13.6 million in 2006, 2005 and 2004, respectively. Amortization expense from continuing operations, which related to intangible assets, was $4.8 million, $1.8 million and $605,000 during 2006, 2005 and 2004, respectively. Non-cash writedowns from continuing operations were $200,000, $800,000 and $1.2 million during 2006, 2005 and 2004, respectively, primarily related to costs associated with fixed assets no longer actively being used and impaired strategic investments.

Capital expenditures related to our continuing operations were $13.0 million, $25.7 million and $40.2 million during 2006, 2005 and 2004, respectively. Purchases of strategic investments were $38.8 million, $3.7 million and $8.9 million and proceeds from sale of strategic investments were $33.1 million, $74.0 million and $0 during 2006, 2005 and 2004, respectively. Acquisitions of businesses, net of cash acquired, were $95.8 million, $45.1 million and $2.5 million during 2006, 2005 and 2004, respectively. Strategic investments and acquisition expenditures primarily relate to outside investments and acquisitions of businesses in support of the development and growth of our business. Our corporate investment in the Deephaven Funds decreased by $94.1 million during 2006, but increased by $66.3 million and $17.7 million during 2005 and 2004, respectively. The change in the balance of our corporate investment in the Deephaven Funds in 2006 primarily relates to net redemptions of $128.3 million offset in part, by positive returns on our investments of $34.2 million.

At its April 18, 2006 meeting, the Board of Directors authorized an increase in the size of the Company s stock repurchase program from $345 million to $495 million. The Company repurchased 4.1 million shares under the stock repurchase program during 2006 for $71.0 million. Through December 31, 2006, the Company had repurchased 41.7 million shares for $366.9 million under its stock repurchase program. The Company may repurchase shares in the open market or through privately negotiated transactions, depending on prevailing market conditions, alternative uses of capital and other factors. The Company cautions that there are no assurances that any further repurchases may actually occur. The Company had approximately 103.7 million shares of Class A Common Stock outstanding as of December 31, 2006.

Our U.S. registered broker-dealers are subject to regulatory requirements intended to ensure the general financial soundness and liquidity of broker-dealers and requiring the maintenance of minimum levels of net capital, as defined in SEC Rule 15c3-1. These regulations also prohibit a broker-dealer from repaying subordinated borrowings, paying cash dividends, making loans to its parent, affiliates or employees, or otherwise entering into transactions which would result in a reduction of its total net capital to less than 120% of its required minimum capital. Moreover, broker-dealers are required to notify the SEC and NASD prior to repaying subordinated borrowings, paying dividends and making loans to its parent, affiliates or employees, or otherwise entering into transactions, which, if executed, would result in a reduction of 30% or more of its excess net capital (net capital less minimum requirement). The SEC has the ability to prohibit or restrict such transactions if the result is detrimental to the financial integrity of the broker-dealer. Our foreign registered broker-dealers and our FCM are subject to capital adequacy requirements of their respective regulatory authorities. As of December 31,

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2006, all of our broker-dealers were in compliance with the regulatory rules. The following table sets forth the net capital levels and requirements for the following significant regulated broker-dealer subsidiaries at December 31, 2006, as filed in their respective regulatory filings (in millions):

Entity	Net Capital	Net Capital Requirement	Excess Net Capital
KEM	$ 80.4	$ 7.0	$ 73.4
KCM	51.4	1.0	50.4
KEMIL	22.1	8.0	14.1
Direct Trading	11.0	0.4	10.6

We have no long-term debt at December 31, 2006 nor do we have any material long-term debt commitments for 2007. We anticipate that available cash resources and credit facilities will be sufficient to meet our anticipated working capital and capital expenditure requirements for at least the next 12 months.

Contractual Obligations

In connection with its operating activities, the Company enters into certain contractual obligations. The Company s future cash payments associated with its contractual obligations pursuant to its operating leases and guaranteed employment contracts longer than one year as of December 31, 2006 are summarized below (in millions):

	Payments due in:				
	2007	2008-2009	2010-2011	Thereafter through October 31, 2021	Total
Operating lease obligations[1]	$ 11.3	$ 20.9	$ 20.0	$ 101.1	$ 153.3
Other obligations[1]	30.4	40.3			70.6
Total	$ 41.6	$ 61.2	$ 20.0	$ 101.1	$ 223.9

[1] - See Footnote 11 to the Consolidated Financial Statements

Off-Balance Sheet Arrangements

As of December 31, 2006, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

Effects of Inflation

Because the majority of the Company s assets are liquid in nature, they are not significantly affected by inflation. However, the rate of inflation may affect the Company s expenses, such as employee compensation, office leasing costs and communications expenses, which may not be readily recoverable in the prices of the services offered by the Company. To the extent inflation results in rising interest rates and has other adverse effects on the securities markets, it may adversely affect the Company s financial position and results of operations.

