

KNIGHT CAPITAL GROUP, INC.
Form 10-Q
May 09, 2007

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007
OR

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

001-14223

Commission File Number

KNIGHT CAPITAL GROUP, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or organization)

22-3689303

(I.R.S. Employer Identification Number)

545 Washington Boulevard, Jersey City, NJ 07310

(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: (201) 222-9400

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

Edgar Filing: KNIGHT CAPITAL GROUP, INC. - Form 10-Q

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.

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 Exchange Act) Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

At May 9, 2007 the number of shares outstanding of the Registrant's Class A Common Stock was 103,856,220 and there were no shares outstanding of the Registrant's Class B Common Stock as of such date.

KNIGHT CAPITAL GROUP, INC.

FORM 10-Q QUARTERLY REPORT

For the Quarter Ended March 31, 2007

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION:

Item 1.	<u>Financial Statements</u>	3
	<u>Consolidated Statements of Operations</u>	3
	<u>Consolidated Statements of Financial Condition</u>	4
	<u>Consolidated Statements of Cash Flows</u>	5
	<u>Notes to Consolidated Financial Statements</u>	6
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	32
Item 4.	<u>Controls and Procedures</u>	33
PART II OTHER INFORMATION:		
Item 1.	<u>Legal Proceedings</u>	34
Item 1A.	<u>Risk Factors</u>	35
Item 2.	<u>Changes in Securities and Use of Proceeds</u>	35
Item 3.	<u>Defaults Upon Senior Securities</u>	36
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	36
Item 5.	<u>Other Information</u>	36
Item 6.	<u>Exhibits</u>	36
	<u>Signatures</u>	37

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	For the three months ended March 31,	
	2007	2006
Revenues		
Commissions and fees	\$ 103,859,455	\$ 102,643,011
Net trading revenue	61,637,081	80,039,151
Asset management fees	60,713,955	70,511,043
Interest and dividends, net	4,817,943	3,313,976
Investment income and other	10,623,229	20,687,263
Total revenues	241,651,663	277,194,444
Transaction-based expenses		
Execution and clearance fees	27,410,486	28,924,406
Soft dollar and commission recapture expense	14,536,648	18,446,324
Payments for order flow and ECN rebates	12,598,965	9,873,398
Total transaction-based expenses	54,546,099	57,244,128
Revenues, net of transaction-based expenses	187,105,564	219,950,316
Other direct expenses		
Employee compensation and benefits	102,232,892	99,556,170
Communications and data processing	8,699,226	7,638,143
Professional fees	5,489,122	6,383,123
Depreciation and amortization	5,401,780	4,407,695
Business development	3,778,832	2,122,317
Occupancy and equipment rentals	3,455,226	3,352,487
Writedown of assets and lease loss accrual		7,997,434
Other	3,332,746	6,448,370
Total other direct expenses	132,389,824	137,905,739
Income from continuing operations before income taxes	54,715,740	82,044,577
Income tax expense	21,530,028	32,912,536
Net income from continuing operations	33,185,712	49,132,041
Loss from discontinued operations, net of tax	(1,332,818)	
Net income	\$ 31,852,894	\$ 49,132,041
Basic earnings per share from continuing operations	\$ 0.33	\$ 0.49
Diluted earnings per share from continuing operations	\$ 0.32	\$ 0.47

Edgar Filing: KNIGHT CAPITAL GROUP, INC. - Form 10-Q

Basic and diluted earnings per share from discontinued operations	\$	(0.01)	\$	
Basic earnings per share	\$	0.32	\$	0.49
Diluted earnings per share	\$	0.31	\$	0.47
Shares used in computation of basic earnings per share		100,906,063		100,422,995
Shares used in computation of diluted earnings per share		104,334,956		104,129,560

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

KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	March 31, 2007 (Unaudited)	December 31, 2006
Assets		
Cash and cash equivalents	\$ 159,232,302	\$ 214,759,915
Securities owned, held at clearing brokers, at market value	711,426,136	711,774,643
Receivable from brokers and dealers	351,754,733	372,897,376
Asset management fees receivable	46,927,428	112,204,064
Investment in Deephaven sponsored funds	195,366,563	187,573,291
Fixed assets and leasehold improvements, at cost, less accumulated depreciation and amortization	64,276,103	66,449,617
Strategic investments	45,936,798	49,436,605
Goodwill	133,072,889	133,042,889
Intangible assets, less accumulated amortization	62,253,105	63,701,006
Other assets	192,576,738	116,374,310
Total assets	\$ 1,962,822,795	\$ 2,028,213,716
Liabilities and Stockholders Equity		
Liabilities		
Securities sold, not yet purchased, at market value	\$ 690,321,227	\$ 693,071,230
Payable to brokers and dealers	53,445,355	47,852,721
Accrued compensation expense	143,068,776	227,846,699
Accrued expenses and other liabilities	108,228,744	96,956,122
Total liabilities	995,064,102	1,065,726,772
Stockholders equity		
Class A Common Stock, \$0.01 par value;		
Shares authorized: 500,000,000 at March 31, 2007 and December 31, 2006; Shares issued: 148,912,707 at March 31, 2007 and 144,958,749 at December 31, 2006; Shares outstanding: 104,621,212 at March 31, 2007 and 103,660,303 at December 31, 2006		
	1,489,127	1,449,588
Additional paid-in capital	544,601,895	519,790,132
Retained earnings	843,712,219	811,859,325
Treasury stock, at cost; 44,291,495 shares at March 31, 2007 and 41,298,446 shares at December 31, 2006	(422,044,548)	(370,612,101)
Total stockholders equity	967,758,693	962,486,944
Total liabilities and stockholders equity	\$ 1,962,822,795	\$ 2,028,213,716

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

KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the three months ended March 31,	
	2007	2006
Cash flows from operating activities		
Net income	\$ 31,852,894	\$ 49,132,041
Loss from discontinued operations, net of tax	(1,332,818)	
Income from continuing operations, net of tax	33,185,712	49,132,041
Adjustments to reconcile income from continuing operations, net of tax to net cash used in operating activities		
Depreciation and amortization	5,401,780	4,407,695
Stock-based compensation	7,914,022	5,660,043
Deferred rent	90,291	220,166
Writedown of assets and lease loss accrual		7,997,434
Unrealized loss on strategic investments	365,392	1,497,434
Unrealized gain on investments in Deephaven sponsored funds	(7,965,334)	(18,950,897)
Operating activities from discontinued operations	(1,332,818)	
(Increase) decrease in operating assets		
Securities owned	348,507	(141,260,618)
Receivable from brokers and dealers	21,142,643	(143,869,138)
Asset management fees receivable	66,553,751	
Other assets	(77,307,481)	(39,452,182)
Increase (decrease) in operating liabilities		
Securities sold, not yet purchased	(2,750,003)	159,858,302
Payable to brokers and dealers	5,592,634	86,707,607
Accrued compensation expense	(84,777,923)	(19,682,664)
Accrued expenses and other liabilities	11,182,331	11,403,966
Net cash used in operating activities	(22,356,496)	(36,330,811)
Cash flows from investing activities		
Purchases of fixed assets and leasehold improvements	(1,780,365)	(2,806,688)
Redemption of Deephaven sponsored funds		22,610,000
Proceeds from strategic investments	5,534,415	
Purchases of strategic investments	(2,400,000)	(4,250,000)
Purchases of businesses, net of cash acquired	(30,000)	
Contingency payment on purchase of business		(1,500,000)
Net cash provided by investing activities	1,324,050	14,053,312
Cash flows from financing activities		
Stock options exercised	9,934,434	2,768,339
Income tax benefit on stock awards exercised	7,002,846	1,248,313
Cost of common stock repurchased	(51,432,447)	(2,542,050)
Net cash (used in) provided by financing activities	(34,495,167)	1,474,602
Decrease in cash and cash equivalents	(55,527,613)	(20,802,897)
Cash and cash equivalents at beginning of period	214,759,915	230,591,067
Cash and cash equivalents at end of period	\$ 159,232,302	\$ 209,788,170

Edgar Filing: KNIGHT CAPITAL GROUP, INC. - Form 10-Q

Supplemental disclosure of cash flow information:

Cash paid for interest	\$ 27,348	\$ 35,578
Cash paid for income taxes	\$ 28,638,096	\$ 23,869,294

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

KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2007

(Unaudited)

1. Organization and Description of the Business

Knight Capital Group, Inc. and its subsidiaries (the Company) have two operating business segments, Asset Management and Global Markets, as well as a Corporate segment. As of March 31, 2007, the Company's operating business segments from continuing operations comprised the following operating subsidiaries:

Asset Management

Deephaven Capital Management LLC (Deephaven) is the registered investment adviser to and sponsor of the Deephaven investment funds (the Deephaven Funds). In addition to being registered as an Investment Adviser with the Securities and Exchange Commission (SEC or Commission), Deephaven is also registered with the Commodity Futures Trading Commission (CFTC) as a commodity pool operator and a commodity trading adviser, and is a member of the National Futures Association (NFA). Due to the nature of Deephaven's investor base, however, Deephaven is not registered as either a Futures Commission Merchant or Introducing Broker with the CFTC/NFA and is exempt from many of the CFTC/NFA regulations. Deephaven also has a U.K. registered investment adviser subsidiary, which is regulated by the Financial Services Authority (FSA) in the U.K., and a Hong Kong registered investment adviser subsidiary, which is regulated by the Hong Kong Securities and Futures Commission.

