

LABRANCHE & CO INC
Form 10-K
March 16, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ý Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2005

or

o Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from to .

Commission file number: 001-15251

LaBRANCHE & CO INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

13-4064735
(I.R.S. Employer
Identification No.)

One Exchange Plaza, New York, New York 10006

(Address of Principal Executive Offices) (Zip Code)

(212) 425-1144

(Registrant's telephone number, including area code)

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

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Title of each Class:

Name of each exchange on which registered:

Common Stock, par value \$0.01

New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

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

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

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 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.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the Common Stock held by non-affiliates of the registrant, based upon the last sale price of the Common Stock reported on the New York Stock Exchange on June 30, 2005, was approximately \$377,715,000.

The number of shares of Common Stock outstanding as of March 10, 2006 was 60,714,487.

DOCUMENTS INCORPORATED BY REFERENCE

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Portions of the registrant's definitive Proxy Statement for the registrant's 2006 Annual Meeting of Stockholders to be held on May 16, 2006 are incorporated by reference in this Annual Report on Form 10-K in response to Part II, item 5 and Part III, items 10, 11, 12, 13 and 14.

PART I

This Annual Report on Form 10-K and the documents incorporated by reference contain forward-looking statements that have been made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on current expectations, estimates and projections about the registrant's industry, management's beliefs and certain assumptions made by management. Words such as anticipates, expects, intends, plans, believes, seeks, estimates, variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict; therefore, actual results may differ materially from those expressed or forecasted in any such forward-looking statements. Unless required by law, the registrant undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. However, readers should carefully review the risk factors set forth herein and in other reports or documents the registrant files from time to time with the Securities and Exchange Commission (the SEC).

Item 1.

BUSINESS.

Overview

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We are the parent corporation of LaBranche & Co. LLC, one of the oldest and largest Specialists in equity securities listed on the New York and American Stock Exchanges. We are also the parent of LaBranche Structured Holdings, Inc. (LSHI), the holding company for a group of entities that are Specialists and Market-Makers in options, futures and exchange-traded funds, or ETFs, traded on various exchanges. As a Specialist and Market-Maker, we play an integral role in the central auction market by acting as the exclusive broker (i.e., agent) or market-maker (i.e., principal) in our portfolio of listed company stocks, options, futures and ETFs. The Specialist facilitates buying and selling of securities of the companies it represents by bringing timely information, critical expertise, and needed liquidity to the forefront of the auction marketplace. LaBranche Financial Services, Inc. (LFSI), another of our operating subsidiaries, provides securities execution, clearing and direct-access floor brokerage services to institutional investors.

LSHI is the sole member of LaBranche Structured Products, LLC, a New York limited liability company (LSP), LaBranche Structured Products Specialists LLC, a New York limited liability company (LSPS), LaBranche Structured Products Europe Limited, a United Kingdom single member private company (LSPE), and LaBranche Structured Products Hong Kong Limited, a Hong Kong single member private company (LSPH). LSP is a registered broker-dealer that operates as a specialist in options, ETFs and futures on the AMEX, the New York Board of Trade (NYBOT), and the Philadelphia Stock Exchange (PHLX), and as a market-maker in options, ETFs and futures on several exchanges. LSPS is a registered broker-dealer and operates as a specialist in ETFs traded on the NYSE. LSPE was organized to operate as a market-maker for ETFs in Europe traded on the London Stock Exchange and the Euroex and Euronext Exchanges, and was registered as a broker-dealer with the United Kingdom's Financial Securities Authority in March 2006. LSPH was organized to operate as a market-maker for ETFs and

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engage in hedging transactions in Asia, and is in the process of registering as a broker-dealer with Hong Kong's Securities and Futures Commission.

We are also the sole stockholder of LABDR Services, Inc. (LABDR) and the sole owner of LaBranche & Co. B.V. (BV). LABDR provides disaster recovery services and back-up facilities to other LaBranche subsidiaries. BV represents LaBranche & Co. LLC in European markets and provides client services to LaBranche & Co. LLC's European listed companies.

We are a Delaware corporation that was incorporated in June 1999. Our principal executive offices are located at One Exchange Plaza, 25th Floor, New York, New York 10006, and our telephone number is (212) 425-1144. Our Internet address is www.labranche.com. We make available free of charge, on or through the investor relations section of our website, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission (SEC). These filings also are available on the SEC's website at www.sec.gov.

Also available on our website are our Corporate Governance Guidelines, our Code of Conduct (applicable to all our directors, officers and employees) and the charters for our Audit Committee, Compensation Committee and Nominating & Corporate Governance Committee. Within the time period required by the SEC and the NYSE, if applicable, we will post any amendment and/or any waiver of our Code of Conduct.

We currently view our business as operating principally in two separate segments: the Specialist and Market-Making segment and the Execution and Clearing segment.

Our Specialist and Market-Making segment currently includes the operations of LaBranche & Co. LLC, LSP, LSPS, LABDR and BV. As of December 31, 2005, the entities within our Specialist and Market-Making segment were specialists on the NYSE, the AMEX, the NYBOT, and PHLX, as well as market-makers on several exchanges. Collectively, our Specialist and Market-Making segment is the specialist for 563 common stock listings and 19 ETFs on the NYSE and 91 common stock listings, 640 options listings, 5 futures and 30 ETFs on the AMEX, PHLX, NYBOT and other exchanges, and is a market-maker for ETFs, options and futures on various exchanges.

