KNIGHT TRADING GROUP INC
Form 10-K
March 15, 2005
Table of Contents

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, 2004**

OR

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

001-14223

Commission File Number

KNIGHT TRADING GROUP, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or organization)

22-3689303

(I.R.S. Employer Identification Number)

525 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 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. x

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2) Yes x No ¨

The aggregate market value of the Class A Common Stock held by nonaffiliates of the Registrant was approximately $1,078.5 million at June 30, 2004 (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 14, 2005 the number of shares outstanding of the Registrant s Class A Common Stock was 109,656,303 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 2004 Annual Meeting of Stockholders to be filed hereafter (incorporated, in part, into Part III hereof).

Table of Contents

KNIGHT TRADING GROUP, INC.

FORM 10-K ANNUAL REPORT

For the Fiscal Year Ended December 31, 2004

TABLE OF CONTENTS

PART I		
Item 1.	**Business**	**4**
Item 2.	**Properties**	**20**
Item 3.	**Legal Proceedings**	**20**
Item 4.	**Submission of Matters to a Vote of Security Holders**	**23**
PART II		
Item 5.	**Market for Registrant s Common Equity and Related Stockholder Matters**	**24**
Item 6.	**Selected Financial Data**	**25**
Item 7.	**Management s Discussion and Analysis of Financial Condition and Results of Operations**	**27**
Item 7A.	**Quantitative and Qualitative Disclosures About Market Risk**	**43**
Item 8.	**Financial Statements and Supplementary Data**	**46**
Item 9.	**Changes in and Disagreements With Accountants on Accounting and Financial Disclosures**	**74**
Item 9A.	**Controls and Procedures**	**74**
PART III		
Item 10.	**Directors and Executive Officers of the Registrant**	**74**
Item 11.	**Executive Compensation**	**74**
Item 12.	**Security Ownership of Certain Beneficial Owners and Management**	**74**
Item 13.	**Certain Relationships and Related Transactions**	**74**
Item 14.	**Principal Accounting Fees and Services**	**74**
PART IV		
Item 15.	**Exhibits and Financial Statement Schedules**	**74**
Signatures		**78**
Certifications		
Exhibit Index		

Table of Contents

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. 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 Risks Affecting our Business in Part I, Item 1 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.

Table of Contents

PART I

Item 1. *Business*

Overview

Knight Trading Group, Inc., a Delaware corporation, and its subsidiaries (collectively Knight or the Company) 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, L.L.C., which was organized in March 1995. In May 2000, the Company changed its name from Knight/Trimark Group, Inc. to Knight Trading Group, Inc. Our corporate headquarters are currently located at 525 Washington Boulevard, Jersey City, New Jersey 07310. Effective March 31, 2005, our corporate headquarters will be relocated to 545 Washington Boulevard, Jersey City, New Jersey 07310. Our telephone number is (201) 222-9400.

Financial information concerning our business segments for each of 2004, 2003 and 2002, 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 amendment to such Code and any waiver 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. The information on our corporate web site is not 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 Trading Group, Inc.

Corporate Communication 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 Trading Group, Inc. and its subsidiaries.

Business Segments

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

Asset Management We operate an asset management business for institutions and high-net-worth individuals. Assets under management were $3.6 billion as of December 31, 2004, up $2.0 billion from the $1.6 billion of assets under management as of December 31, 2003.

4

Table of Contents

Equity Markets We are a leading execution specialist providing comprehensive trade execution services to institutional and broker-dealer clients, offering capital commitment and access to a deep pool of liquidity across the depth and breadth of the U.S. equity markets.

In the third quarter of 2004, the Company entered into an agreement to sell one of its business segments, Derivative Markets, to Citigroup Financial Products Inc. (Citigroup). This transaction closed as of the close of business on December 9, 2004. In accordance with generally accepted accounting principles (GAAP), the results of this business 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 10 Discontinued Operations included in Part II, Item 8 Financial Statements and Supplementary Data of this document.