Global Markets

Knight Equity Markets, L.P. (KEM) operates as a market-maker in over-the-counter (OTC) equity securities, primarily those traded in the Nasdaq Stock Market and on the OTC Bulletin Board. KEM also operates the Company's primary domestic institutional sales business. Donaldson & Co., a division of KEM, offers soft dollar and commission recapture services. KEM is a broker-dealer registered with the SEC and is a member of the Nasdaq Stock Exchange (Nasdaq), National Association of Securities Dealers, Inc. (NASD), the International Securities Exchange, LLC, the National Stock Exchange and the NFA.

Knight Capital Markets LLC (KCM) primarily operates as a market-maker in the Nasdaq Intermarket and the over-the-counter market for New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) listed securities. KCM is a broker-dealer registered with the SEC and is a member of Nasdaq and the NASD.

Knight Equity Markets International Limited (KEMIL) is a U.K. registered broker-dealer that provides execution services for institutional and broker-dealer clients in U.S., European and international equities. KEMIL is authorized and regulated by the FSA and is a member of the London Stock Exchange, Deutsche Börse AG, Euronext N.V. (incorporating Euronext Amsterdam, Euronext Brussels, Euronext Lisbon and Euronext Paris), Borsa Italiana, OMX (incorporating the Copenhagen Stock Exchange, Helsinki Stock Exchange and Stockholm Stock Exchange), Oslo Børs and virt-x.

Direct Trading Institutional, L.P. (Direct Trading) provides institutions with direct market access trading through Knight Direct, an advanced electronic platform. Direct Trading is a broker-dealer registered with the SEC and is a member of Nasdaq, the NASD and the NFA.

Edgar Filing: KNIGHT CAPITAL GROUP, INC. - Form 10-Q

Direct Edge ECN LLC (Direct Edge) operates as an electronic communications network (ECN). Direct Edge is a liquidity destination offering the ability to match trades in Nasdaq Global Market, Nasdaq Global Select Market, Nasdaq Capital Market and NYSE and AMEX listed securities by displaying orders in the NASD Alternative Display Facility. Direct Edge is a broker-dealer registered with the SEC and is a member of Nasdaq, the NASD, the National Stock Exchange, Chicago Stock Exchange, CBOE Stock Exchange, Boston Stock Exchange and NYSE Arca, Inc.

Hotspot FX, Inc. and its subsidiaries (Hotspot) provide institutions, dealers and retail clients with spot foreign exchange executions through an advanced, fully electronic platform. Hotspot was acquired by the Company in April 2006. One Hotspot subsidiary is regulated by the FSA and another Hotspot subsidiary is a Futures Commission Merchant registered with the CFTC and is a member of the NFA.

ValuBond Securities, Inc. (ValuBond) provides electronic access and trade execution products for the fixed income market. ValuBond was acquired by the Company in October 2006. ValuBond is registered with the SEC and is a member of the NASD and the Municipal Securities Rulemaking Board (MSRB).

The Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and the corporate investment in the Deephaven Funds. Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses related to corporate matters, directors' fees, investor and public relations expenses and directors' and officers' insurance.

Discontinued Operations

The Company completed the sale of its Derivative Markets business to Citigroup Financial Products Inc. (Citigroup) for \$237 million in December of 2004. Costs associated with the Derivative Markets segment have been included within discontinued operations for the three months ended March 31, 2007. For a further discussion of the sale of the Company's Derivative Markets business and its associated accounting treatment, see Footnote 9 Discontinued Operations.

2. Significant Accounting Policies

Basis of consolidation and form of presentation

The accompanying unaudited consolidated financial statements include the accounts of the Company and its subsidiaries and, in the opinion of management, reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim period. All significant intercompany transactions and balances within continuing operations have been eliminated. Certain footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to SEC rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. The nature of the Company's business is such that the results of an interim period are not necessarily indicative of the results for the full year. These unaudited consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 as filed with the SEC.

Certain prior period amounts have been reclassified to conform to the current period presentation.

Cash and cash equivalents

Cash and cash equivalents include money market accounts, which are payable on demand, and short-term investments with an original maturity of less than 90 days. The carrying amount of such cash equivalents approximates their fair value due to the short-term nature of these instruments.

Market making and sales activities

Securities owned and securities sold, not yet purchased, which primarily consist of listed and OTC equities, are carried at market value and are recorded on a trade date basis. Net trading revenue (trading gains, net of trading losses) and commissions (which includes commission equivalents earned on institutional client orders) and related expenses are also recorded on a trade date basis.

Payments for order flow and ECN rebates represent payments to broker-dealer clients, in the normal course of business, for directing their order flow in U.S. equities to the Company, and rebates for providing liquidity to Direct Edge. Soft dollar and commission recapture expense represents payments to institutions in connection with soft dollar and commission recapture programs. The Company's clearing agreements call for payment or receipt of interest income, net of interest expense, for facilitating the settlement and financing of securities transactions.

Asset management fees

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

Estimated fair value of financial instruments

The market value of securities owned and securities sold, not yet purchased is estimated using market quotations available from major securities exchanges, clearing brokers and dealers. Management estimates that the fair values of other financial instruments recognized on the Consolidated Statements of Financial Condition (including receivables, payables and accrued expenses) approximate their carrying values, as such financial instruments are short-term in nature, bear interest at current market rates or are subject to frequent repricing.

Goodwill and intangible assets

The Company applies the provisions of Statement of Financial Accounting Standards (SFAS) No. 142 *Goodwill and Other Intangible Assets*, which requires that goodwill and intangible assets with an indefinite useful life no longer be amortized, but instead, be tested for impairment annually or when an event occurs or circumstances change that signify the existence of impairment. Other intangible assets are amortized on a straight line basis over their useful lives.

Strategic investments

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

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

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

Treasury stock

The Company records its purchases of treasury stock at cost as a separate component of Stockholders' equity. The Company obtains treasury stock through purchases in the open market or through privately negotiated transactions.

Foreign currencies

The functional currency of the Company's foreign subsidiaries is the U.S. dollar. Assets and liabilities in foreign currencies are translated into U.S. dollars using current exchange rates at the date of the Consolidated Statements of Financial Condition. Revenues and expenses are translated at average rates during the periods. Gains or losses resulting from foreign currency transactions are included in Investment income and other on the Company's Consolidated Statements of Operations.

Depreciation, amortization and occupancy

Fixed assets are being depreciated on a straight-line basis over their estimated useful lives of three to seven years. Leasehold improvements are being amortized on a straight-line basis over the shorter of the life of the related office lease or the expected useful life of the assets. The Company records rent expense on a straight-line basis over the lives of the leases. The Company capitalizes certain costs associated with the acquisition or development of internal-use software and amortizes the software over its estimated useful life of three years, commencing at the time the software is placed in service.

Writedown of fixed assets

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

Lease loss accrual

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

Income taxes

The Company records deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities and measures them using the enacted tax rates and laws that will be in effect when such differences are expected to reverse. The Company evaluates the recoverability of future tax deductions by assessing the adequacy of future expected taxable income from all sources, including reversal of temporary differences and forecasted operating earnings. Net deferred tax assets and liabilities are included in Other assets and Accrued expenses and other liabilities, respectively, on the Consolidated Statements of Financial Condition.

On January 1, 2007 the Company adopted Financial Standards Accounting Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48). The Company recognized no material adjustment in the liability for unrecognized income tax benefits as a result of the implementation of FIN 48.

Stock-based compensation

On January 1, 2006, the Company adopted SFAS No. 123-R, *Share-Based Payment* (SFAS No. 123-R), using the modified prospective method. Under SFAS No. 123-R, the grant date fair values of stock-based employee awards that require future service are amortized over the relevant service period.

Upon the adoption of SFAS No. 123-R, the Company changed its expense attribution method for options. For option awards granted subsequent to the adoption of SFAS No. 123-R, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award, which is the same methodology that the Company uses to account for restricted share awards. For unvested option awards granted prior to the adoption of SFAS No. 123-R, the Company continues to recognize compensation cost using a graded-vesting method (as it had on a pro-forma basis previously). The graded-vesting method recognizes compensation cost separately for each vesting tranche.

SFAS No. 123-R requires expected forfeitures to be considered in determining stock-based employee compensation expense. For all periods presented, the Company recorded a benefit for expected forfeitures on all outstanding stock-based awards.

For stock-based payments issued after the adoption of SFAS No. 123-R, the Company applies a non-substantive vesting period approach whereby the expense is accelerated for those employees and directors that receive awards and are eligible to retire prior to the award vesting. Prior to the adoption of SFAS No. 123-R, the Company applied a nominal vesting approach for employee stock-based compensation awards with retirement eligible provisions. Under the nominal vesting approach, the Company recognized actual and pro-forma compensation cost over the vesting period and, if the employee retired before the end of the vesting period, the Company recognized any remaining unrecognized compensation cost at the date of retirement. The impact of this change in the vesting period approach did not have a material impact on the results of operations for the periods presented herein.