Discontinued Operations

As of the close of business on December 9, 2004, the Company sold substantially all of the assets and certain of the liabilities that comprised the Derivatives Markets business operated by Knight Financial Products LLC and Knight Execution Partners LLC to Citigroup for approximately $237.0 million in cash, subject to an adjustment based on the final determination of the book value of the Derivative Markets business at the time the deal closed. The result of this adjustment and other expenses related to the sale resulted in income of $122,000, net of tax, during 2005. The decision to sell the Derivative Markets segment was based on a review of

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the overall options industry, the capital and risk required to maintain this business successfully and the business role in the Company s long-term strategy. The net income included in our Income from discontinued operations, net of tax, on the Consolidated Statements of Operations, excluding the gain on the sale in 2004 of $80.0 million, was approximately $122,000 and $21.0 million for the years ended 2005 and 2004, respectively.

Critical Accounting Policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. We believe that, of our significant accounting policies, the following policies involve a higher degree of judgment.

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

The Company incurred $8.5 million of Writedown of assets and lease loss accruals in 2006. A loss of $8.0 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 2008, 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 rates for office space and the amount of available office space in Jersey City, N.J. to assess the reasonableness of our applicable assumptions.

Impairment of Goodwill and Intangible Assets The useful lives of intangible assets are determined upon acquisition. Intangible assets are amortized over their respective lives. Goodwill and the useful lives of intangible assets are tested for impairment, at a minimum, annually or when an event occurs or circumstances change that signifies the existence of impairment.

Goodwill of $133.0 million as of December 31, 2006 is all related to our Global Markets segment. Goodwill is primarily related to the purchases of our listed equities market-maker, KCM and the businesses now operating as Donaldson, Direct Trading, Direct Edge, Hotspot and ValuBond. We performed our annual test for impairment of goodwill in the second quarter of 2006 and determined that goodwill was not impaired during that time. As part of our test for impairment, we considered the profitability of the applicable reporting unit, an assessment of fair value of the reporting unit based on various valuation methodologies, as well as the overall market value of the Company, compared to the Company s book value. Furthermore, the Company believes there was no impairment of the goodwill balance at December 31, 2006.

Intangible assets, less accumulated amortization, of $63.7 million as of December 31, 2006 are all attributable to our Global Markets segment. Substantially all intangible assets resulted from the purchases of the businesses of Donaldson, which represents $10.2 million of the balance, Direct Trading, which represents $16.5 million of the balance, and Hotspot, which represents $33.3 million of the balance. These assets, which primarily consist of customer relationships, are being amortized on a straight-line basis over their useful lives, which have been determined to range from two to thirty years. We performed our annual test for impairment of intangible assets in the second quarter of 2006 and determined that intangible assets were not impaired during that time. Furthermore, the Company believes there was no impairment of these intangible assets at December 31, 2006.

Strategic Investments Strategic investments include non-controlling equity ownership interests in financial services-related businesses and are accounted for under the equity method at cost or at fair value. The equity

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

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

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

Market-Making Activities Securities owned and securities sold, not yet purchased, which primarily consist of listed and OTC stocks, are carried at market value and are recorded on a trade date basis. Market value is estimated daily using market quotations available from major securities exchanges and dealers.

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

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

Other Estimates The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions. In addition to the estimates that we make in connection with accounting for the items noted above, the use of estimates is also important in determining provisions for potential losses that may arise from litigation, regulatory proceedings and tax audits.

SFAS No. 123-R requires that we make certain estimates and assumptions relating to volatility and forfeiture rates when determining stock-based employee compensation expense. Volatility is estimated based on several factors including implied volatility of market-traded options on our common stock on the grant date and the historical volatility of the Company s common stock. Forfeiture rates are estimated based on historical rates of forfeiture of employee stock awards.

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A portion of our Employee compensation and benefits expense on the Consolidated Statements of Operations represents discretionary bonuses, which are accrued for throughout the year and paid after the end of the year. Among many factors, discretionary bonus accruals are generally influenced by the Company s overall performance and competitive industry compensation levels.