Effective in the fourth quarter of 2004, the Company instituted a new segment reporting format to remove from its operating business segments all corporate overhead expenses and investment income earned on strategic investments and our corporate investment in the funds managed by our Asset Management segment (the Deephaven Funds). These results are now reported in a separate Corporate segment. Prior to this change, corporate overhead expenses and investment income earned on our strategic investments were allocated to the operating business segments based upon the Company s allocation methodologies, generally based on each segment s respective usage or other appropriate measure. Additionally, prior to the change, investment income earned on our corporate investment in the Deephaven Funds was fully allocated to the Asset Management segment. This change to segment reporting was made in order to better reflect management s approach to operating and directing the businesses after the sale of the Derivative Markets business segment. Prior period segment data has been restated to conform to the 2004 presentation. Included in the total assets of the Corporate segment is the Company s corporate investment in the Deephaven Funds which was $215.3 million at December 31, 2004, as compared to $197.6 million at December 31, 2003.

The following table sets forth the revenues, expenses excluding regulatory charges and related matters, writedown of assets and lease loss accrual and international charges (Operating Expenses) and income (loss) from continuing operations before regulatory charges and related matters, writedown of assets and lease loss accrual, international charges, income taxes and minority interest (Pre-Tax Operating Earnings) of our business segments and on a consolidated basis (in millions):

	2004	2003	2002
Equity Markets			
Revenues	$ 531.7	$ 459.6	$ 348.8
Operating Expenses	461.3	387.1	355.2
Pre-Tax Operating Earnings	70.4	72.5	(6.4)
Asset Management			
Revenues	78.2	58.4	38.8
Operating Expenses	48.6	28.9	22.8
Pre-Tax Operating Earnings	29.6	29.5	16.0
Corporate			
Revenues	16.6	28.5	13.3
Operating Expenses	33.5	29.7	39.8
Pre-Tax Operating Earnings	(16.9)	(1.2)	(26.5)
Consolidated(1)			
Revenues	625.8	545.9	398.0

Operating Expenses	542.7	445.1	414.9
Pre-Tax Operating Earnings	$ 83.1	$ 100.8	$ (16.9)

Table of Contents

(1) Consolidated Revenues and Operating Expenses include the elimination of intercompany transactions between Equity Markets and Asset Management of $702,000, $657,000 and $2.9 million for 2004, 2003 and 2002, respectively.

A reconciliation of the (loss) income from continuing operations before income taxes, in accordance with GAAP, (Pre-Tax GAAP Income) to Pre-Tax Operating Earnings from continuing operations 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 hedge funds (the Deephaven Funds). Generally, hedge funds are defined as unregulated investment pools that may invest in any asset class, including derivatives, and use long and short positions, as well as leverage in order to generate returns for investors. A distinguishing feature of hedge funds is their use of long or short positions to offset market risks and isolate arbitrage opportunities.

Below is a summary of our assets under management at December 31, 2004, 2003 and 2002, respectively and our blended fund returns for the years then ended:

	2004	2003	2002
Year-end Assets Under Management (billions)	$ 3.6	$ 1.6	$ 1.2
Annual fund return to investors*	6.5%	13.9%	7.8%

* 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, consisting 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 returns.

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

Clients and Product Offerings

In Asset Management, our clients include institutions, funds-of-funds, pension plan sponsors, trusts, endowments and high-net-worth individuals. We differentiate ourselves based on our reputation, client relationships, experience and stability of the management team, investment strategies, leverage, risk profile, fee structures and historical fund returns. Included within Deephaven s $3.6 billion of assets under management as of December 31, 2004 is a corporate investment of approximately $215 million held by the Company and approximately $25 million of investments held by employee deferred compensation plans and certain officers, directors and employees of the Company. On January 1, 2005, the Company invested an additional $100 million in the Deephaven Funds. As of December 31, 2004, one institutional investor accounted for more than 10% of the Deephaven Funds assets under management, accounting for 13.2% of such assets.