Other

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

3. Securities Owned and Securities Sold, Not Yet Purchased

Securities owned and securities sold, not yet purchased are carried at market value and consist of the following (in millions):

	March 31, 2007	December 31, 2006
Securities owned:		
Equities	\$ 702.5	\$ 703.0
U.S. government obligations	8.9	8.8
	\$ 711.4	\$ 711.8
Securities sold, not yet purchased:		
Equities	\$ 690.3	\$ 693.1
	\$ 690.3	\$ 693.1

4. Receivable from and Payable to Brokers and Dealers

Amounts receivable from and payable to brokers and dealers consist of the following (in millions):

	March 31, 2007	December 31, 2006
Receivable:		
Clearing brokers and other	\$ 278.8	\$ 305.3
Securities failed to deliver	64.0	42.3
Deposits for securities borrowed	8.9	25.2
	\$ 351.8	\$ 372.9
Payable:		
Securities failed to receive	\$ 43.0	\$ 34.4
Clearing brokers and other	10.5	13.4
	\$ 53.4	\$ 47.9

5. Goodwill and Intangible Assets

Goodwill and intangible assets with indefinite useful lives are tested for impairment annually or when an event occurs or circumstances change that signify the existence of impairment. As part of the test for impairment, the Company considers the profitability of the respective segment or reporting unit, an assessment of the fair value of the respective segment or reporting unit as well as the overall market value of the Company compared to its net book value. In June 2006, the Company tested for the impairment of goodwill and intangible assets and concluded that there was no impairment.

The goodwill balance of \$133.1 million at March 31, 2007 relates to the Global Markets business segment. Goodwill is net of accumulated amortization of \$21.9 million recorded through December 31, 2001, the effective date the Company adopted SFAS No. 142. Goodwill primarily represents the Company's purchases of the businesses now operating as KCM, Direct Trading, Direct Edge, Hotspot, Donaldson and ValuBond.

The Company had intangible assets, net of accumulated amortization, of \$62.3 million and \$63.7 million at March 31, 2007 and December 31, 2006, respectively, all included within the Global Markets business segment. Intangible assets decreased by \$1.4 million during the three months ended March 31, 2007 due to amortization expense. Intangible assets primarily represent client relationships and are being amortized over their remaining useful lives, the majority of which have been determined to range from eight to thirty years.

The Company recorded amortization expense, related to its intangible assets of \$1.4 million and \$735,000 for the three months ended March 31, 2007 and 2006, respectively. The estimated amortization expense relating to the intangible assets for each of the next five years approximates \$4.3 million in 2007, \$5.7 million in 2008, \$5.1 million in 2009, and \$4.9 million in each of 2010 and 2011.

The chart below summarizes the activity of the Company's Goodwill and Intangible assets, net of accumulated amortization, from continuing operations, for the three months ended March 31, 2007 (in millions):

	Goodwill	Intangible Assets
Balance at January 1, 2006	\$ 47.7	\$ 29.8
Contingent payments on purchases of businesses	1.5	
Amortization expense		(0.7)
Balance at March 31, 2006	\$ 49.2	\$ 29.0
Balance at January 1, 2007	\$ 133.1	\$ 63.7
Amortization expense		(1.4)

Balance at March 31, 2007	\$ 133.1	\$ 62.3
---------------------------	----------	---------

6. Investment in Deephaven Sponsored Funds and Strategic Investments

The Company's wholly-owned subsidiary, Deephaven, is the registered investment adviser and sponsor of the Deephaven Funds, which engage in various trading strategies involving equities, debt instruments and derivatives. The underlying investments in the Deephaven Funds are carried at market value. Of the \$3.6 billion and \$4.2 billion of assets under management in the Deephaven Funds as of March 31, 2007 and December 31, 2006, respectively, the Company had corporate investments of \$195.4 million and \$187.6 million, respectively. Other assets on the Consolidated Statements of Financial Condition at March 31, 2007 and December 31, 2006 included \$52.6 million and \$31.6 million, respectively, of investments in the Deephaven Funds related to employee deferred compensation plans. Certain officers, directors and employees of the Company held direct investments of approximately \$9.5 million and \$6.2 million in the Deephaven Funds, in the aggregate, as of March 31, 2007 and December 31, 2006, respectively.

Included in Investment income and other on the Company's Consolidated Statements of Operations is income from the Company's corporate investments in the Deephaven Funds of \$8.0 million and \$19.0 million for the three months ended March 31, 2007 and 2006, respectively.

In connection with the sale of the Derivative Markets business in December 2004 (see Footnote 9, *Discontinued Operations*) and in light of the reorganization of the Company's business segments, the Company transferred its investment in the International Securities Exchange, Inc. (ISE), which was previously held by its broker-dealer subsidiaries, to a corporate investment holding company. During the first quarter of 2005, this equity investment became marketable and, accordingly, was accounted for as an equity security under SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities* and was classified as an available-for-sale security. The Company sold all of its remaining shares of the ISE in the last nine months of 2006 for a pre-tax gain of \$30.1 million. As of March 31, 2006, the Company owned 743,000 shares of common stock in the ISE, which had an aggregate fair value and amortized cost of \$30.9 million and \$2.9 million, respectively.

7. Significant Clients

The Company considers significant clients to be those clients who account for 10% or more of the total U.S. equity dollar value traded by the Company during the period. No clients accounted for more than 10% of the Company's U.S. equity dollar value traded during the three months ended March 31, 2007. One client accounted for approximately 11.4% of the Company's U.S. equity dollar value traded during the three months ended March 31, 2006.

No investor accounted for more than 10% of the Deephaven Funds' asset under management as of March 31, 2007. One investor accounted for 10.2% of the Deephaven Funds' asset under management as of March 31, 2006.

8. Writedown of Assets and Lease Loss Accrual

There were no charges for Writedown of assets and lease loss accrual during the three months ended March 31, 2007.

The Writedown of assets and lease loss accrual for the three months ended March 31, 2006 were \$8.0 million. The charge primarily related to costs associated with excess real estate capacity at the Company's 545 Washington Boulevard facility in Jersey City, N.J.

9. Discontinued Operations

The Company completed the sale of its Derivative Markets business to Citigroup for \$237 million in cash in December 2004. In accordance with SFAS No. 144, the results of the Derivative Markets business segment, the

revenues and expenses associated with these businesses as well as all costs associated with the sale transaction have been included in Loss from discontinued operations, net of tax on the Consolidated Statements of Operations for all periods presented. As described in Footnote 11

Regulatory Charges and Related Matters, during the first quarter of 2007, the Company recorded a charge of \$1.3 million, net of taxes, related to a regulatory matter involving the Derivative Markets segment.

	Three months ending March 31, 2007	
Revenues	\$	
Pre-tax loss from discontinued operations	\$	(2.0)
Income tax benefit		0.6
Loss from discontinued operations, net of tax	\$	(1.3)

10. Commitments and Contingent Liabilities

In the ordinary course of business, the nature of the Company's business subjects it to claims, lawsuits, regulatory examinations and other proceedings. We are subject to several of these matters at the present time. The results of these matters cannot be predicted with certainty. There can be no assurance that these matters will not have a material adverse effect on the Company's results of operations in any future period and a material judgment could have a material adverse impact on the Company's financial condition and results of operations. However, it is the opinion of management, after consultation with legal counsel that, based on information currently available, the ultimate outcome of these matters will not have a material adverse impact on the business, financial condition or operating results of the Company although they might be material to the operating results for any particular period, depending, in part, upon operating results for that period.

The Company leases office space under noncancelable operating leases. Certain office leases contain fixed escalation clauses. Rental expense from continuing operations under the office leases was \$2.2 million and \$2.1 million for the three months ended March 31, 2007 and 2006, respectively and is included in Occupancy and equipment rentals on the Consolidated Statements of Operations.

The Company leases certain computer and other equipment under noncancelable operating leases and has entered into guaranteed employment contracts with certain of its employees. As of March 31, 2007, future minimum rental commitments under all noncancelable office, computer and equipment leases (Operating Leases), and guaranteed employment contracts longer than one year (Other Obligations) were as follows (in millions):

	Operating Leases	Other Obligations	Total
Nine months ending December 31, 2007	\$ 8.5	\$ 41.2	\$ 49.7
Year ending December 31, 2008	10.9	32.0	42.9
Year ending December 31, 2009	10.4	14.9	25.3
Year ending December 31, 2010	9.8		9.8
Year ending December 31, 2011	10.2		10.2
Thereafter through October 31, 2021	101.9		101.9
	\$ 151.7	\$ 88.1	\$ 239.8

During the normal course of business, the Company collateralizes certain leases or other contractual obligations through letters of credit or segregated funds held in escrow accounts. As of March 31, 2007, the Company has provided a letter of credit for \$6.0 million, collateralized by U.S. Treasury Bills, as a guarantee for one of the Company's lease obligations.