We estimate and accrue for potential losses that may arise out of litigation, regulatory proceedings and tax audits to the extent that such losses are probable and can be estimated in accordance with SFAS No. 5 *Accounting for Contingencies*. Significant judgment is required in making these estimates and our final liabilities may ultimately be materially different. Our total liability accrued with respect to litigation and regulatory proceedings is determined on a case-by-case basis and represents an estimate of probable losses based on, among other factors, the progress of each case, our experience with and industry experience with similar cases and the opinions and views of internal and external legal counsel. Given the inherent difficulty of predicting the outcome of our litigation and regulatory matters, particularly in cases or proceedings in which substantial or indeterminate damages or fines are sought, or where cases or proceedings are in the early stages, we cannot estimate losses or ranges of losses for cases or proceedings where there is only a reasonable possibility that a loss may be incurred. For more information on our legal and regulatory matters, see Legal Proceedings in Part I, Item 3 included in this document.

Recently Issued Accounting Standards

In July 2006, the FASB issued FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* (FIN 48), which clarifies the way companies account for uncertainty in income taxes. FIN 48 provides guidance related to a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, or expected to be taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of FIN 48 to have a material impact on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157 *Fair Value Measurements* (SFAS No. 157), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective for the Company beginning as of January 1, 2008. We are evaluating the potential impact of adopting SFAS No. 157.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108 *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements* (SAB 108), which provides guidance on quantifying and evaluating the materiality of unrecorded prior year misstatements. The SEC staff indicates that the Company should quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. Companies may choose to restate their financial statements for any material misstatements arising from the application of SAB 108 or recognize a cumulative effect adjustment within the current year opening balance in retained earnings, with disclosure of such items. SAB 108 is effective for fiscal years ending after November 15, 2006. SAB 108 did not have an impact on our consolidated financial statements as of December 31, 2006.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk***

Market Risk

Our market-making and trading activities expose our capital to significant risks. These risks include, but are not limited to, absolute and relative price movements, price volatility and changes in liquidity, over which we have virtually no control.

For working capital purposes, we invest in money market funds, commercial paper and government securities or maintain interest-bearing balances in our trading accounts with clearing brokers, which are classified as Cash and cash equivalents and Receivable from brokers and dealers, respectively, on the Consolidated

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Statements of Financial Condition. These other amounts do not have maturity dates or present a material market risk, as the balances are short-term in nature and subject to daily repricing. Our cash and cash equivalents held in foreign currencies are subject to the exposure of foreign currency fluctuations. These balances are monitored daily, and are not material to the Company s overall cash position.

In Global Markets, we employ proprietary position management and trading systems that provide real-time, on-line position management and inventory control. We monitor our risks by reviewing trading positions and their appropriate risk measures. We have established a system whereby transactions are monitored by senior management on a real-time basis as are individual and aggregate dollar and inventory position totals and real-time profits and losses. The management of trading positions is enhanced by review of mark-to-market valuations and position summaries on a daily basis.

In the normal course of our equities market-making business, we maintain inventories of exchange-listed and OTC equity securities. The fair value of these securities at December 31, 2006 and 2005 was $703.0 million and $372.0 million, respectively, in long positions and $693.1 million and $345.5 million, respectively, in short positions. The potential change in fair value, using a hypothetical 10% decline in prices, is estimated to be a $992,000 loss and a $2.7 million loss as of December 31, 2006 and 2005, respectively, due to the offset of gains in short positions with the losses in long positions. The following table illustrates, for the period indicated, our average, highest and lowest month-end inventory at market value (based on both the aggregate and the net of the long and short positions of trading securities from our OTC and listed market-making business) (in millions).

	2006		2005		2004	
	Aggregate of Long and Short Positions	Net of Long and Short Positions	Aggregate of Long and Short Positions	Net of Long and Short Positions	Aggregate of Long and Short Positions	Net of Long and Short Positions
Average month-end	$ 1,157.2	$ 30.5	$ 700.3	$ 32.6	$ 525.8	$ 27.9
Highest month-end	1,564.4	51.4	874.8	46.2	627.5	74.5
Lowest month-end	903.9	7.8	496.9	10.6	411.4	1.2

As of December 31, 2006, we had a $187.6 million corporate investment in the Deephaven Funds, $144.3 million of which was invested in the Market Neutral Fund. As of December 31, 2006, approximately 38% of the Deephaven Funds assets under management were in the Deephaven Market Neutral Fund. The investment philosophy for the Market Neutral Fund is to seek to produce returns for its investors using various investment strategies focusing on delivering attractive risk-adjusted rates of return. 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 investment strategies, including event-driven, volatility-driven, fundamental equity, credit-driven and global macro strategies among others. There is no material limitation on the types of investment strategies that may be employed by the Market Neutral Fund.