Currently, the majority 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 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 capture mispricings or spreads between related capital instruments. Because the primary basis of the Market Neutral Fund s 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 expected 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. Within the Market Neutral Fund, Deephaven employs a variety of market neutral investment strategies, including convertible arbitrage, event arbitrage, relative value equity and distressed debt. As of the end of 2004, the majority of the assets within the Market Neutral Fund were invested within global convertible arbitrage (approximately 36%), relative value equity (approximately 30%), global event arbitrage (approximately 17%) and distressed debt and credit arbitrage (approximately 17%) strategies. As of December 31, 2004, the Market Neutral Fund had approximately $3.1 billion in assets under management.

In the first quarter of 2004, Deephaven launched a new single-strategy fund, the Deephaven Long/Short Equity Fund (Long/Short Fund). The Long/Short Fund s objective is to generate superior risk-adjusted rates of return by investing, both long and short, in equity securities of companies located around the world operating in a wide range of industries. By employing fundamental analysis using quantitative and qualitative factors, the Long/Short Fund s strategy is designed to identify those stocks which are likely to increase or decrease in price over the near to medium-term. As of December 31, 2004, the Long/Short Fund had approximately $110 million in assets under management.

In the second quarter of 2004, Deephaven launched another new single-strategy fund, the Deephaven Event Arbitrage Fund (Event Arb Fund). The investment strategy of the Event Arb Fund is risk or merger arbitrage. It invests in situations involving mergers, tender offers, exchange offers and other transactions in which one company is attempting to acquire another. The Event Arb Fund will also invest in situations in which a single company is undertaking a major reorganization, liquidation or spin-off. The arbitrage aspects of the strategy involve an assessment of the likelihood that the transaction will, in fact, 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, 2004, the Event Arb Fund held approximately $330 million in assets under management.

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 expects to launch another new fund, the Deephaven Credit Opportunities Fund in 2005. 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, long/short equity and event arbitrage portfolios. As Deephaven launches new single strategy funds, such as the Deephaven Credit Opportunities Fund, 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.

Table of Contents

There is a growing 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
2003	6,297	820,009
2004	7,436	972,608

Source: Hedge Fund Research, Inc. 2004 Industry Report

Asset Management Technology

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 has fully operational business continuity operations in place in St. Paul, Minnesota.

Equity Markets Segment

Business Segment Overview

Domestic Equity Markets Operations

We are a leading execution specialist providing comprehensive trade execution services to institutional and broker-dealer clients, offering capital commitment and access to a deep pool of liquidity across the depth and breadth of the U.S. equity markets. 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 Equity Markets revenues and profitability come from our equity trading and market-making 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, 2004 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, 2004, we were ranked number one for OTC Bulletin Board share volume and number seven in share volume in listed securities on the NYSE and AMEX.

Our domestic Equity Markets activities are primarily transacted out of two subsidiaries, Knight Equity Markets, L.P. (KEM ; formerly Knight Securities, L.P.) and Knight Capital Markets LLC (KCM). Both KEM and KCM are broker-dealers registered with the SEC and are members of the National Association of Securities Dealers (the NASD).

Table of Contents

International Equity Markets Operations

Our international Equity Markets activities are primarily operated through Knight Equity Markets International Limited (KEMIL ; formerly Knight Securities International Ltd.), a U.K. registered broker-dealer that provides execution services for European institutional and broker-dealer clients in U.S. and European equities. Our goal is to continue to expand our institutional business and product offerings in Europe in 2005.

In 2003, we ceased operations of Knight Securities Japan (KSJ), our Japanese market-making venture with Nikko Cordial Group. For additional discussion related to KSJ, see the section entitled Discontinued Operations, set forth in Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 herein.

Clients and Product Offerings

Within Equity Markets, we offer products and provide services to two main client groups: broker-dealers and institutions. Our marketing strategy for our Equity Markets segment is to continue to differentiate ourselves from competitors by providing high quality and competitive trade execution services with superior client service. Based on our internal allocation methodologies, our broker-dealer clients and institutional clients (which include our soft dollar and commission recapture clients) each generated approximately half of our Equity Markets revenues in 2004.