In 2003, the Company entered into long-term employment contracts with certain senior managers of Deephaven. These employment agreements, which became effective on January 1, 2004, had a three-year term which expired on December 31, 2006. The agreements provided for profit sharing bonuses based on the financial performance of Deephaven, which, for 2005 and 2006, represented 50% of pre-tax earnings prior to the profit-sharing bonuses. The employment agreements included an option for renewal by the Deephaven managers through 2009 under the identical financial terms; however, the renewal option was not exercised. Pursuant to the terms of a simultaneously executed option agreement between the Company and these senior Deephaven managers, in the event of a change of control of the Company during the initial three-year employment term, the Deephaven senior managers had the option to obtain a 51% interest in Deephaven in exchange for the termination of their employment contracts and associated profit-sharing bonuses. As the Company did not experience a change of control during the term of these employment contracts, this option expired.

In December 2006, the Company entered into new long-term employment agreements with three senior managers of Deephaven (the Deephaven Managers), two of whom were parties to the 2003 agreements. The new agreements, which became effective on January 1, 2007, are for three-year terms and include a right of renewal by the Deephaven Managers through 2012 under certain circumstances. The new employment agreements provide profit-sharing bonuses based on the financial performance of Deephaven. According to the terms of the contracts, the Deephaven Managers will receive 50% of the first \$60 million, and 75% thereafter, of pre-tax earnings prior to the profit-sharing bonuses. The Deephaven Managers also received one million shares of Knight restricted common stock, which vest ratably over three years.

Effective January 1, 2007, the Deephaven Managers were also granted an option (the Option), exercisable after January 1, 2008 and until December 31, 2012, and conditioned on meeting certain requirements, to obtain a 49% interest in Deephaven (or a new limited liability company to which the Company's interests in Deephaven would be contributed) in exchange for the termination of their new employment agreements and associated profit-sharing bonuses. The agreement also provides that in the event of a change of control of the Company following January 1, 2007 and prior to December 31, 2012, the Deephaven Managers would have the option (the Change of Control Option), in exchange for the termination of their new employment contracts and associated profit-sharing bonuses, to obtain a 51% interest in Deephaven or, if the Option has already been exercised, to increase their 49% interest resulting from the exercise of the Option by an additional 2%. Following any exercise of the Option or Change of Control Option by the Deephaven Managers, pre-tax earnings prior to profit sharing will be allocated between Knight and the Deephaven Managers in the same manner as under the new employment agreements. During the life of the Option, the agreements provide that the Company may not sell Deephaven without the approval of the Deephaven Managers.

11. Regulatory Charges and Related Matters

In 2006, the Company received a request from the staff of the SEC for voluntary production of certain documentation related to options activities of its former Derivative Markets business segment which, prior to its sale by the Company in December 2004, was primarily operated through Knight Financial Products LLC. The Company believes this request is part of a broader review by the staff of the SEC regarding certain trading practices in the options industry during the period 1999-2005. The Company responded to this request and is cooperating with the staff of the SEC and certain regional exchanges to resolve this matter. During the first quarter of 2007, the Company recorded a charge of \$1.3 million, net of tax, relating to this matter. This charge has been reported in discontinued operations.

12. Comprehensive Income

Comprehensive income includes net income and changes in equity except those resulting from investments by, or distributions to, stockholders. Comprehensive income for the three months ended March 31, 2007 and 2006 is (in millions):

	For the three months ended March 31,	
	2007	2006
Net income	\$ 31.9	\$ 49.1
Other comprehensive income, net of tax:		
Net unrealized gains on investment securities held as available-for-sale		6.2
Total comprehensive income, net of tax	\$ 31.9	\$ 55.3

For the three months ended March 31, 2006, Other comprehensive income, net of tax, represents net unrealized gains on the Company's strategic investment in the ISE. The Company did not hold any available-for-sale securities during the three months ended March 31, 2007.

13. Earnings per Share

Basic earnings per common share (EPS) has been calculated by dividing net income by the weighted average shares of Class A Common Stock outstanding during each respective period. Diluted EPS reflects the potential reduction in EPS using the treasury stock method to reflect the impact of common stock equivalents if stock awards such as stock options and restricted stock were exercised or converted into common stock.

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations from continuing operations for the three months ended March 31, 2007 and 2006 (in millions, except per share data):

	For the three months ended March 31,			
	2007			2006
	Numerator / net income	Denominator / shares	Numerator / net income	Denominator / shares
Income and shares used in basic calculations	\$ 33.2	100.9	\$ 49.1	100.4
Effect of dilutive stock based awards		3.4		3.7
Income and shares used in diluted calculations	\$ 33.2	104.3	\$ 49.1	104.1
Basic earnings per share from continuing operations		\$ 0.33		\$ 0.49
Diluted earnings per share from continuing operations		\$ 0.32		\$ 0.47

14. Stock-Based Compensation

The Company has established the Knight Capital Group, Inc. 1998 Long Term Incentive Plan, the Knight Capital Group, Inc. 1998 Nonemployee Director Stock Option Plan, the Knight Capital Group, Inc. 2003 Equity Incentive Plan and the Knight Capital Group, Inc. 2006 Equity Incentive Plan (the 2006 Plan) (collectively, the Stock Plans). The purpose of the Stock Plans is to provide long-term incentive compensation to employees and directors of the Company. The Stock Plans are administered by the Compensation Committee of the Company's Board of Directors, and allow for the grant of options, stock appreciation rights (2006 Plan only), restricted stock and restricted stock units (collectively, the awards), as defined by the Stock Plans. The Stock Plans limit the number of awards that may be granted to a single individual as well as limit the amount of options, stock appreciation rights (2006 Plan only) or shares of restricted stock or restricted stock units that may be awarded. As of March 31, 2007, the Company has not issued any stock appreciation rights or restricted stock units.

Restricted Shares

Eligible employees receive restricted shares as a portion of their total compensation. Restricted share awards generally vest ratably over three years. The Company has the right to fully vest employees in their awards upon retirement and in certain other circumstances. Awards are otherwise canceled if employment is terminated before the end of the relevant vesting period.

The Company measures compensation cost related to restricted shares based on the market value of the Company's common stock at the date of grant, which the Stock Plans define as the average of the high and low sales price on the date prior to the grant date. For the three months ended March 31, 2007 and 2006, the Company recorded compensation expense of \$6.3 million and \$3.8 million, respectively, relating to restricted shares, which has been included in Employee compensation and benefits on the Consolidated Statements of Operations.

The following table summarizes restricted share activity during the three months ended March 31, 2007 (shares in millions):

	Number of Restricted Shares	Weighted- Average Grant date Fair Value
Outstanding at January 1, 2007	2.7	\$ 11.55
Granted	2.3	18.65
Vested	(0.7)	11.43
Surrendered	(0.0)	11.10
Outstanding at March 31, 2007	4.2	\$ 15.43

There is \$53.5 million of unamortized compensation related to the unvested restricted shares outstanding at March 31, 2007. The cost of these unvested restricted shares is expected to be recognized over a weighted average life of 2.0 years.

Stock Options

The Company's policy is to grant options for the purchase of shares of Class A Common Stock at not less than market value, which the Stock Plans define as the average of the high and low sales price on the date prior to the grant date. Options generally vest ratably over a three or four-year period and expire on the fifth or tenth anniversary of the grant date, pursuant to the terms of the applicable option award agreement. The Company has the right to fully vest employees in their awards upon retirement and in certain other circumstances. Awards are otherwise canceled if employment is terminated before the end of the relevant vesting period. The Company's policy is to issue new shares upon share option exercises by its employees.

The fair value of each option granted is estimated as of its respective grant date using the Black-Scholes option-pricing model. Stock options granted have exercise prices equal to the market value of the Company's common stock at the date of grant as defined by the Stock Plans. The principal assumptions utilized in valuing options and the methodology for estimating such model inputs include: 1) risk-free interest rate estimate is based on the yield of U.S. zero coupon securities with a maturity equal to the expected life of the option; 2) expected volatility estimate is based on several factors including implied volatility of market-traded options on the Company's common stock on the grant date and the historical volatility of the Company's common stock; and 3) expected option life estimate is based on internal studies of historical experience and projected exercise behavior based on different employee groups and specific option characteristics, including the effect of employee terminations. Based on the results of the model, the weighted-average fair value of the stock options granted during the quarter ended March 31, 2007 and 2006 was \$6.28 and \$3.87 per option, respectively.

For the three months ended March 31, 2007, the Company recorded compensation expense of \$1.6 million relating to options, which has been included in Employee compensation and benefits on the Consolidated Statements of Operations.

The following table summarizes stock option activity during the three months ended March 31, 2007 (options in millions):

	Number of Options	Weighed- Average Exercise Price
Outstanding at January 1, 2007	8.8	\$ 9.43
Granted at market value	0.5	17.93
Exercised	(1.7)	5.95
Surrendered	(0.1)	20.08
Outstanding at March 31, 2007	7.6	\$ 10.64
Vested at March 31, 2007	4.1	\$ 9.77
Available for future grants at March 31, 2007*	11.6	

* represents both options and awards available for grant

There is \$7.6 million of unrecognized compensation related to unvested stock options outstanding at March 31, 2007. The cost of these unvested awards is expected to be recognized over a weighted average life of 1.4 years.

15. Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return as well as combined state income tax returns in certain jurisdictions. In other jurisdictions, the Company and its subsidiaries file separate company state income tax returns.