Our Execution and Clearing segment currently includes the operations of LFSI, which provides securities execution and clearing services to retail and institutional clients and correspondents. LFSI's central focus is to bring the customer closer to the point of sale and provide price discovery at the highest possible speed and lowest possible cost.

Compensation and related benefits for certain employees and certain company-wide professional fees are allocated to our two principal business segments. However, certain revenues and administrative and corporate overhead expenses, which consist primarily of interest on our public debt, are not specifically allocated to our two principal business segments and thus are

treated as other revenues and expenses. A description of our principal business segments is presented below.

Our Specialist and Market-Making Segment

The Specialist and Market-Making Industry

Generally, trading of securities on the NYSE, the AMEX and other auction-based securities markets is conducted through an auction process managed by the specialist for that security. The specialist is a broker-dealer who applies for and, if accepted, is assigned the role to maintain a fair and orderly market in its specialist securities. The number of specialist units on the NYSE and the AMEX has decreased substantially over the past several years due to consolidation within the industry. There are currently seven NYSE specialist firms, of which the five largest, as ranked by number of specialist stocks, were responsible for 95.2% and 95.1% of the average daily share volume traded on the NYSE in 2005 and 2004, respectively. There are currently 14 equity specialist firms, 16 option specialists and 11 ETF specialists on the AMEX. Many other firms act as market-makers in these securities on the AMEX, adding liquidity to the market in addition to the exclusive specialists' obligation to do so. There are also many other market-makers on the other exchanges on which we make markets.

On the NYSE, specialist firms for cash equity securities compete for the original listing of these securities through an allocation process organized by the NYSE. As part of this allocation process, companies seeking a listing may select a specialist firm in one of two ways. Under the first method, the NYSE's allocation committee selects the specialist firm based on specific criteria. Under the second method, available since March 1997, the listing company requests that the allocation committee select three to five potential specialist firms suitable for the security, based on criteria specified by the listing company. The issuer then meets with each specialist firm presented by the allocation committee. Within one week after meeting the competing specialist firms, the listing company selects a specialist firm. Currently, almost every company listing on the NYSE chooses its specialist firm under the second allocation method.

On the AMEX, the specialist firm for each equity security, option and future compete for the original listing of that security through an allocation process organized by the AMEX. The AMEX has an allocation committee, which selects the specialist firm for each security based on specified criteria, giving weight to the desires of the listed company. On both the NYSE and AMEX, the specialist for each ETF is chosen by either the exchange or the ETF issuer.

When assigned a particular security, the specialist firm agrees to specific obligations. The specialist is required to maintain, as far as practicable, a fair and orderly market. This implies that the trading will have reasonable depth and price continuity, so that, under normal circumstances, a customer may buy or sell the security in a manner consistent with market conditions. A specialist firm helps market participants achieve price improvement in their trades because the best bids and offers are discovered through the auction process. In performing its obligations, the specialist firm is exposed to all transactions that occur in each of its specialist securities, either through electronic orders or floor brokers. In any given transaction, the specialist firm may act as:

an auctioneer by setting opening prices for its specialist securities and by matching the highest bids with the lowest offers, permitting buyers and sellers to trade directly;

a facilitator bringing together buyers and sellers who do not know of each other in order to execute a trade which would not otherwise occur;

an agent for broker-dealers who wish to execute transactions as instructed by their customers (typically, these orders are limit orders entrusted to the specialist at prices above or below the current market price); or

a principal using its own capital to buy or sell securities for its own account.

In addition to normal specialist functions, a specialist in ETFs may provide seed money to the ETF, creating shares in such ETF by purchasing and depositing a group of securities and/or cash into the fund

The specialist firm's decision to buy or sell its specialist securities as principal may be based on obligation or inclination. For example, the specialist firm may be obligated to buy or sell its specialist securities to counter short-term imbalances in the prevailing market, thus helping to maintain a fair and orderly market in that stock. At other times, the specialist firm may be inclined to buy or sell the securities as principal based on market conditions. In actively-traded securities, the specialist firm continually buys and sells its specialist securities at varying prices throughout each trading day. The specialist firm's goal and expectation is to profit from differences between the prices at which it buys and sells these securities. In fulfilling its specialist obligations, however, the specialist firm may, at times, be obligated to trade against the market, or may be prevented from participating in a trade, which could adversely impact its profitability. In addition, the specialist firm's trading practices are subject to a number of restrictions, as described in Rules Governing Our Specialist and Market-Making Activities.

Recent Trends in Trading

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Specialist and market-making firms generate revenues by executing trades, either as agent or principal, in their specialist and market-making securities. Specialist firms' revenues generally are significantly impacted by the share volume of trading on the applicable market. Market activity historically has tended to be cyclical, and trading volumes from 2002 through 2004 evidenced a decline in individual and institutional trading.