Broker-Dealer Clients

Our broker-dealer clients primarily include global, national and regional broker-dealers and on-line brokers. The majority of our equity order flow comes from providing market-making and execution services to our broker-dealer clients. We seek to provide broker-dealers with quality and competitive trade executions that enable them to satisfy their fiduciary duties to their customers to seek and obtain the best execution reasonably available in the marketplace. 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. We make payments to certain broker-dealers in return for them routing order flow to us. We have adjusted our payment for order flow rates several times over the past three years to better reflect the value of our liquidity.

In 2004, our largest broker-dealer client accounted for approximately 11.8% of the Company s U.S. equity dollar value traded. No other client accounted for over 10% of our U.S. equity dollar value traded.

Institutional Clients

Our institutional clients primarily include mutual funds, pension plans, plan sponsors, hedge funds, trusts and endowments. We seek to provide institutions with high quality and competitive trade executions, superior client service and a wide range of product offerings. Over the past three years, we have worked to aggressively expand our institutional business and offerings. As a result, we hired additional senior sales traders, opened regional offices in San Francisco and Chicago in 2003 and expanded our Jersey City, London and Boston offices in 2004. At the end of 2004, we employed 78 institutional sales professionals, up from 65 at the end of 2003.

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 that of other sources. When liquidity is not naturally present in the market, we often commit our own capital to complete our clients trades. Our institutional product offerings include trade execution services, listed block trading, program trading, international equities, special situations / risk arbitrage, soft dollar and commission recapture programs and corporate services. The majority of our revenues from institutional clients are commissions on agency transactions or commission-equivalents on riskless principal transactions.

Table of Contents

In an effort to strengthen our product offerings to our institutional clients, on December 1, 2003, we acquired the business of Donaldson & Co., Incorporated (Donaldson), an Atlanta-based firm that offers soft dollar and commission recapture programs to institutions. We earn agency commissions for providing soft dollar and commission recapture services.

Equity Markets Competition

Equity trading and market-making 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 electronic communications networks (commonly referred to 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 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 offerings 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 reductions in 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 now voluntarily display certain eligible limit orders in OTC Bulletin Board securities which could have a material impact on our profitability in these securities. 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 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 requirement 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 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 equity research, execution quality, reputation, soft dollar and commission recapture services, technology, client relationships, and service and capital commitment. Based on industry surveys, over 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. We have not, and do not, provide research services. With our acquisition of the business of Donaldson, we strengthened the soft dollar and commission recapture

services we provide to our clients. 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.

Equity Markets Technology

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 2005. 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, we have automated a portion of our execution services through our internally developed quantitative models. We plan to increase 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 effectively 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 Equity 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.

Within Equity Markets, we use a customized version of the BRASS® trading system originally built by SunGard Trading Systems for OTC equities. For listed equities, we use a customized version of the Appletree trading system originally built by TCAM Systems, Inc. We also use an internally developed integrated institutional sales technology platform, which consists of an order management system for the entry, management and routing of institutional orders, a system for the simultaneous distribution of indications of interest and trade advertisements to various sources, and a rules-based trade allocation matching engine to receive allocation instructions from clients and automate post-trade processing.

Alternative trading facilities are in place for our domestic Equity Markets operations in Westchester County, New York. 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

Overview

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.

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 applicable 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 and KCM, are subject to regulations concerning all aspects of their business, including trade practices, best execution practices, capital structure, record retention and the conduct of its 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 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, which resulted in the payment of fines and settlements. 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.

Significant legislation, rule-making and market structure changes have occurred over the last few years that have had an impact on the Company and its business segments. The introduction of decimalization, combined with the one-penny minimum price spread, has caused a dramatic reduction in average spreads, which in turn has had a profound effect on our Equity Markets profitability. Subsequent rule-making by the SEC and NASD, and corresponding market structure changes, have had similar effects on the Company and its business segments. In addition, legislation such as the USA Patriot Act of 2001 imposed significant new obligations on broker-dealers and mutual funds to detect and deter money laundering and terrorist financing activity, including standards for verifying client identification at account opening, and obligations to monitor client transactions and report suspicious activities. The increased obligations of financial institutions to identify their customers, watch for and report suspicious transactions, respond to requests for information by regulatory authorities and law enforcement agencies, and share information with other financial institutions, requires 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 Equity 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, the SEC recently re-proposed 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 will 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. Depending on the final outcome, it is possible that Regulation NMS, and its associated rules, could negatively impact our Equity Markets business.