The following table reconciles the U.S. federal statutory income tax rate from continuing operations to the Company's actual income tax rate:

	For the three months ended March 31,	
	2007	2006
Income tax expense at the U.S. federal statutory rate	35.0%	35.0%
U.S. state and local income tax expense, net of U.S. federal income tax effect	3.9%	4.9%
Other, net	0.4%	0.2%
Income tax expense	39.3%	40.1%

Effective January 1, 2007 the Company adopted FIN 48. The Company recognized no material adjustment in the liability for unrecognized income tax benefits as a result of the implementation of FIN 48. At the adoption date of January 1, 2007 and at March 31, 2007, the Company had \$0.9 million of unrecognized tax benefits, all of which would affect the Company's effective tax rate if recognized.

As of January 1, 2007, the Company is subject to U.S. Federal income tax examinations for the tax years 2004 through 2005, and to non-U.S. income tax examinations for the tax years of 2002 through 2005. In addition, the Company is subject to state and local income tax examinations in various jurisdictions for the tax years 2000 through 2005.

The Company's policy for recording interest and penalties associated with audits is to record such items as a component of Income from continuing operations before income taxes. Penalties are recorded in Other expenses and interest paid or received is recorded in Interest and dividends, net, in the Consolidated Statements of Operations.

16. Business Segments

The Company currently has two operating business segments, Asset Management and Global Markets as well as a Corporate segment. The Asset Management segment consists of investment management and sponsorship of the Deephaven Funds. The Global Markets segment offers superior execution quality through natural liquidity, capital facilitation and trading technology, with comprehensive products and services that support the capital formation process. The Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and the Company's corporate investment in the Deephaven Funds. Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses relating to corporate matters, directors' fees, investor and public relations expenses and directors' and officers' insurance.

The Company's revenues, income from continuing operations before income taxes and total assets by segment are summarized below (amounts in millions).

	Asset Management	Global Markets	Corporate	Consolidated Total
<i>For the three months ended March 31, 2007:</i>				
Revenues	\$ 61.2	\$ 172.6	\$ 7.8	\$ 241.7
Income from continuing operations before income taxes	18.9	36.1	(0.3)	54.7
Total assets	206.5	1,728.1	28.2	1,962.8
<i>For the three months ended March 31, 2006:</i>				
Revenues	\$ 70.8	\$ 188.7	\$ 17.7	\$ 277.2
Income from continuing operations before income taxes ¹	26.8	48.5	6.7	82.0
Total assets	106.8	1,190.6	427.6	1,725.0

¹ Global Markets segment includes \$8.0 million in Writedown of assets and lease loss accrual for the three months ended March 31, 2006 (described in Footnote 8).

Totals may not add due to rounding

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our results of operations should be read in conjunction with our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006 as filed with the Securities and Exchange Commission (SEC). This discussion contains forward-looking statements that involve risks and uncertainties, including those discussed in our Form 10-K. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth elsewhere in this document and in our Form 10-K.

Certain statements contained in this Quarterly Report on Form 10-Q, including without limitation, those under Management's Discussion and Analysis of Financial Condition and Results of Operations herein (MD&A), Quantitative and Qualitative Disclosures About Market Risk in Part I, Item 3, and Legal Proceedings in Part II, Item 1, and the documents incorporated by reference, may constitute forward-looking statements. These forward-looking statements are not historical facts, and are based on current expectations, estimates and projections about the Company's industry, management's beliefs and certain assumptions made by management, many of which, by their nature, are inherently uncertain and beyond our control. Accordingly, readers are cautioned that any such forward-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict including, without limitation, risks associated with the costs, integration, performance and operation of the businesses recently acquired, or that may be acquired in the future, by the Company and the risks associated with the recent change in management at Deephaven Capital Management LLC (together with its subsidiaries, Deephaven) and the potential impact on the Deephaven business and assets under management. 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 within MD&A herein, in Risk Factors in the Company's Annual Report on Form 10-K, and in other reports or documents the Company files from time to time with the SEC. This discussion should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto contained in this report.

Executive Overview

We are a leading financial services firm that provides voice and electronic access to the capital markets across multiple asset classes for buy-side, sell-side and corporate clients, and asset management for institutions and private clients. We continually apply knowledge and innovation to the trading and asset management processes to build lasting client partnerships through consistent performance and superior client service. We have two operating business segments, Asset Management and Global Markets, as well as a Corporate segment.

Asset Management Our Asset Management business, Deephaven Capital Management (Deephaven), is a global, multi-strategy alternative investment manager focused on delivering attractive risk-adjusted returns with low correlation to the broader markets for institutions and private clients. Assets under management were \$3.9 billion as of April 1, 2007, up from \$3.1 billion as of April 1, 2006.

Global Markets Our Global Markets business offers superior execution quality through natural liquidity, capital facilitation and trading technology, with comprehensive products and services that support the capital formation process. We make a market or trade in nearly every U.S. equity security and provide trade execution services in a large number of international securities, futures, options, foreign currencies and fixed income instruments.

The Company's Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and our corporate investment in funds managed by the Asset Management segment (the

Deephaven Funds). Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses related to corporate matters, directors' fees, investor and public relations expenses and directors' and officers' insurance.

In December 2004, the Company completed the sale of one of its business segments, Derivative Markets, to Citigroup Financial Products Inc. (Citigroup). In accordance with generally accepted accounting principles (GAAP), the results of this segment have been included within discontinued operations for all periods presented. For a further discussion of the sale of the Company's Derivative Markets business, see Footnote 9 Discontinued Operations included in Part I, Item 1 Financial Statements of this document

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

	For the three months ended	
	March 31, 2007	March 31, 2006
Asset Management		
Revenues	\$ 61.2	\$ 70.8
Operating Expenses	42.3	44.1
Pre-Tax Operating Earnings	18.9	26.8
Global Markets		
Revenues	172.6	188.7
Operating Expenses	136.5	132.1
Pre-Tax Operating Earnings	36.1	56.5
Corporate		
Revenues	7.8	17.7
Operating Expenses	8.2	11.0
Pre-Tax Operating Earnings	(0.3)	6.7
Consolidated		
Revenues	241.7	277.2
Operating Expenses	186.9	187.2
Pre-Tax Operating Earnings	\$ 54.7	\$ 90.0

* Totals may not add due to rounding.

Consolidated Revenues for the three months ended March 31, 2007 decreased \$35.5 million, or 12.8% from the same period a year ago, while Consolidated Operating Expenses remained virtually unchanged. Overall, Consolidated Pre-Tax Operating Earnings for the three months ended March 31, 2007 decreased \$35.3 million from the same period a year ago.

The changes in our Pre-Tax Operating Earnings by segment from the three months ended March 31, 2006 to the three months ended March 31, 2007, respectively, are summarized as follows:

Asset Management Our Pre-Tax Operating Earnings from Asset Management for the three months ended March 31, 2007 decreased by \$7.9 million, or 29.3%, from the comparable period in 2006 primarily due to lower incentive fees as a result of lower fund returns,

Edgar Filing: KNIGHT CAPITAL GROUP, INC. - Form 10-Q

offset in part by higher management fees from higher average assets under management.

Global Markets Our Pre-Tax Operating Earnings from Global Markets for the three months ended March 31, 2007 decreased by \$20.4 million, or 36.0%, from the comparable period in 2006, primarily due to fewer shares traded and decreased revenue capture.

Corporate Our Pre-Tax Operating Earnings from our Corporate segment for the three months ended March 31, 2007 decreased by \$7.1 million, primarily due to lower returns on, and the average monthly investment balance in, our Deephaven corporate investments.

A reconciliation of income from continuing operations before income taxes in accordance with GAAP (Pre-Tax GAAP Income) to Pre-Tax Operating Earnings and of total GAAP expenses to Operating Expenses is included elsewhere in this section.

Certain Factors Affecting Results of Operations

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

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

Trends

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

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

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

There has been consolidation among market centers over the past several years, and several regional exchanges have entered into joint ventures with broker-dealers to create their own alternative trading

systems (i.e. ECNs) and compete within the OTC and listed trading venues. In addition, many broker-dealers are offering their own internal crossing networks creating further fragmentation in the marketplace.

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

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

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

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

Income Statement Items

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

Revenues

Our revenues consist principally of Commissions and fees and Net trading revenue from Global Markets and Asset management fees from Asset Management.

Revenues on transactions for which we charge explicit commissions or commission equivalents, which include the majority of our institutional client orders, are included within Commissions and fees. Commissions and fees are primarily affected by changes in our equity transaction volumes with institutional clients, changes in commission rates, the growth of Direct Trading, Direct Edge, Hotspot and ValuBond and the growth of our soft dollar and commission recapture activity.

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

Asset management fees represent fees earned by Deephaven for sponsoring and managing the Deephaven Funds as well as fees earned from separately managed accounts. These fees consist of annual management fees, calculated as fixed percentages of assets under management, and incentive fees, generally calculated as a percentage of the funds and managed accounts year-to-date profits, if any.