There will be unhedged asset factor risks (i.e. equity, credit, interest rate, foreign exchange) in the Market Neutral Fund. Deephaven also manages single-strategy funds that pursue investment strategies which involve substantial risks based on the fact that they are less diversified strategies and could be more vulnerable to structural economic and regulatory changes, or general market conditions. The less diversified nature 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.

Separately, Deephaven s business also involves specific categories of trading and operational risk. For example, although Deephaven may attempt 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

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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.

Deephaven monitors its trading risks by reviewing trading positions and their appropriate risk measures. We have established a system whereby transactions are monitored by management and an independent risk control function, as are individual and aggregate dollar and inventory position totals and profits and losses by strategy. The management of trading positions is enhanced by review of mark-to-market valuations and position summaries. There can be no assurances that any of the Deephaven Funds strategies will be successful in achieving either its risk control or its profit objectives.

Operational Risk

Operational risk can arise from many factors ranging from routine processing errors to potentially costly incidents arising, for example, from major systems failures. The Company incurs operational risk across all of its business activities, including revenue generating activities as well as support functions. Legal and compliance risk is included in the scope of operational risk and is discussed below under Legal Risk.

Primary responsibility for the management of operational risk lies with the business segments and supporting functions. The business segments maintain controls designed to manage and mitigate operational risk for existing activities. As new products and business activities are developed, operational risks are identified and controls are designed to mitigate the identified risks.

Disaster recovery plans are in place for critical facilities related to our primary operations and resources and redundancies are built into the systems as deemed appropriate. The Company has also established policies, procedures and technologies to protect its systems and other assets from unauthorized access.

Legal Risk

Legal risk includes the risk of non-compliance with applicable legal and regulatory requirements and standards. Legal risk also includes contractual and commercial risk such as the risk that a counterparty s performance obligations will be unenforceable. The Company is generally subject to extensive regulation in the different jurisdictions in which it conducts its business (see Government Regulation and Market Structure in Part I, Item 1). The Company has established procedures based on legal and regulatory requirements that are designed to foster compliance with applicable statutory and regulatory requirements. The Company also has established procedures that are designed to require that the Company s policies relating to conduct, ethics and business practices are followed.

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Consolidated Quarterly Results (unaudited)

The following table sets forth certain unaudited consolidated quarterly statement of operations data for 2006 and 2005. In the opinion of management, this unaudited information has been prepared on substantially the same basis as the consolidated financial statements appearing elsewhere in this document and includes all adjustments (consisting of normal recurring adjustments) necessary to present fairly the unaudited consolidated quarterly data. The unaudited consolidated quarterly data should be read in conjunction with the audited consolidated financial statements and notes thereto appearing elsewhere in this document. The results of any quarter are not necessarily indicative of results for any future period.