We have London-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.

Table of Contents

Our asset management subsidiary, Deephaven, is a private asset management company that is not registered as an investment adviser and, as such, is subject to limited regulatory oversight by the SEC. Although Deephaven is not registered as an investment adviser, it is subject to the anti-fraud provisions of the Investment Advisers Act of 1940, including Section 206(3). Deephaven is 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.

The SEC has enacted new rules that require most hedge funds, including Deephaven, to register as investment advisors by February 1, 2006. This will result in additional responsibilities and obligations on Deephaven s business.

The Company believes that it is 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 in London are subject to capital adequacy requirements of the Financial Services Authority in the United Kingdom.

During 2004, we were in compliance with our 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, 2004, our headcount was 683 full-time employees, compared to 933 full-time employees at December 31, 2003. The reduction in headcount primarily related to the sale of our Derivative Markets business to Citigroup in 2004. Of our 683 full-time employees at December 31, 2004, 624 were employed in the U.S. and 59 in the United Kingdom. None of our employees are subject to a collective bargaining agreement. We believe that our relations with our employees are good.

Risks Affecting Our Business

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; and changes in currency 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 Equity 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 business, 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 its 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 Financial Services Authority (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 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.

Over the last two years, various regulatory and enforcement agencies have been reviewing regulatory reporting obligations and best execution, trading and soft dollar practices as they relate to the brokerage industry. These reviews could result in enforcement actions or new regulations which could adversely affect our operations.

In addition, the SEC, NASD and SROs are constantly proposing, or enacting, new regulations for the marketplace. For example, the SEC recently re-proposed 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 will 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. Depending on the final outcome, it is possible that Regulation NMS, and its associated rules, could negatively impact our Equity 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 by the U.S. Congress, as well as certain U.S. regulatory entities and the governing bodies of non-U.S. jurisdictions. It is impossible to predict what, if any, changes in regulation applicable to the

Deephaven Funds, its investment advisor, the markets in which they trade and invest or the counterparties with which they do business may be instituted in the future. Any such regulation could negatively impact the profit potential of our Asset Management business.

Table of Contents

As a result, regulatory actions, 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 May 2005, 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 and 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 market-making and trading and our asset management business

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 skill of our trading personnel, general market conditions, the amount of, and volatility in, our quantitative market making and program trading portfolios, 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.

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, this increases the risk of loss and the volatility of the underlying Deephaven Funds portfolios. There can be no assurance that we will be able

Table of Contents

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 market-making 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 clients; the performance of our international operations; our ability to manage personnel, overhead and other expenses, including our occupancy expenses under our office leases and legal fees relating to legal and regulatory proceedings; the strength of our client relationships; the amount of, and volatility in, our quantitative market making and program trading portfolios; changes in payments for order flow and clearing costs; the level of assets under management; the income earned on assets under management; 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; 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 Equity 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.

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. The current majority of the Deephaven Funds assets under management are within the Market Neutral Fund which employs market neutral investment strategies focusing on the preservation of capital. The general objective of market neutral investment strategies is 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 expected 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-strategies have 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.

Investors in our asset management business may generally redeem their investments in the Deephaven Funds 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 and the loss of accounts. Such redemptions could have a material adverse effect on the value of our investment in the Deephaven Funds and our results of operations.

Table of Contents

At December 31, 2004, the Company held a corporate investment of approximately $215 million in the Deephaven Funds. Additionally, on January 1, 2005, the Company invested an additional $100 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.

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

We derive substantially all of our revenues from trading and market-making 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 Equity Markets business primarily from global, national and regional broker-dealers, and also alternative trading systems, including 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 Equity 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 the Deephaven Funds. 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 the majority 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 such mispricings as 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 such strategies than they were in previous years. The profit potential of the Deephaven Funds may be materially reduced as a result of the saturation of the alternative investment field.

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.