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

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

Transaction-based expenses

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

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

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

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

Other direct expenses

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

Employee compensation and benefits expense, our largest expense, primarily consists of salaries and wages paid to all employees and profitability-based compensation, which includes compensation paid to sales personnel and incentive compensation paid to all other employees based on our profitability. Compensation for employees engaged in sales activities is determined primarily based on a percentage of their gross revenues net of certain transaction-based expenses. The majority of compensation in Asset Management is determined by formulas based upon the profitability of the Asset Management segment, subject to certain minimum guaranteed payments. Employee compensation and benefits expense fluctuates, for the most part, based on changes in our revenues, profitability and the number of employees.

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

Three Months Ended March 31, 2007 and 2006**Continuing Operations***Revenues*

	For the three months ended March 31,		Change	% of Change
	2007	2006		
Incentive fees (millions)	\$ 49.4	\$ 62.9	\$ (13.5)	-21.5%
Management fees (millions)	11.3	7.6	3.7	49.2%
Interest income and other (millions)	0.5	0.3	0.2	57.6%
Total Revenues from Asset Management (in millions)	\$ 61.2	\$ 70.8	\$ (9.6)	-13.6%
Average month-end balance of assets under management (millions)	\$ 4,071.5	\$ 2,946.2	\$ 1,125.2	38.2%
Quarterly fund return to investors*	4.9%	8.5%	-3.6%	-42.5%

* Quarterly fund return represents the blended quarterly return across all assets under management in the Deephaven Funds.

Total revenues from the Asset Management segment, which primarily consists of incentive fees, decreased 13.6% to \$61.2 million for the three months ended March 31, 2007, from \$70.8 million for the comparable period in 2006. The decrease is primarily due to lower incentive fees as a result of decreased fund returns, offset in part by an increase in management fees due to higher average assets under management. The average month-end balance of assets under management for the three months ended March 31, 2007 was \$4.1 billion, up from \$2.9 billion for the comparable period in 2006. The blended quarterly fund return across all assets under management for the three months ended March 31, 2007 was a gain of 4.9%, down from a gain of 8.5% for the comparable period in 2006.

	For the three months ended March 31,		Change	% of Change
	2007	2006		
Commissions and fees (millions)	\$ 103.9	\$ 102.6	\$ 1.2	1.2%
Net trading revenue (millions)	61.6	80.0	(18.4)	-23.0%
Interest and dividends, net (millions)	4.3	2.4	1.9	80.8%
Investment income and other (millions)	2.8	3.6	(0.8)	-22.0%
Total Revenues from Global Markets (millions)	\$ 172.6	\$ 188.7	\$ (16.1)	-8.5%
U.S. equity dollar value traded (\$ billions)	562.5	559.7	2.8	0.5%
U.S. equity trades executed (millions)	66.9	61.0	5.9	9.6%
Nasdaq and Listed equity shares traded (billions)	23.8	27.9	(4.1)	-14.7%
OTC Bulletin Board and Pink Sheet shares traded (billions)	218.8	373.7	(154.9)	-41.4%
Average revenue capture per U.S. equity dollar value traded (bps)	2.0	2.3	(0.3)	-14.2%

Total revenues from the Global Markets segment, which primarily comprises Commissions and fees and Net trading revenue from our domestic businesses, decreased 8.5% to \$172.6 million for the three months ended March 31, 2007, from \$188.7 million for the comparable period in 2006. Revenues for the three months ended March 31, 2007, were negatively impacted by a decrease in revenue capture per U.S. equity dollar value traded and lower share volume in OTC Bulletin Board and Pink Sheet shares partially offset by revenues from Hotspot and ValuBond, which were acquired during 2006.

Average revenue capture per U.S. equity dollar value traded was 2.0 basis points (bps) for the first quarter of 2007, down 14.2% from 2.3 bps in the first quarter of 2006. Average revenue capture per U.S. equity dollar

value traded is calculated as the total of net domestic trading revenues plus U.S. institutional commissions and commission equivalents (included in Commissions and fees), less certain transaction-related regulatory fees (included in Execution and clearance fees), (collectively Core Equity Revenues) divided by the total dollar value of the related equity transactions. Core Equity Revenues were \$111.0 million and \$128.6 million for the three months ended March 31, 2007 and 2006, respectively. Core Equity Revenues do not include revenues from KEMIL's European institutional business, Donaldson, Direct Trading, Direct Edge, Hotspot and ValuBond.

	For the three months ended March 31,		Change	% of Change
	2007	2006		
Total Revenues from Corporate (millions)	\$ 7.8	\$ 17.7	\$ (9.9)	-55.8%

Average corporate investment balance in the Deephaven Funds (millions) \$ 193.3 \$ 284.5 \$ (91.2) -32.1%

Total revenues from the Corporate segment, which primarily represents income from our corporate investment in the Deephaven Funds and other strategic investments, decreased 55.8% to \$7.8 million for the three months ended March 31, 2007, from \$17.7 million for the comparable period in 2006. Income from our corporate investment in the Deephaven Funds decreased to \$8.0 million for the three months ended March 31, 2007, from \$19.0 million for the comparable period in 2006, due to lower returns on a lower average monthly investment balance.

Transaction-based expenses

Execution and clearance fees decreased 5.2% to \$27.4 million for the three months ended March 31, 2007, from \$28.9 million for the comparable period in 2006, primarily due to lower clearing rates. As a percentage of total revenue, Execution and clearance fees increased to 11.3% for the three months ended March 31, 2007, from 10.4% for the comparable period in 2006. These costs increased as a percentage of revenue primarily due to the decrease in revenues from Asset Management, which have no associated execution and clearance fees, and lower revenue capture. Execution and clearance fees fluctuate based on changes in transaction volumes, regulatory fees and efficiencies in processing the transactions. Soft dollar and commission recapture expense decreased 21.2% to \$14.5 million for the three months ended March 31, 2007, from \$18.4 million for the comparable period in 2006.

Payments for order flow and ECN rebates increased to \$12.6 million for the three months ended March 31, 2007, from \$9.9 million for the comparable period in 2006. As a percentage of total revenue, Payments for order flow and ECN rebates increased to 5.2% for the three months ended March 31, 2007, from 3.6% for the comparable period in 2006. This expense increased primarily due to increased profitability-based rebates paid to broker-dealer clients and increased third party volumes within Direct Edge.

Other direct expenses

Employee compensation and benefits expense increased 2.7% to \$102.2 million for the three months ended March 31, 2007, from \$99.6 million for the comparable period in 2006. As a percentage of total revenue, Employee compensation and benefits increased to 42.3% for the three months ended March 31, 2007, from 35.9% for the comparable period in 2006. The increase on a dollar basis was primarily due to additional employees related to the acquisitions of Hotspot and ValuBond, increased stock-based compensation, as well as non-recurring compensation associated with the new Deephaven employment agreements. The number of full time employees in our continuing operations increased to 836 at March 31, 2007, from 724 at March 31, 2006, primarily due to these acquisitions.

Communications and data processing expense increased 13.9% to \$8.7 million for the three months ended March 31, 2007, from \$7.6 million for the comparable period in 2006. Depreciation and amortization expense increased 22.6% to \$5.4 million for the three months ended March 31, 2007, from \$4.4 million for the

comparable period in 2006 due to the purchase of additional fixed assets and additional expense related to the amortization of intangible assets in connection with the acquisitions of Hotspot and ValuBond. Occupancy and equipment rentals expense increased slightly to \$3.5 million for the three months ended March 31, 2007, from \$3.4 million for the comparable period in 2006.

Professional fees decreased 14.0% to \$5.5 million for the three months ended March 31, 2007, from \$6.4 million for the comparable period in 2006. The decrease in 2007 was primarily due to decreases in legal expenses, which have fluctuated based on the activity relating to our various legal and regulatory proceedings, and consulting expenses.

Business development expense increased to \$3.8 million for the three months ended March 31, 2007, from \$2.1 million for the comparable period in 2006. The primary reason for the increase was higher expenses related to the corporate brand campaign, marketing and travel and entertainment costs.

For the three months ended March 31, 2006, the Company incurred a charge of \$8.0 million in writedowns of assets and lease loss accruals primarily relating to costs associated with excess real estate capacity in Jersey City, N.J.

Other expenses decreased to \$3.3 million for the three months ended March 31, 2007, from \$6.4 million for the comparable period in 2006. Other expenses in 2006 include a short swing profit settlement of approximately \$2.8 million relating to trading by two Deephaven funds in the shares of a company while the funds owned in aggregate more than 10% of the outstanding shares of the stock of that company.

Our effective tax rates from continuing operations of 39.3% and 40.1% for the three months ended March 31, 2007, and 2006, respectively, differed from the federal statutory rate of 35% primarily due to state income taxes and non-deductible charges.

Discontinued Operations

Loss from discontinued operations, net of tax, was \$1.3 million for the three months ended March 31, 2007. See Footnote 9 *Discontinued Operations* and Footnote 11 *Regulatory Charges and Related Matters*, included in Part I, Item 1 *Financial Statements* of this document for a further discussion.