	Quarter Ended							
	Dec. 31, 2006	**Sept. 30, 2006**	**Jun. 30, 2006**	**Mar. 31, 2006**	**Dec. 31, 2005**	**Sept. 30, 2005**	**Jun. 30, 2005**	**Mar. 31, 2005**
	(in thousands, except per share amounts)							
Revenues								
Commissions and fees	$ 96,524	$ 95,740	$ 111,146	$ 101,905	$ 83,223	$ 74,860	$ 68,022	$ 70,116
Net trading revenue	52,657	42,846	68,220	80,039	48,792	52,349	27,051	37,422
Asset management fees	78,765	50,536	14,076	70,511	21,326	41,983	8,037	17,881
Interest and dividends, net	4,762	5,175	2,775	3,314	2,700	1,763	2,216	2,340
Investment income and other	27,417	15,711	8,404	20,687	45,255	13,141	6,347	9,799
Total revenues	260,125	210,008	204,621	276,456	201,297	184,097	111,673	137,557
Transaction-based expenses								
Execution and clearance fees	25,857	22,100	30,026	28,925	27,947	24,585	23,348	23,547
Soft dollar and commission recapture expense	13,964	16,431	17,355	17,708	17,634	15,903	14,650	15,485
Payments for order flow and ECN rebates	10,529	9,663	12,126	9,873	6,377	3,857	3,582	7,404
Total transaction-based expenses	50,350	48,194	59,507	56,506	51,958	44,344	41,580	46,435
Revenues, net of transaction-based expenses	209,775	161,814	145,114	219,950	149,338	139,752	70,093	91,121
Other direct expenses								
Employee compensation and benefits	105,635	82,546	64,616	99,556	56,140	68,268	48,194	56,857
Communications and data processing	8,594	8,484	8,404	7,638	8,578	7,969	8,151	7,814
Professional fees	5,356	3,737	5,092	6,383	5,167	6,056	4,550	3,776
Depreciation and amortization	5,462	5,446	5,325	4,408	4,109	4,209	3,734	4,302
Occupancy and equipment rentals	3,621	3,164	3,398	3,353	3,368	3,239	2,830	4,123
Business development	5,715	3,371	3,134	2,122	1,801	1,616	1,708	1,293
Writedown of assets and lease loss accrual			482	7,997		5,509	4,546	
Regulatory charges and related matters					3,703		2,000	
Other	3,832	2,925	3,897	6,449	2,677	2,785	3,426	2,654
Total other direct expenses	138,215	109,673	94,348	137,906	85,543	99,652	79,139	80,820
Income (loss) from continuing operations before income taxes	71,560	52,141	50,766	82,044	63,795	40,100	(9,045)	10,301
Income tax expense (benefit)	24,146	20,681	20,426	32,912	21,924	16,137	(3,430)	4,281
Net income (loss) from continuing operations	47,414	31,460	30,340	49,132	41,871	23,964	(5,616)	6,020
Income (loss) from discontinued operations, net of tax						388		(266)

Net income (loss)	$	47,414	$	31,460	$	30,340	$	49,132	$	41,871	$	24,352	$	(5,616)	$	5,754
Diluted earnings per share from continuing operations	$	0.45	$	0.30	$	0.29	$	0.47	$	0.41	$	0.23	$	(0.05)	$	0.05
Diluted earnings per share from discontinued operations	$		$		$		$		$		$		$		$	
Diluted earnings per share	$	0.45	$	0.30	$	0.29	$	0.47	$	0.41	$	0.23	$	(0.05)	$	0.05

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Item 8. ***Financial Statements and Supplementary Data***

KNIGHT CAPITAL GROUP, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Knight Capital Group Inc. s (Knight) management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended, as a process designed by, or under the supervision of, the company s principal executive and principal financial officers and effected by the company s board of directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of Knight;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of Knight; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of Knight s internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control-Integrated Framework*.

Based on our assessment, Knight s management has concluded that, as of December 31, 2006, internal control over financial reporting is effective.

Knight management s assessment of the effectiveness of the Company s internal control over financial reporting as of December 31, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Knight Capital Group, Inc.

We have completed integrated audits of Knight Capital Group, Inc. s consolidated financial statements and of its internal control over financial reporting as of December 31, 2006, in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Knight Capital Group, Inc. and its subsidiaries (the Company) at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 17 to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation in 2006.

Internal control over financial reporting

Also, in our opinion, management s assessment, included in Management s Report on Internal Control Over Financial Reporting appearing within this section, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the COSO. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting

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includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