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

At times, a limited number of Equity 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 Equity Markets trading and market-making services to remain concentrated within a limited number of clients. None of our clients are 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 2004, one client accounted for 11.8% of our total U.S. equity dollar value traded in our Equity Markets segment. Our Asset Management segment also has a limited number of investors. At December 31, 2004, there was one institution that accounted for 13.2% 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.

17

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 and other 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, which have resulted in the payment of fines and settlements. 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, 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

We intend to pursue in the future 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 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 Equity 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 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 also 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 trading and market-making activities and the credit risks associated with our clearing brokers

The majority of our revenues are derived from trading and market-making activities in our Equity 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 Equity 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 market-making and asset management 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 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 currently have business continuity operations in place for our Asset Management business and for the majority of our Equity Markets business. 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.

Table of Contents

We may not be successful in moving our corporate headquarters

We lease approximately 266,000 square feet at our 545 Washington Boulevard location in Jersey City, NJ, which is largely unoccupied. We have commenced moving portions of our business and personnel to this space and expect to complete the move of our business and personnel by the end of 2005. This move will involve a number of risks. If we are unsuccessful in transferring our technology and operational infrastructure over to this new location in a smooth and stable manner, we could incur business delays or disruptions. In addition, issues related to the move will result in our management having to spend additional time and resources, taking them away from the day-to-day management of the business. Lastly, the cost of the move is estimated to be over $45 million, a majority of which has already been paid. If the construction and build-out are not completed in a timely manner or if plans are changed or delays occur, we could incur additional costs above the budgeted amount. If any of the above factors were to occur, it could result in a material adverse effect on the Company s 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 2. *Properties*

Our corporate headquarters are located in Jersey City, New Jersey. We lease approximately 118,000 square feet at 525 Washington Boulevard under a lease that expires in March 2006, and we have an option to extend the lease term for an additional five-year period. We also lease approximately 266,000 square feet at 545 Washington Boulevard under a lease that expires in October 2021, which is largely unoccupied. We intend to complete the move of our business and personnel into our new facility at 545 Washington Boulevard by the end of 2005. 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; San Francisco, CA; Santa Clara, CA; and London, England.

During 2004, we reserved $2.6 million in lease loss accruals related to excess real estate capacity at our 545 Washington Boulevard location in Jersey City, NJ. The Company engaged a real estate broker in order to sub-lease approximately 78,000 square feet based on an assessment of our real estate needs. This accrual was derived from assumptions and estimates based on lease terms of an anticipated sub-lease agreement, which assumed a sub-lease would have commenced in the middle of 2005, anticipated market prices along the Jersey City waterfront and estimated up-front costs including broker fees and build-out allowances.

We believe that our present facilities, together with our current options to extend lease terms and occupy additional space, exceed our needs. We are actively reviewing our real estate needs and may in the future sublet, assign or return some of our space.

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

KEM Arbitration: As disclosed in the Company s Form 8-K filing on September 23, 2004, KEM was notified on September 22, 2004 by NASD Dispute Resolution, Inc. of a favorable decision with respect to the arbitration claims filed on December 27, 2001, by a former employee against Knight Securities, L.P. (KSLP), now known as KEM. All claims and counterclaims in the arbitration were dismissed, except that the NASD arbitration panel awarded the former employee the amount of $19,101 (without interest) relating to the calculation of his override bonus payment for the year 2000. We have not received a challenge to the arbitration panel decision and, therefore, this matter has been concluded.

Short Selling Litigation: As disclosed in the Company s prior public filings in or around June 2002, KEM, along with numerous other broker-dealers, was named in a lawsuit entitled *JAG Media Holdings, Inc. et al. v. A.G. Edwards & Sons, Inc. et al.*, (*JAG Media*) in the United States District Court for the Southern District of Texas in which it was generally alleged that the firm improperly engaged in short sale transactions concerning a single security. The *JAG Media* case was dismissed against KEM and all other moving defendants by the Court in September 2004, although the Court has not yet entered the final judgment.