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

In an effort to provide additional information regarding the Company's results as determined by GAAP, the Company also discloses certain non-GAAP information which management believes provides useful information to investors. Within this Form 10-Q, the Company has disclosed its Operating Expenses and its Pre-Tax Operating Earnings to assist the reader in understanding the impact of Writedown of assets and lease loss accrual on the Company's quarterly results for 2007 and 2006 by segment, thereby facilitating more useful period-to-period comparisons of the Company's continuing businesses. For additional information related to segments, see Footnote 16 *Business Segments* included in Part I, Item 1 *Financial Statements* included in this document. Charts are presented in millions.

Total GAAP Expenses to Operating Expenses*

	For the three months ended March 31, 2007			
	Asset Management	Global Markets	Corporate	Total
Transaction-based expenses	\$	\$ 54.5	\$	\$ 54.5
Other direct expenses	42.3	81.9	8.2	132.4
Total GAAP and Operating Expenses	\$ 42.3	\$ 136.5	\$ 8.2	\$ 186.9

	For the three months ended March 31, 2006			
	Asset Management	Global Markets	Corporate	Total
Transaction-based expenses	\$	\$ 57.2	\$	\$ 57.2
Other direct expenses	44.1	82.9	11.0	138.0
Total GAAP Expenses	44.1	140.1	11.0	195.2
Writedown of assets and lease loss accrual		(8.0)		(8.0)
Operating Expenses	\$ 44.1	\$ 132.1	\$ 11.0	\$ 187.2

Pre-Tax GAAP Income from Continuing Operations to Pre-Tax Operating Earnings*

	For the three months ended March 31, 2007			
	Asset Management	Global Markets	Corporate	Total
Pre-tax GAAP Income from Continuing Operations and Pre-tax Operating Earnings	\$ 18.9	\$ 36.1	\$ (0.3)	\$ 54.7

	For the three months ended March 31, 2006			
	Asset Management	Global Markets	Corporate	Total
Pre-tax GAAP Income from Continuing Operations	\$ 26.8	\$ 48.5	\$ 6.7	\$ 82.0
Writedown of assets and lease loss accrual		8.0		8.0
Pre-tax Operating Earnings	\$ 26.8	\$ 56.5	\$ 6.7	\$ 90.0

* Totals may not add due to rounding.

Liquidity and Capital Resources

Historically, we have financed our business primarily through cash generated by operations, as well as the proceeds from our stock issuances and, in 2004, from the proceeds of the sale of our Derivative Markets segment. As of March 31, 2007, we had \$2.0 billion in assets, 65% of which consisted of cash or assets readily convertible into cash, principally receivables from brokers and dealers, asset management fees receivable and securities owned. Asset management fees receivable includes incentive and management fees earned for sponsoring and managing the Deephaven Funds. Receivables from brokers and dealers include interest bearing cash balances held with clearing brokers, including, or net of, amounts related to securities transactions that have not yet reached their contracted settlement date, which is generally within three business days of the trade date. Securities owned principally consist of equity securities that trade in Nasdaq, on the OTC Bulletin Board and on the NYSE and AMEX markets. At March 31, 2007, the Company had net current assets, which consists of net assets readily convertible into cash, of approximately \$227.3 million. In addition, our corporate investment in the Deephaven Funds was \$195.4 million at March 31, 2007, the majority of which can be liquidated upon request to Deephaven subject to a ninety-day written notification period and monthly redemption limits. At March 31, 2007

we also had Asset management fees receivable of \$46.9 million, which mostly consists of Incentive allocation fees which are traditionally paid to us within 30 days after each six month performance period ending June 30th or December 31st.

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

We have acquired several businesses over the last two years. Several of these acquisitions provide for contingent payments. The acquisition of the business of Direct Trading contains an additional contingent payment due in the third quarter of 2007 based on the profitability of that business during the second year of operation post-acquisition. The acquisition of Direct Edge contains three additional annual contingent payments based on meeting certain revenue and client retention metrics. In April 2006, the Company acquired Hotspot for \$77.5 million in cash. In October 2006, the Company acquired ValuBond for \$18.2 million in cash. No assurance can be given with respect to the business effect of these transactions or the timing, likelihood or business effect of any other possible transactions.

Income from continuing operations before income taxes was \$54.7 million and \$82.0 million for the three months ended March 31, 2007 and 2006, respectively. Included in these amounts were certain non-cash expenses such as depreciation and amortization and certain non-cash writedowns. Depreciation expense from continuing operations was \$4.0 million and \$3.7 million for the three months ended March 31, 2007 and 2006, respectively. Amortization expense from continuing operations, which related to intangible assets, was \$1.4 million and \$735,000 for the three months ended March 31, 2007 and 2006, respectively.

Capital expenditures related to our continuing operations were \$1.8 million and \$2.8 million during the three months ended March 31, 2007 and 2006, respectively. Purchases of strategic investments were \$2.4 million and \$4.3 million and proceeds from sale of strategic investments were \$5.5 million and \$0 during the three months ended March 31, 2007 and 2006, respectively. Payments related to acquisitions of businesses were \$1.5 million during the three months ended March 31, 2006. Strategic investments and acquisition expenditures primarily relate to outside investments and acquisitions of businesses in support of the development and growth of our business. Our corporate investment in the Deephaven Funds increased by \$7.8 million during the three months ended March 31, 2007, primarily due to earnings, but decreased by \$3.7 million during the three months ended March 31, 2006 due to redemptions of \$22.6 million, offset by \$19.0 million in earnings.

At its April 18, 2006 meeting, the Board of Directors authorized an increase in the size of the Company's stock repurchase program from \$345 million to \$495 million. The Company repurchased 2.7 million shares under the stock repurchase program during the first quarter of 2007 for \$45.4 million. Through March 31, 2007, the Company had repurchased 44.4 million shares for \$412.4 million under its stock repurchase program. The Company may repurchase shares in the open market or through privately negotiated transactions, depending on prevailing market conditions, alternative uses of capital and other factors. The Company cautions that there are no assurances that any further repurchases may actually occur. The Company had approximately 104.6 million shares of Class A Common Stock outstanding as of March 31, 2007.

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

FCM are subject to capital adequacy requirements of their respective regulatory authorities. As of March 31, 2007, all of our broker-dealers were in compliance with the regulatory rules. The following table sets forth the net capital levels and requirements for the following significant regulated broker-dealer subsidiaries at March 31, 2007, as filed in their respective regulatory filings (in millions):

Entity	Net Capital	Net Capital Requirement	Excess Net Capital
KEM	\$ 43.4	\$ 4.4	\$ 39.0
KCM	58.0	1.0	57.0
KEMIL	23.1	7.2	15.9
Direct Trading	7.9	0.4	7.5

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

Off-Balance Sheet Arrangements

As of March 31, 2007, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

Critical Accounting Policies

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

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

The Company incurred \$8.0 million of Writedown of assets and lease loss accruals in the first quarter of 2006, relating to the lease loss accrual on a portion of our lease at 545 Washington Boulevard in Jersey City, N.J., encompassing approximately 78,000 square feet, all of which is unoccupied. The Company engaged a real estate broker to sub-lease this excess space, but to date our efforts to sub-let this space have not been successful. This accrual was derived from assumptions and estimates based on lease terms of an anticipated sub-lease agreement, which assumed a sub-lease would commence in the beginning of 2008, anticipated market prices along the Jersey City waterfront and estimated up-front costs, including broker fees and build-out allowances. We continually monitor the market rates for office space and the amount of available office space in Jersey City, N.J. to assess the reasonableness of our applicable assumptions.

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

Goodwill of \$133.1 million as of March 31, 2007 is all related to our Global Markets segment. Goodwill is primarily related to the purchases of our listed equities market-maker, KCM and the businesses now operating as

Donaldson, Direct Trading, Direct Edge, Hotspot and ValuBond. We performed our annual test for impairment of goodwill in the second quarter of 2006 and determined that goodwill was not impaired at that time. As part of our test for impairment, we considered the profitability of the applicable reporting unit, an assessment of fair value of the reporting unit based on various valuation methodologies, as well as the overall market value of the Company, compared to the Company's book value. Furthermore, the Company believes there was no impairment of the goodwill balance at March 31, 2007.

Intangible assets, less accumulated amortization, of \$62.3 million as of March 31, 2007 are all attributable to our Global Markets segment. Substantially all intangible assets resulted from the purchases of the businesses of Donaldson, Direct Trading, and Hotspot. These assets, which primarily consist of customer relationships, are being amortized on a straight-line basis over their useful lives, the majority of which have been determined to range from eight to thirty years. We performed our annual test for impairment of intangible assets in the second quarter of 2006 and determined that intangible assets were not impaired during that time. Furthermore, the Company believes there was no impairment of these intangible assets at March 31, 2007.

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

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

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

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

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

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

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

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

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

We estimate and accrue for potential losses that may arise out of litigation, regulatory proceedings and tax audits to the extent that such losses are probable and can be estimated in accordance with SFAS No. 5 *Accounting for Contingencies*. Significant judgment is required in making these estimates and our final liabilities may ultimately be materially different. Our total liability accrued with respect to litigation and regulatory proceedings is determined on a case-by-case basis and represents an estimate of probable losses based on, among other factors, the progress of each case, our experience with and industry experience with similar cases and the opinions and views of internal and external legal counsel. Given the inherent difficulty of predicting the outcome of our litigation and regulatory matters, particularly in cases or proceedings in which substantial or indeterminate damages or fines are sought, or where cases or proceedings are in the early stages, we cannot estimate losses or ranges of losses for cases or proceedings where there is only a reasonable possibility that a loss may be incurred. For more information on our legal and regulatory matters, see *Legal Proceedings* in Part I, Item 3 of the Company's Annual Report on Form 10-K and Part II, Item 1 included in this document.