Since 2000, ETFs have grown as an alternative to other investments. ETFs are share-based investment funds that pool investors' capital and trade on stock exchanges throughout the day at prices determined by the market. ETFs attempt to imitate a stock market index or narrowly defined basket, rather than actively add or remove stocks. As a result, these ETFs offer investors the diversification advantages of a mutual fund, while also possessing certain tax and other advantages of traditional stocks. According to data provided by the Investment Company Institute, ETF assets grew to approximately \$296.0 billion as of December 31, 2005 from \$226.2 billion as of December 31, 2004, representing a growth rate of approximately 31%. Some of the more recognizable ETFs are the Nasdaq 100 Tracking Stock (QQQ), Standard & Poors Depositary

Receipts (SPDRs) and Vanguard Index Participation Receipts (VIPERS). We believe the increase in program trading during this period is at least partially related to the growth in ETFs because hedging trades executed by market makers tend to be done electronically and in small increments.

In 2005, trading volumes in cash equity securities grew, as well. Average daily trading volume on the NYSE increased in 2005 to 1.6 billion shares from approximately 1.4 billion shares in each of 2004 and 2003. This increase in trading volume, in part, helped to stabilize our cash equity specialist revenues in 2005. This stabilization follows a period of declining trading volume from 2002 through 2004, which may have been attributable to:

a relatively slow return by the retail investor to the equity markets following the 2000-2002 bear market;

popular interest in alternative investments, particularly residential real estate and commodities; and

the continued emergence of a new class of investors, including hedge funds, that invests in non-traditional instruments.

In addition to the historically lower trading volume on the NYSE, we believe several other factors negatively impacted equity specialists revenues from 2002 through 2004, including:

declining volatility of stock prices as measured by the CBOE's Volatility Index®, a key measure of market expectation of near-term volatility and investor sentiment. As volatility in markets diminishes, the need for specialists to employ capital to mitigate volatility decreases, which in turn reduces specialists' level of principal participation; and

increased program trading as a percentage of total NYSE average daily share volume. Program trading and the decimalization of stock prices often results in a number of smaller orders executed through the NYSE's SuperDOT® system. As a result, block-trading strategies have become less prevalent.

Although these factors continued to adversely affect our cash equity specialists' results in 2005, our revenues from our cash equities specialist business stabilized in 2005.

The recent changes in investor behavior from concentration on individual stocks to alternatives such as sector and index trading, as well as ETFs, also has substantially fueled the growth for trading in options, futures and ETFs. Accordingly, over the past few years we have increased our focus on our options, futures and ETFs specialist and market making-operations.

The majority of trades in NYSE-listed stocks take place on the NYSE. In 2005, specialist firms handled approximately 76% of trades in NYSE-listed stocks, a decline from approximately 79% in 2004. The percentage of trades in NYSE-listed stocks on the floor of the NYSE is affected as follows:

some stocks are listed on multiple exchanges, such as regional exchanges, and trades take place on those exchanges as well as in the over-the-counter market and through alternative trading systems (ATs); and

at times, significant volume in NYSE-listed stocks takes place before and after regular NYSE trading hours.

Technological advances have contributed to increased trading through ATs, such as electronic communications networks, or ECNs, and electronic crossing systems. While the first ECN was created in 1969, most of the ECNs currently in operation were started only during the past several years. These systems electronically facilitate the matching of buy and sell orders that are entered by their network members. If a match does not occur, some ATs will forward unfilled orders to other ATs or to exchanges such as the NYSE. Some of these networks also allow limited negotiation between members to facilitate a match. These ATs generally limit trades over their systems to their members, who are typically large financial institutions, professional traders or brokerage firms. Additionally, some ATs are being developed to facilitate trading by retail investors. In April 1999, the SEC ruled that these networks are allowed, and in specified cases are required, to register and become subject to regulation as stock exchanges. It is possible that the presence of these ATs and other emerging electronic trading systems have contributed to the overall decline in the percentage of equity shares traded on the NYSE over the past five years from approximately 83% to approximately 76%. Notwithstanding the presence of these ATs and other emerging trading technologies, the NYSE remains the predominant trading marketplace for listed securities. It is unclear, however, how ATs and other new technologies, in addition to other recent events (such as the merger of the NYSE and Archipelago, the hybrid model and Regulation NMS, all as described below), will continue to affect the future percentages of trading in listed stocks on the NYSE.

In response to the development of ATs, in 2001 the NYSE launched Network NYSE, a suite of market information and auto-execution products offering new choices to different types of customers. Some examples of these products include:

NYSE Direct+®, an automatic execution service for limit orders up to 1,099 shares, enabling investors to automatically execute orders at the national best bid offer;

NYSE Open Book(SM), an online market data product allowing subscribers to view information on the NYSE limit order books; and

Institutional Express(SM), an electronic gateway to satisfy large order requirements and the growing information needs of NYSE member firms and their institutional customers.

Our Specialist and Market-Making Operations

Due largely to acquisitions and an increase in the number of our specialist stocks from 1997 through 2001, we historically experienced strong revenue growth in our Specialist and Market-Making segment during that period. From 2002 through 2004, however, our aggregate specialist and market making revenues declined from \$401.2 million in 2002 to \$245.0 million in 2004.