Since the filing of *JAG Media*, KEM and/or the Company, together with other defendants, have also been named in similar actions in other jurisdictions concerning additional securities. 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 cases currently pending are *Exotics.com et ano. v. Maltin et al* in the Superior Court of California, Los Angeles County and *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 pending 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 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 in an Order dated February 25, 2005. The Company believes that it has meritorious defenses to each lawsuit and is defending each lawsuit vigorously.

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). The KEM Trading Dispute Arbitration is in its preliminary stages. KEM believes it has meritorious claims against the counterparty but there is no assurance of a favorable outcome. On March 7, 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. KEM believes it has meritorious defenses and is defending this action vigorously.

Other Litigation:

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 (KFP) (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. The Company is defending this matter vigorously and believes it has meritorious defenses.

In January 2005, an action entitled *Rule v. Chicago Board Options Exchange, Inc. et al.* was filed in the United States District Court for the Northern District of Illinois against thirty-five securities firms, including the Company and its former operating subsidiary, KFP (collectively the market maker defendants), as well as four options exchanges,. The Company has not yet been served with the complaint. The plaintiff alleges that 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 plaintiff. The plaintiff alleges 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 Company intends to defend this matter vigorously and believes it has meritorious defenses. 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.

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 defending this matter vigorously and believes it has meritorious defenses. 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.

Regulatory

The Company owns subsidiaries which are regulated broker-dealers and which 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 our Annual Report on Form 10-K for the year ended December 31, 2003, in March 2004, KSLP, now known as KEM, received Wells Notices from the staffs of the SEC s Division of Enforcement and from NASD s Department of Market Regulation. As disclosed in our Quarterly Report on Form 10-Q for the three months ended June 30, 2004, on July 7, 2004, the Company announced that KSLP had reached an agreement in principle with the staffs of the SEC and NASD to settle the investigations covered by these Wells Notices, which remained subject to the drafting of settlement papers and final approval by the SEC and NASD. On December 16, 2004, the Company announced that KSLP concluded its settlement with the SEC and NASD (collectively the Settlement).

The Settlement related to certain institutional trade activity, conduct and supervision that occurred in 1999 through 2001; and books and records, document production and record-keeping deficiencies. The findings concerning KSLP included violations of the antifraud provisions of Section 15(c)(1) of the Securities Exchange Act of 1934 (Exchange Act) and associated rules. The findings also included violations of the SEC books and records rules (Rules 17a-3 and 17a-4 under the Exchange Act) in connection with the retention of e-mails and order tickets and the use of trade modifiers; violations of NASD rules concerning the production of books and records (NASD Rule 8210), including just and equitable principles of trade (NASD Rule 2110); failures to supervise under Exchange Act Section 15(b)(4)(E) and NASD Rules 3010 and 2110; and violations of NASD rules in connection with the use of trade modifiers (NASD Rules 4632 and 4642) and the filing of NASD Form U5 notices for certain former employees (NASD Rule 2110). The Settlement took the form of administrative orders, in which KSLP neither admitted nor denied the findings. The Settlement resolves the matters for which KSLP received Wells Notices from the staffs of the SEC and the NASD but does not address the Wells Notices received by four former employees of KSLP. On March 7, 2005, NASD announced 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.

Under the terms of the Settlement, the Company was required to disgorge approximately $41.1 million in institutional trading profits, and pay approximately $13.2 million in interest and $25.0 million in penalties for a total of $79.3 million, which is recorded as Regulatory charges and related matters on the Consolidated Statements of Operations. This amount was paid in full in 2004. An independent distribution consultant will determine how the funds will be distributed, subject to the approval of the SEC.

In addition, as set forth in the SEC s Order in the Settlement (the SEC s Order), KEM voluntarily agreed to retain an independent compliance consultant to comprehensively review, among other things: (1) KEM s policies and procedures designed to ensure compliance with federal securities laws and the NASD rules with respect to best execution obligations, trade reporting requirements, limit order requirements and books and records requirements; (2) KEM s procedures for implementing such policies and procedures, and systems; and (3) KEM s supervisory and compliance structure. This review is ongoing.

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.

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. 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 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.