New York, New York

February 28, 2007

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KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	December 31, 2006	December 31, 2005
Assets		
Cash and cash equivalents	$ 214,759,915	$ 230,591,067
Securities owned, held at clearing brokers, at market value	711,774,643	380,366,778
Receivable from brokers and dealers	372,897,376	229,828,734
Asset management fees receivable	112,204,064	46,464,072
Investment in Deephaven sponsored funds	187,573,291	281,656,753
Fixed assets and leasehold improvements, at cost, less accumulated depreciation and amortization of $98,903,086 in 2006 and $99,757,958 in 2005	66,449,617	67,656,533
Strategic investments	49,436,605	31,896,425
Goodwill	133,042,889	47,682,880
Intangible assets, less accumulated amortization of $7,247,009 in 2006 and $2,434,573 in 2005	63,701,006	29,773,442
Other assets	116,374,310	70,099,660
Total assets	$ 2,028,213,716	$ 1,416,016,344
Liabilities and Stockholders Equity		
Liabilities		
Securities sold, not yet purchased, at market value	$ 693,071,230	$ 345,457,499
Payable to brokers and dealers	47,852,721	35,102,415
Accrued compensation expense	227,846,699	117,763,834
Accrued expenses and other liabilities	96,956,122	94,244,447
Total liabilities	1,065,726,772	592,568,195
Commitments and contingent liabilities (Notes 11 and 18)		
Stockholders equity		
Class A Common Stock, $0.01 par value; Shares authorized: 500,000,000 at December 31, 2006 and 2005; Shares issued: 144,958,749 at December 31, 2006 and 139,745,722 at December 31, 2005; Shares outstanding: 103,660,303 at December 31, 2006 and 102,966,359 at December 31, 2005	1,449,588	1,397,457
Additional paid-in capital	519,790,132	452,839,356
Retained earnings	811,859,325	653,513,691
Treasury stock, at cost; 41,298,446 shares in 2006 and 36,779,363 shares in 2005	(370,612,101)	(294,652,742)
Accumulated other comprehensive income, net of tax		10,350,387
Total stockholders equity	962,486,944	823,448,149
Total liabilities and stockholders equity	$ 2,028,213,716	$ 1,416,016,344

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

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KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	For the years ended December 31, 2006	2005	2004
Revenues			
Commissions and fees	$ 405,314,624	$ 296,221,767	$ 276,010,852
Net trading revenue	243,761,406	165,614,332	250,992,997
Asset management fees	213,887,518	89,226,578	77,658,193
Interest and dividends, net	16,027,113	9,019,081	4,647,059
Investment income and other	72,218,950	74,541,327	16,441,253
Total revenues	951,209,611	634,623,085	625,750,354
Transaction-based expenses			
Execution and clearance fees	106,908,040	99,426,667	111,787,940
Soft dollar and commission recapture expense	65,458,057	63,670,978	60,117,556
Payments for order flow and ECN rebates	42,191,360	21,220,284	36,632,317
Total transaction-based expenses	214,557,457	184,317,929	208,537,813
Revenues, net of transaction-based expenses	736,652,154	450,305,156	417,212,541
Other direct expenses			
Employee compensation and benefits	352,353,058	229,459,520	244,549,546
Communications and data processing	33,119,478	32,512,930	28,896,451
Depreciation and amortization	20,641,106	16,354,746	14,247,699
Professional fees	20,568,212	19,554,523	14,914,772
Business development	14,342,728	6,418,984	8,268,973
Occupancy and equipment rentals	13,535,902	13,553,631	16,852,358
Writedown of assets and lease loss accrual	8,479,703	10,055,252	3,810,453
Regulatory charges and related matters		5,703,428	79,341,732
Other	17,101,352	11,540,764	6,844,285
Total other direct expenses	480,141,539	345,153,778	417,726,269
Income (loss) from continuing operations before income taxes	256,510,615	105,151,378	(513,728)
Income tax expense	98,164,981	38,912,480	9,258,157
Net income (loss) from continuing operations	158,345,634	66,238,898	(9,771,885)
Income from discontinued operations, net of tax		122,007	100,903,791
Net income	$ 158,345,634	$ 66,360,905	$ 91,131,906
Basic earnings per share from continuing operations	$ 1.56	$ 0.64	$ (0.09)
Diluted earnings per share from continuing operations	$ 1.49	$ 0.62	$ (0.08)
Basic earnings per share from discontinued operations	$	$	$ 0.90

Diluted earnings per share from discontinued operations	$	$	$ 0.86
Basic earnings per share	$ 1.56	$ 0.64	$ 0.81
Diluted earnings per share	$ 1.49	$ 0.62	$ 0.77
Shares used in computation of basic earnings per share	101,420,428	103,455,791	112,423,158
Shares used in computation of diluted earnings per share	106,242,653	106,881,855	117,636,085

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

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KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

For the Years Ended December 31, 2004, 2005 and 2006

	Class A Common Stock		Treasury Stock					
	Shares	Amount	Shares	Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, January 1, 2004	128,187,060	$ 1,281,871	(13,076,505)	$ (68,795,258)	$ 358,588,409	$ 496,020,880	$	$ 787,095,902
Net income						91,131,906		91,131,906
Common stock repurchased			(7,593,817)	(78,841,155)				(78,841,155)
Stock options exercised	4,527,202	45,272			27,163,276			