Our revenues stabilized in 2005, and our aggregate specialist and market-making revenues increased to an aggregate of \$283.6 million. These results were due, in part, to an overall increase in market trading and our strategic response to the above-described recent changes in investor behavior from concentration on individual stocks to alternatives such as sector and index trading, as well as ETFs. Over the past few years, we have increased our focus on our options, futures and ETFs specialist and market making-operations. The Specialist and Market-Making segment has been employing more capital in its trading activities on more exchanges, and in derivative products and ETFs, in order to seek growth opportunities while maintaining a leadership position in the cash equities specialist market. Our initial acquisition strategy and strategic organic growth has enabled us to gather products in our specialist and market-making operations on additional exchanges and in additional countries. A restructuring of certain of our specialist and market-making subsidiaries has allowed us to develop our specialist and market-making operations across various exchanges and marketplaces. These initiatives have also enabled us to better allocate and deploy our capital, workforce and technology across our operations in order to more efficiently seek out opportunities as they arise. We also believe that a recently proposed NYSE rule, pending approval by the SEC, could substantially reduce the liquid asset requirements of our NYSE specialist operations, and could provide us with additional capital to efficiently redeploy our working capital to new opportunities in other products and markets.

Our NYSE and AMEX Equity Specialists

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Our NYSE and AMEX equity specialist operations are conducted through our LaBranche & Co. LLC subsidiary. As a specialist in equity securities and rights listed on the NYSE and in equity securities on the AMEX, LaBranche & Co. LLC's role is to maintain, as far as practicable, a fair and orderly market in its specialist stocks. In doing so, it provides a service to its listed companies, and to the brokers, traders and investors who trade in its specialist stocks. As a result of our commitment to providing high quality specialist services, we have developed a solid reputation among our constituencies, including investors, members of the Wall Street community and our listed companies.

Since our initial public offering, we have increased the number of our listed companies and specialist market share both internally and through acquisitions. Since the NYSE implemented its new specialist allocation process in March 1997, we have been selected by 194 new listed companies, resulting from 490 listing interviews through December 31, 2005. In addition, we have acquired eleven specialist operations since 1997, adding approximately 500 NYSE common stocks and 52 AMEX common stocks. As a result of internal growth and selective acquisitions, our LaBranche & Co. LLC subsidiary currently is a leading NYSE specialist as illustrated by the following data:

the dollar volume traded of stocks for which LaBranche & Co. LLC was the specialist on the NYSE in 2005 was \$3.4 trillion, or 24.7% of total 2005 NYSE dollar volume, and was \$2.8 trillion in 2004, or 25.4% of total 2004 NYSE dollar volume;

the share volume traded of stocks for which LaBranche & Co. LLC was the specialist on the NYSE in 2005 was 102.1 billion, or 26.3% of total 2005 NYSE share volume, and was 96.1 billion in 2004, or 27.1% of total 2004 NYSE share volume; and

as of December 31, 2005, the total number of LaBranche & Co. LLC's NYSE common stock listings was 563, or 21.3% of all NYSE common stock listings, and as of December 31, 2004, its total number of NYSE common stock listings was 580, or 22.1% of all NYSE common stock listings.

By these three measurements, LaBranche & Co. LLC was one of the largest NYSE specialist firms as of December 31, 2005 and 2004. In addition, LaBranche & Co. LLC acted as the specialist for 240 other NYSE-listed securities (e.g., preferred stocks and derivative securities).

As of December 31, 2005, LaBranche & Co. LLC's listed companies included:

105 of the S&P 500 Index companies;

30 of the S&P 100 Index companies; and

7 of the 30 companies comprising the Dow Jones Industrial Average (DJIA). Our DJIA stocks are 3M Co., Altria Group, Inc., American Express Company, E.I. du Pont de Nemours and Company, Exxon Mobil Corporation, Merck & Co. Inc., and SBC Communications Inc. (renamed AT&T Inc after its acquisition of AT&T Corp. in 2005).

Our Options, Futures and ETFs Specialists and Market-Makers

Through September 25, 2002, our AMEX specialist operations for both equities and options were conducted entirely by LaBranche & Co. LLC. Since then, in order to continue our expansion into new products and markets, we have conducted our options, ETFs and other derivatives specialist and market-making business activities on the AMEX, NYBOT, PHLX, Chicago Board Options Exchange® (CBOE), and other exchanges through our LSP subsidiary, and have conducted our NYSE ETFs specialist operations through our LSPS subsidiary. Our equity specialist activities on the AMEX continue to be conducted by LaBranche & Co. LLC.

In August and September 2005, we reorganized our options, futures and ETFs specialist and market-making operations under our LSHI holding company subsidiary in order to facilitate the liquidity and working capital management of our specialist and market-making activities. During 2005, our options, futures and ETFs specialist and market-making operations continued to expand substantially, through our LSP and LSPS subsidiaries. From 2002 through 2005, we expanded our market-making activities to different derivative products as well as to other exchanges. As of December 31, 2005, we acted as the specialist for 640 options, 5 futures and 30 ETFs listed on the AMEX, NYBOT, PHLX and other

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exchanges, and acted as a market-maker in ETFs, options and futures on several exchanges. We also were the specialist in 19 ETFs listed on the NYSE.