Recently Issued Accounting Standards

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk
Market Risk

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

For working capital purposes, we invest in money market funds, commercial paper and government securities or maintain interest-bearing balances in our trading accounts with clearing brokers, which are classified as Cash and cash equivalents and Receivable from brokers and dealers, respectively, on the Consolidated Statements of Financial Condition. These other amounts do not have maturity dates or present a material market risk, as the balances are short-term in nature and subject to daily repricing. Our cash and cash equivalents held in foreign currencies are subject to the exposure of foreign currency fluctuations. These balances are monitored daily, and are not material to the Company's overall cash position.

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

In the normal course of our equities market-making business, we maintain inventories of exchange-listed and OTC equity securities. The fair value of these securities at March 31, 2007 and 2006 was \$705.0 million and \$513.1 million, respectively, in long positions and \$690.3 million and \$505.3 million, respectively, in short positions. The potential change in fair value, using a hypothetical 10% decline in prices, is estimated to be a \$1.5 million loss and a \$782,000 loss as of March 31, 2007 and 2006, respectively, due to the offset of gains in short positions with the losses in long positions.

As of March 31, 2007, we had a \$195.4 million corporate investment in the Deephaven Funds, \$150.4 million of which was invested in the Market Neutral Fund. As of March 31, 2007, approximately 43% of the Deephaven Funds' assets under management were in the Deephaven Market Neutral Fund. The investment philosophy for the Market Neutral Fund is to seek to produce returns for its investors using various investment strategies focusing on delivering attractive risk-adjusted rates of return. The performance of the Market Neutral Fund is intended to be substantially non-correlated with the general debt and equity markets, as well as with a number of other non-traditional investment strategies. Its returns are primarily dependent upon equity trading volumes, equity volatility, mergers and acquisitions and secondary offering activity in the capital markets, and credit spread relationships, among other factors. Within the Market Neutral Fund, Deephaven generally employs a variety of investment strategies, including event-driven, volatility-driven, fundamental equity, credit-driven and global macro strategies among others. There is no material limitation on the types of investment strategies that may be employed by the Market Neutral Fund.

There will be unhedged asset factor risks (i.e. equity, credit, interest rate, foreign exchange) in the Market Neutral Fund. Deephaven also manages single-strategy funds that pursue investment strategies which involve substantial risks based on the fact that they are less diversified strategies and could be more vulnerable to structural economic and regulatory changes, or general market conditions. The less diversified nature of these strategies may cause their performance to be more volatile and result in the incurrence of greater losses during unprofitable periods as compared to a more diversified approach.

Separately, Deephaven's business also involves specific categories of trading and operational risk. For example, although Deephaven may attempt to hedge positions as part of its trading strategies, there is no assurance that adequate hedging opportunities will exist. Moreover, Deephaven relies to a material degree on its

prime brokers to provide leverage, custody, execution and other services, but there is no assurance that the prime brokers will continue to provide the amount of leverage which they have in the past, or on the same terms, or provide any of the other services they currently provide, on a cost-effective basis. Deephaven also faces significant risk from the fact that any of its trading counter-parties could fail, which would likely have the effect of greatly diminishing the value of the assets which are the subject of trades with that counterparty. Finally, if Deephaven does not appropriately structure its use of leverage, the losses the funds incur could be materially exacerbated.

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

Operational Risk

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

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

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

Legal Risk

Legal risk includes the risk of non-compliance with applicable legal and regulatory requirements and standards. Legal risk also includes contractual and commercial risk such as the risk that a counterparty's performance obligations will be unenforceable. The Company is generally subject to extensive regulation in the different jurisdictions in which it conducts its business (see Government Regulation and Market Structure in Part I, Item 1 of our Annual Report on Form 10-K for the year ended December 31, 2006). The Company has established procedures based on legal and regulatory requirements that are designed to foster compliance with applicable statutory and regulatory requirements. The Company also has established procedures that are designed to require that the Company's policies relating to conduct, ethics and business practices are followed.

Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-14(c) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective. There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the last fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

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

Legal

Short Selling Litigation

In April, the following development occurred in the short selling litigation described in the Company's Annual Report on Form 10-K for the year ended December 31, 2006:

On or about April 10, 2007, approximately 20 securities firms, including the Company, were named in a complaint entitled *Eagletech Communications Inc. et al. v. Citigroup, Inc. et al.* filed in the Circuit Court, Broward County, Florida. In general, the complaint alleges that defendants participated in a scheme to manipulate Eagletech stock using methods such as naked short selling. The complaint, which consists of 8 causes of action, has not yet been served upon the Company. Knight intends on defending this action vigorously.

Last Atlantis Capital LLC et al. v. Chicago Board Options Exchange, Inc. et al.

During the first quarter of 2007, the following development occurred in the action entitled *Last Atlantis Capital LLC et al. v. Chicago Board Options Exchange, Inc. et al.* described in the Company's Annual report on Form 10-K for the year ended December 31, 2006:

On March 23, 2007, the court granted plaintiffs' motion for reconsideration in part, by allowing them to file an amended complaint against the market-maker defendants, but not against the options exchanges. The amended complaint, filed April 5, 2007, alleges federal claims based on the Securities Exchange Act of 1934 and state law claims based on Illinois statutory and common law. Knight intends to defend this action vigorously.

Regulatory

The Company owns subsidiaries including regulated entities that are subject to extensive oversight under federal, state and applicable international laws as well as SRO rules. Changes in market structure and the need to remain competitive require constant changes to our systems and order handling procedures. The Company makes these changes while continuously endeavoring to comply with many complex laws and rules. Compliance, surveillance or trading issues, common in the securities industry, and which are monitored or reported to the SEC, CFTC or SROs, are reviewed in the ordinary course of business by our primary regulators, the SEC, NASD, FSA, CFTC, MSRB and NFA. 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 U.S. regulators, foreign regulators and 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 a SEC, CFTC, FSA 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, 2006, in March 2005, NASD announced that it had charged Kenneth Pasternak, former CEO of Knight Securities, L.P. (KSLP, now known as KEM), 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. Pursuant to a decision dated April 11, 2007, the majority of a NASD Hearing Panel found that Pasternak and Leighton failed to supervise KSLP's Institutional Sales Department reasonably during the period of January 1999 to September 2000 in violation of NASD rules. Pasternak and Leighton were each fined \$100,000. Pasternak was suspended in all supervisory capacities for two years and Leighton was barred in all supervisory capacities. On or about May 3, 2007, Pasternak and Leighton each filed a Notice of Appeal from the NASD's decision. In August 2005, the SEC announced that it had filed a civil fraud action in the United States District Court for the District of New Jersey against Kenneth Pasternak and John Leighton. The SEC matter is still pending.

As disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006, in 2006, the Company received a request from the staff of the SEC for voluntary production of certain documentation related to options activities of its subsidiary, Knight Financial Products LLC, during the period of time that the subsidiary conducted the Derivative Markets business prior to its sale by the Company in December 2004. The Company believes this request is part of a broader review by the staff of the SEC regarding certain trading practices in the options industry during the period 1999-2005. The Company responded to this request and is cooperating with the staff of the SEC and certain regional exchanges to resolve this matter. For further information regarding this matter, see Footnote 11 Regulatory Charges and Related Matters, in Part I, Item 1 Financial Statements included in this document.

For further information on Legal Proceedings, see the section entitled Legal Proceedings, in Part I, Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2006.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Item 2. Changes in Securities and Use of Proceeds

The following table contains information about our purchases of our Class A Common Stock during the first quarter of 2007:

Period ⁽¹⁾	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs ⁽²⁾	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
January 1, 2007 - January 31, 2007	860,360	\$ 18.59	550,000	\$ 117,821,586
February 1, 2007 - February 28, 2007	1,337,279	17.13	1,325,000	95,120,642
March 1, 2007 - March 31, 2007	795,410	15.75	794,007	82,611,220
Total	2,993,049	17.18	2,669,007	

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

(2) On April 4, 2002, the Company's Board of Directors announced the authorization of a stock repurchase program, which allowed for the purchase of Class A Common Stock up to a total amount of \$35 million. This repurchase program was increased by an aggregate of \$460 million to a total of \$495 million by

resolutions of the Company's Board of Directors adopted on July 16, 2002, May 12, 2003, April 20, 2004, August 8, 2004, April 19, 2005, October 18, 2005 and April 18, 2006. 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, but cautions that there are no assurances that any future repurchases will actually occur. The repurchase program has no set expiration or termination date.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit No.	Exhibit
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Jersey City, State of New Jersey, on this 9th day of May, 2007.

KNIGHT CAPITAL GROUP, INC.

By: */s/* THOMAS M. JOYCE
Chairman of the Board and Chief Executive Officer

By: */s/* JOHN B. HOWARD
Chief Financial Officer
(Chief Accounting Officer)