Table of Contents

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:

2004	High	Low
First Quarter	$ 17.27	$ 11.20
Second Quarter	13.53	9.65
Third Quarter	10.30	8.06
Fourth Quarter.	12.19	9.13
2003		
First Quarter	5.97	3.88
Second Quarter	7.40	3.90
Third Quarter	12.60	6.26
Fourth Quarter.	15.25	11.41

The closing sale price of our Class A Common Stock as reported on the Nasdaq National Market as of March 14, 2005, was $10.30 per share. As of that date there were approximately 595 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 55,000 beneficial holders of our Class A Common Stock.

We have never declared or paid a cash dividend on our Class A Common Stock. We do not anticipate paying any cash dividends in the foreseeable future. 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 2004:

Period(1)	Total Number of Shares Purchased(2)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(3)	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
October 1, 2004 - October 31, 2004	510,700	$ 9.71	510,700	$ 124,380,075

November 1, 2004 - November 30, 2004	917,200	11.05	917,200	114,245,501
December 1, 2004 - December 31, 2004	1,315,000	11.46	1,315,000	99,179,839
Total	2,742,900	11.00	2,742,900	

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

(2) All shares were repurchased through our publicly announced stock repurchase program. Table excludes shares repurchased related to tax withholdings resulting from the vesting of employee restricted stock.

(3) 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 $215 million to a total of $250 million by resolutions of the Company s Board of Directors adopted on July 16, 2002, May 12, 2003, April 20, 2004 and August 8, 2004. 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 total remaining authorization under the program was $30.9 million as of March 14, 2005. The repurchase program has no set expiration or termination date.

Table of Contents

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

The following selected consolidated financial data are qualified by the Consolidated Financial Statements of Knight Trading Group, Inc. and the Notes thereto included elsewhere in this document. You should read the following 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 2002, 2003 and 2004 and the Consolidated Statements of Financial Condition Data at December 31, 2003 and 2004 have been derived from our audited Consolidated Financial Statements included elsewhere in this document. The Consolidated Statements of Operations Data for 2000 and 2001 and the Consolidated Statements of Financial Condition Data at December 31, 2000, 2001 and 2002 are derived from Consolidated Financial Statements not included in this document.

	For the years ended December 31,				
	2004	**2003**	**2002**	**2001**	**2000**
Consolidated Statements of Operations Data (1):	**(In thousands, except share and per share data)**				
Revenues					
Net trading revenue	$ 250,993	$ 290,938	$ 269,323	$ 451,877	$ 1,058,814
Commissions and fees	276,011	163,147	75,599	28,633	26,732
Asset management fees	77,658	57,903	34,510	36,757	41,884
Interest and dividends, net	4,647	3,657	5,357	16,505	26,567
Investment income and other	16,441	30,264	13,199	8,521	7,031
Total revenues	625,750	545,909	397,988	542,293	1,161,028
Expenses					
Employee compensation and benefits	244,550	206,860	169,044	192,880	365,708
Execution and clearance fees	111,788	102,659	85,917	96,305	124,433
Soft dollar and commission recapture	60,118	9,986	7,372	6,252	4,545
Payments for order flow	36,632	32,179	36,306	52,482	160,633
Communications and data processing	28,896	27,992	31,077	42,017	30,475
Depreciation and amortization	14,046	19,201	26,488	33,147	20,047
Occupancy and equipment rentals	16,599	16,892	21,671	16,480	16,021
Professional fees	14,915	10,993	16,384	13,461	18,352
Business development	8,269	7,160	6,852	9,580	13,140
Writedown of assets and lease loss accrual	3,810	16,508	15,423	18,967	
International charges			31,221		
Regulatory charges and related matters	79,342				
Other	6,844	11,152	13,771	14,289	14,371
Total expenses	625,809	461,582	461,526	495,860	767,725
(Loss) income before income taxes, minority interest and discontinued operations	(59)	84,327	(63,538)	46,433	393,303
Income tax expense (benefit)	9,453	32,786	(20,081)	23,131	148,411
(Loss) income before minority interest and discontinued operations	(9,512)	51,541	(43,457)	23,302	244,892
Minority interest in consolidated subsidiaries			5,101	6,477	

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