We are responsible for creating a fair and orderly market in the trading of our specialist options, futures and ETFs. In doing so, we may at times be obligated to trade against the market, adversely impacting the profitability of the trade or creating a position that may not necessarily be desired. To hedge the risk of our derivative positions, we may buy or sell the underlying asset(s). As a market-maker, we also trade these derivative securities as principal out of both obligation and inclination.

As a registered market-maker in options, ETFs and futures, our Specialist and Market-Making segment generally engages in a course of dealings that is reasonably calculated to contribute to the maintenance of a fair and orderly market. We also may hedge these positions with the underlying assets or other financial instruments. In our market-making function, we bring immediacy and liquidity to the markets when we choose to participate.

In January 2005, we formed LSPE to be a market-maker for ETFs traded on the London Stock Exchange, Euroex and Euronext exchanges. In August 2005, we formed LSPH to be a market-maker in ETFs traded in Hong Kong and to conduct hedging transactions in Hong Kong markets related to our specialist and market-making activities. As part of our LSP-entity reorganization in August and September 2005, both LSPE and LSPH became wholly-owned subsidiaries of LSHI. LSPE and LSPH have yet to commence operations. LSPE was registered as a broker-dealer with the UK's Financial Securities Authority (FSA) in March 2006, and LSPH is in the process of registering as a broker-dealer with Hong Kong's Securities and Futures Commission (SFC). Upon commencement of operations, we expect LSPE and LSPH to strengthen our specialist and market-making relationships with U.S. ETF issuers abroad, which we believe will help our Specialist and Market-Making segment further diversify its exchange base and better manage its risk.

Our Specialist Support Services

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In April 2002, BV was organized to represent LaBranche & Co. LLC in European markets and to provide client services to LaBranche & Co. LLC's European-listed companies. BV was established under Dutch law, and its office is in Amsterdam, The Netherlands. Through a services agreement, BV provides monitoring and trading services for LaBranche & Co. LLC's specialist stock positions, as specifically directed by appropriately designated LaBranche & Co. LLC personnel. In addition, BV markets the services of our specialist entities to existing and prospective European NYSE-listed issuers.

For detailed financial information in connection with our Specialist and Market-Making segment, please see Management's Discussion and Analysis of Financial Condition and Results of Operations' Specialist and Market-Making Segment Operating Results' and Note 17 to the Financial Statements filed herewith.

Rules Governing Our Specialist and Market- Making Activities

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Under NYSE and AMEX rules, a specialist has a duty to maintain, as far as practicable, a fair and orderly market in its specialist securities. In order to fulfill its obligations, the specialist must at times trade for its own account, even when it may adversely affect the specialist s

profitability. In addition, under certain circumstances, the specialist is prohibited from making trades as principal in its specialist stocks. The specialist's obligations are briefly described below.

Requirement to Trade as Principal. A specialist must buy and sell securities as principal when necessary to minimize an actual or reasonably anticipated short-term imbalance between supply and demand in the auction market. The specialist must effect these transactions when their absence could result in an unreasonable lack of continuity and/or depth in its specialist stocks. The specialist is not expected to act as a barrier in a rising market or as support in a falling market, but must use its own judgment to try to keep such price increases and declines equitable and consistent with market conditions.

A specialist must make continuous two-sided quotations that are timely and that accurately reflect market conditions. In making these quotations, the specialist's transactions are calculated to contribute to the maintenance of price continuity with reasonable depth.

In addition, the specialist cannot be in a control relationship with any of its listed companies. Generally, this means a specialist may not acquire more than 5% of any common or preferred issue of its specialist stocks and may not own 10% or more of any common or preferred stock. A specialist may not hold any position as an officer or director with, receive payments or loans from, or engage in certain business transactions with any of its listed companies.

New SEC-Proposed Market Rules. In February 2004 and again on August 2, 2004, the NYSE proposed to expand its Direct+® trading system to eliminate the current limits on size, timing and types of orders that currently may be executed electronically through the Direct+® system and thereby create a so-called hybrid market intended to incorporate a number of new trade execution options while preserving the option of access to auction price discovery and deep liquidity. Specifically, the NYSE's proposals would eliminate the 1,099-share restriction on NYSE Direct+® orders, as well as the prohibition against entering orders for the same account within 30 seconds, and would permit market orders and immediate-or-cancel orders to be eligible for Direct+® execution. In addition, the NYSE's proposals contain a number of other new features designed to create a liquidity pool accessible for electronic and auction price discovery; the opportunity for benefits associated with human judgment at the point of sale; and accountable performance with focused communication by specialists. The NYSE has begun the technological work necessary to implement its proposed changes in the NYSE Direct+® system and, in December 2004, extended the pilot phase of this Direct+® system through December 23, 2005, subject to review and approval of these proposed changes by the SEC. It is possible that the NYSE may again extend this pilot phase in order to complete the technological work to finalize the Direct+® system.

In February 2004, the SEC proposed new rules which would require, subject to certain exceptions, that every order execution facility (*i.e.*, every national securities exchange, national securities association that operates an order execution facility, alternative trading system, exchange specialist and market maker, OTC market maker, block positioner and any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent) establish, maintain and enforce policies and procedures reasonably designed to prevent the execution of a trade-through (*viz.*, the execution of an order at a price that is inferior to a price displayed in another market) in its market. As originally proposed, this requirement would apply

to all incoming orders in NMS Stocks, including all NASDAQ, NYSE and AMEX-listed stocks and any order execution facility that executes orders internally within its market, whether or not that market posts its best bid and offer, and would have (1) allowed customers (and broker dealers trading for their own accounts) to opt-out of the protections of the rule by providing informed consent to the execution of their orders, on an order-by-order basis, in one market without regard to the possibility of obtaining a better price in another market, and (2) taken into account the differences between the speed of execution in electronic versus manual markets by providing an automated market with the ability to trade through a non-automated market at a price up to a certain amount away from the best bid or offer displayed by the non-automated market.

On April 6, 2005, the SEC adopted Regulation NMS (Regulation NMS). Regulation NMS is expected to become effective in the second half of 2006 and could have a significant impact on the regulation of trading on securities exchanges and marketplaces. Specifically, the rule establishes inter-market protection against trade-throughs for all NMS stocks and protection of only those quotations that are immediately accessible through automatic execution. The rule generally does not contain the opt-out exception described above that would have allowed market participants to disregard displayed quotations, but does include a number of exceptions to the opt-out proscription to help ensure that the rule is workable with high-volume securities. The rule also is anticipated to protect the best bids and offers of each exchange, Nasdaq, and the NASD's Alternative Display Facility. While it is too early to anticipate the impact that Regulation NMS could have on our trading, it is possible that the rule could materially affect our compliance costs and alter the competitive environment in which our Specialist and Market-Making segment functions. Refer to Recent Trends in NYSE Trading for detailed discussion.

The Recently-Consummated NYSE Merger. On April 20, 2005, Archipelago Holdings, Inc., entered into a definitive merger agreement with the NYSE, as amended on July 20, 2005, pursuant to which Archipelago and NYSE agreed to combine their businesses and become wholly-owned subsidiaries of NYSE Group, Inc., a newly-created, for-profit and publicly-traded holding company. On March 7, 2006, the merger was consummated. Consequently, the former NYSE business is now held in three separate entities under the NYSE Group: New York Stock Exchange LLC; NYSE Market, Inc. and NYSE Regulation, Inc. New York Stock Exchange LLC will only hold the equity interests of NYSE Market and NYSE Regulation.

NYSE Market has issued trading licenses to all registered broker-dealers wishing to conduct business on the NYSE, subject to payment of a fee to NYSE Market. These trading licenses replaced the prior trading rights provided by the ownership or lease of an NYSE membership prior to the NYSE/Archipelago merger. In January 2006, we participated in a Dutch auction for these trading licenses and successfully bid for 90 trading licenses in our Specialist and Market-Making segment (five additional licenses were obtained for our Execution and Clearing segment operations). Organizations holding trading licenses generally are subject to the same rules that were applicable to member organizations prior to the merger. Each trading license entitles its holder to physical and electronic access to the trading facilities of NYSE Market, subject to such limitations and requirements as may be specified, and in each case

includes the right to designate a natural person, subject to pre-approval by NYSE Regulation, who may have physical access to the floor and facilities of NYSE Market to trade.

In connection with the NYSE/Archipelago merger, the NYSE amended NYSE Rule 103B, the Exchange Allocation Policy. The NYSE Market is granted the right to determine the number and identity of specialist firms from which a new listing issuer may choose its specialist, provided the group consists of at least four specialist firms. The NYSE Market and the issuer are provided with the same material with respect to each specialist firm applicant as would have been reviewed by the Allocation Committee in allocating a listing. We, therefore, do not expect the NYSE merger to materially affect the specialist allocation process or our specialist operations on the NYSE.

Listed Company Services

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We are committed to providing our listed companies with a high level of service, in addition to our specialist functions on the trading floor. Our corporate relations effort is devoted to serving our listed companies by providing them with current market information and insight on general market trends. We organize an annual educational conference that reviews trends in the securities industry and equity markets. For newly listed companies, we provide additional investor relations support services to assist the companies with their transition to the exchange on which they are listed. These services add significant value for companies considering a listing on an exchange.

Competition in the Specialist and Market-Making Industry

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We obtain each of our new listings on the NYSE and AMEX by participating in an allocation process. As part of this process, either the allocation committee of the NYSE or AMEX or the listing company chooses the specialist firm. We compete with other specialist firms based on a number of factors, including:

the strength of our capital base;

our willingness to commit our own capital and trade for our own account while conducting our specialist operations; and

the ancillary services we offer our specialist companies, such as providing information on the trading activity in their stocks.

The specialist industry experienced a vast and accelerated consolidation over the period of 1995 through 2001 with the five largest specialist units, as ranked by their number of specialist stock listings, accounting for 95.2% of the daily share volume traded on the NYSE in 2005 as compared to 95.1% in 2004. The competition for obtaining newly listed companies is intense. We expect competition to continue and intensify as some of our competitors may have greater financial resources and product service offerings.

As more fully described above in **The Recently-Consummated NYSE Merger**, under the newly released NYSE Rule 103B, **The Exchange Allocation Policy**, the NYSE Market is granted the right to determine the number and identity of specialist firms from which a new listing

issuer may choose a specialist, provided the group consists of at least four specialist firms. The NYSE Market and the issuer will be provided with the same material with respect to each specialist firm applicant as would have been reviewed by the Allocation Committee in allocating a listing. We, therefore, do not expect the NYSE merger to materially affect the specialist allocation process or our specialist operations on the NYSE.

Our Specialist and Market-Making Segment s Competitive Position

We are committed to providing the highest quality service to our various constituencies. Our strong competitive position is based on the following factors:

Leading Position in the Specialist and Market-Making Market. We have a long-standing reputation as a leading specialist firm. We have successfully grown our business and improved our services through widely varying market conditions. Our cash equities specialist operations during 2005 accounted for 25.1% of the dollar value and 26.4% of the share volume traded on the NYSE, and 124 of our specialist common stock listings were securities of non-U.S. companies as of December 31, 2005. By these measures, we were the largest specialist firm on the NYSE. We are also one of the largest ETF specialist firms on the NYSE and AMEX, as the specialist in 49 ETFs out of an aggregate of 201 listed ETFs as of December 31, 2005. We are also one of the largest market-makers on various exchanges in options futures and ETFs.

Diverse and High Quality Specialist and Market-Making Securities. The companies for whose securities we are specialist and market-maker operate in a variety of industries, including financial services, media, oil and gas, retail, technology and telecommunications. Many of these companies are leaders in their respective fields. They range in market capitalization from some of the smallest on the NYSE and AMEX to some of the largest and most well-known. Being the specialist and market-maker in the securities of industry leaders could benefit us as these leading companies expand their businesses through internal growth and acquisitions.

Ability to deploy capital efficiently. We have employed more capital in our trading activities on more exchanges, and in derivative products and ETFs, in seeking growth opportunities while maintaining a leadership position in the cash equities specialist market. Our initial acquisition strategy and strategic organic growth has enabled us to gather products in our specialist and market-making operations on additional exchanges and in additional countries. A restructuring of certain of our specialist and market-making subsidiaries has allowed us to develop our specialist and market-making operations across various exchanges and market places. The organizational structure of our Specialist and Market-Making segment should enable us to better allocate and deploy our capital, workforce and technology across our operations in order to more efficiently seek out opportunities as they arise.

Strong Trading and Technology Skills. We utilize our trading skills to actively participate as principal in trading our specialist and market-making securities. We significantly improve liquidity in our specialist and market-making securities and

quickly and ably create ETFs for our ETFs specialist customers, particularly during periods of market volatility. Additionally, as the securities trading marketplace becomes more electronic, as further evidenced by the NYSE's proposed hybrid market model, we are developing electronic trading capabilities which will allow us to interact in a fast and more automated auction market. We have a technology group which develops algorithmic models that may be used in electronic trading markets and in the proposed hybrid model.

Innovative Customer-Oriented Services. In addition to our specialist and market-making functions on the trading floor, we provide our specialist-based listed companies with a high level of service (*e.g.*, detailed information on the trading activity of their securities), as well as customized support services to assist in their investor relations efforts.

Completed Acquisitions and Strategic Organic Growth. Since 1997, we have acquired eleven specialist operations adding approximately 500 NYSE common stocks and 52 AMEX common stocks, solidifying our position as one of the leading NYSE specialist firms, as well as establishing and expanding our presence on the AMEX. We also have continued our organic growth by creating the current LSHI structure to facilitate our expansion within the options, futures and ETFs specialist and market-making market. Our growth as a specialist in ETFs has particularly played a role in this growth, as we are now the specialist in 49 ETFs traded on the NYSE and the AMEX.

Our Execution and Clearing Segment

Recent Trends in Execution and Clearing Industry

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The traditional clearing industry has, over the last few years, consolidated down to a small number of highly capitalized and extremely focused competitors. Mostly owned by or affiliated with large investment or commercial banks, these few top competitors command the dominant share of the fully-disclosed correspondent clearing market. As a result, barriers to entry have risen and the capital expenditures necessary to maintain market share have increased.

As the result of years of advances in order delivery and execution technology, trading costs for customers across all categories (retail, institutional, etc.) have dropped dramatically. These advances in trading technologies, and the resulting economies afforded the customer, have also engendered an entirely new style of investment management, where algorithms embedded in servers generate, direct and account for orders with minimal human interaction. Orders generated and delivered over purely electronic platforms now account for more than 50% of NYSE volume.

In addition, there has arisen a number of non-traditional execution venues that bypass the traditional exchanges and ECN's in which institutions can trade directly with each other without exposing orders to market-wide price verification.

Our Execution and Clearing Operations

LFSI, which is the sole operating entity constituting our Execution and Clearing segment, provides clearance and execution services to a range of clients. To our broker dealer correspondents, we provide traditional clearance services. To our own customers, which include institutions and individuals, we provide a range of customized execution services, including direct-access brokerage.

LFSI does not focus on commoditized bulk clearance and execution. LFSI targets businesses where our flexibility, customization and a versatile clearance platform provide us with a competitive advantage.

Our Institutional Executive Group (IEG) provides institutions with highly customized service built around special execution needs. IEG focuses on timely executions with minimal market impact. IEG handles and clears trades on every major domestic stock exchange, with straight through processing from order origination to trade execution. IEG also provides soft dollar execution and other administrative services to institutional customers. IEG has active relationships with over 255 accounts and is developing its business nationwide.

For detailed financial information in connection with our Execution and Clearing segment, please see Management's Discussion and Analysis of Financial Condition and Results of Operations Execution and Clearing Segment Operating Results and Note 17 to the Financial Statements filed herewith.

Regulatory Matters

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The securities industry in the United States is subject to regulation under both Federal and state laws. In addition, the SEC, NYSE, AMEX and other regulatory organizations require compliance with their rules and regulations.

Our broker-dealer subsidiaries are subject to regulations concerning the operational and financial aspects of their respective businesses. They are subject to registration requirements of various government entities and self-regulatory organizations (commonly referred to as SROs) with which they must comply before they may conduct business. Our broker-dealer subsidiaries are also subject to laws, rules and regulations requiring them to comply with financial reporting rules, trade practices, capital structure obligations and record retention requirements. Failure, or even the assertion by a regulatory organization of failure, by any of our broker-dealer subsidiaries to comply with any of these laws, rules or regulations could result in censure, fine, the issuance of cease-and-desist orders or the suspension or disqualification of its directors, officers or employees and other negative consequences, which could have an adverse effect on our business. Refer to [Legal Proceedings Specialist Trading Investigations](#). From time to time, in the ordinary course of business, we have been subject to fines for violations of such laws, rules or regulations.

Our trading subsidiaries are under constant review by the NYSE, the AMEX and the other exchanges on which they conduct operations on all aspects of their operations and financial condition. In particular, as part of the price discovery mechanism implemented by the NYSE,

every NYSE specialist transaction is published immediately and broadcast worldwide. The NYSE's Market Surveillance Division employs sophisticated monitoring and requires adherence to stringent rules approved by the SEC in its examination of NYSE specialists' trading in all stocks. The NASD's AMEX Regulation Division monitors and reviews specialists' adherence to AMEX rules and regulations, as well.

The USA PATRIOT Act of 2001 (the PATRIOT Act), which was extended on March 9, 2006, contains anti-money laundering and financial transparency laws and mandates the implementation of various new regulations that apply to broker-dealers and other U.S. financial institutions, including procedures for verifying client identity at account opening, and obligations to monitor client transactions and report suspicious activities. Through its provisions, the PATRIOT Act seeks to promote cooperation among U.S. financial services companies, regulators and law enforcement officials in identifying parties that may be involved in terrorism or money laundering. The increased obligations of financial institutions, including our broker-dealer subsidiaries, require the implementation and maintenance of internal control procedures which have increased our costs and may subject us to liability.

Capital Requirements

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Our broker-dealer subsidiaries are also subject to net capital requirements as required by SEC Rule 15c3-1, and net liquid asset requirements as required by the NYSE and AMEX. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources section for our broker-dealer subsidiaries' capital requirements and actual amounts.

Failure by any of our broker-dealer subsidiaries to maintain the required net capital and/or net liquid assets may subject it to suspension or revocation of SEC registration or suspension or expulsion by the respective exchanges of which it is a member.

Employees

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As of December 31, 2005, we had 525 full-time employees, of which 382 were employed at our Specialist and Market-Making segment, 96 were employed at our Execution and Clearing segment, and 47 were employed at the holding company.

Item 1A. RISK FACTORS

The following risk factors should be carefully considered in evaluating our business and us because they have a significant impact on our business, operating results, financial condition, and cash flows. If any of these risks actually occurs, our business, financial condition, operating results and/or cash flows could be adversely affected.

The market structure in which we operate may change, making it difficult for us to maintain our levels of profitability.

The market structure in which we operate is subject to changes that could adversely affect our financial condition and results of operations. Most notably, the NYSE's recently-consummated

merger with Archipelago, as well as recent proposed changes in the NYSE's automated trade execution system and the SEC's recent proposed structural changes in the U.S. equity trading markets, may have an adverse effect on our business.

In February 2004 and again on August 2, 2004, the NYSE proposed to expand its Direct+® trading system to eliminate the current limits on size, timing and types of orders that currently may be executed electronically through the Direct+® system and thereby create a so-called hybrid market intended to incorporate a number of new trade execution options while preserving the option of access to auction price discovery and deep liquidity. Specifically, the NYSE's proposals would eliminate the 1,099-share restriction on NYSE Direct+® orders, as well as the prohibition against entering orders for the same account within 30 seconds, and would permit market orders and immediate-or-cancel orders to be eligible for Direct+® execution. In addition, the NYSE's proposals contain a number of other new features designed to create a liquidity pool accessible for electronic and auction price discovery; the opportunity for benefits associated with human judgment at the point of sale; and accountable performance with focused communication by specialists. The NYSE has begun the technological work necessary to implement its proposed changes in the NYSE Direct+® system and, in December 2004, extended the pilot phase of this Direct+® system through December 23, 2005, subject to review and approval of these proposed changes by the SEC. It is possible that the NYSE may again extend this pilot phase in order to complete the technological work to finalize the Direct+® system.

In February 2004, the SEC proposed new rules which would require, subject to certain exceptions, that every order execution facility (*i.e.*, every national securities exchange, national securities association that operates an order execution facility, alternative trading system, exchange specialist and market maker, OTC market maker, block positioner