

ARCHIPELAGO HOLDINGS INC
Form 10-Q
May 16, 2005

**UNITED STATES SECURITIES AND EXCHANGE
COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

**✓ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE
ACT OF 1934**

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2005

OR

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

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER: 001-32274

ARCHIPELAGO HOLDINGS, INC.

(Exact name of Registrant as specified in its charter)

DELAWARE

86-1075595

Edgar Filing: ARCHIPELAGO HOLDINGS INC - Form 10-Q

(State or other jurisdiction of
incorporation or
organization)

(I.R.S. Employer
Identification Number)

100 South Wacker Drive, Suite 1800

Chicago, IL 60606

(312) 960-1696

(Address, including zip code, and
telephone number including area code, of
Registrant's principal executive offices)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

As of May 4, 2005, the Registrant had approximately 47,216,000 shares of common stock, \$0.01 par value per share, outstanding.

ARCHIPELAGO HOLDINGS, INC.

QUARTERLY REPORT ON FORM 10-Q

TABLE OF CONTENTS

PART I Financial Information

Item 1. Financial Statements

Condensed Consolidated Statements of Financial Condition as of December 30, 2004 and March 31, 2005 (unaudited)

Condensed Consolidated Statements of Operations for the Three Months Ended March 31, 2004 and 2005 (unaudited)

Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2004 and 2005 (unaudited)

Notes to Condensed Consolidated Financial Statements (unaudited)

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

Item 3. Quantitative and Qualitative Disclosure about Market Risk

Item 4. Controls and Procedures

PART II Other Information

Item 1. Legal Proceedings

Item 2. Unregistered Sale of Equity Securities and Use of Proceeds

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits

Signatures

FORWARD-LOOKING STATEMENTS

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements regarding Archipelago Holdings, Inc. and its subsidiaries (collectively "Archipelago"). These statements relate to future events our financial performance and may include information relating to pending transactions involving Archipelago (including the benefits of the transaction and future plans and expectations following the consummation of transaction) and are intended to be covered by the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are based on the current belief of management and involve unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements, to be materially different from those expressed or implied in this Report. In some cases, you can identify forward-looking statements with terminology such as "may", "will", "should", "expects", "intends", "plans", "anticipates", "believes", "estimates", "predicts", "potential", "continue", "pending" or other comparable terminology. These statements are only predictions. You should not place undue reliance on forward-looking statements which speak only as of the date of this Report. Actual events or results may differ materially and we undertake no on going obligation, other than that imposed by law, to update these statements. You should, however, consult any further disclosures of a forward-looking nature Archipelago may make in our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. These forward-looking statements are subject to numerous risks and uncertainties, including, but not limited to: general economic conditions; our future operating results; market penetration and financial condition; industry trading activity and fluctuations; regulatory changes and competition; the ability to obtain governmental approval of any pending transaction on the proposed terms and schedule; the failure to obtain stockholder approval for any pending transaction; the inability to integrate businesses successfully following the consummation of any pending transaction; the risk that any expected cost savings and any revenue synergies resulting from any pending transaction may not be fully realized or may take longer to realize than expected; the risk that disruption from any pending transaction may make it more difficult to maintain relationships with clients, employees or suppliers; as well as the risks and uncertainties described in Part I, Item 1. under the section heading "Certain Factors That May Affect Our Business" of our Form 10-K filed with the Securities and Exchange Commission on March 23, 2005 and the factors discussed below under "Management's Discussion and Analysis." You are urged to carefully consider these factors. All forward-looking statements attributable to us are expressly qualified in their entirety by the foregoing cautionary statements.

Important Acquisition Information with Respect to the PCX Holdings Acquisition

In connection with the proposed acquisition of PCX Holdings and its subsidiaries by Archipelago, the parties intend to file relevant materials with the SEC, including a registration statement on Form S-4. Such documents, however, are not currently available. INVESTORS ARE URGED TO READ THE REGISTRATION STATEMENT REGARDING THE PROPOSED TRANSACTION WHEN IT BECOMES AVAILABLE, BECAUSE IT WILL CONTAIN IMPORTANT INFORMATION. Investors will be able to obtain a free copy of the registration statement, as well as other filings containing information about Archipelago, PCX Holdings, the Pacific Exchange and PCX Equities without charge, at the SEC's website (<http://www.sec.gov>) once such documents are filed with the SEC. Copies of the registration statement will also be available, without charge, once they are filed with the SEC by directing a request to Archipelago, Attention: Investor Relations, at 100 South Wacker Drive, Suite 1800, Chicago, Illinois 60606 or calling (888) 514-7284, or by directing a request to the Shareholder Services Department of PCX Holdings at 115 Sansome Street, San Francisco, California 94104 or calling (415) 393-4114.

This filing (including the exhibits hereto) shall not constitute an offer to sell or the solicitation of an offer to buy any securities, nor shall there be any sale of securities in any jurisdiction in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such jurisdiction. No offering of securities shall be made except by means of a prospectus meeting the requirements of Section 10 of the Securities Act of 1933, as amended.

Important Acquisition Information with Respect to the Archipelago New York Stock Exchange (NYSE) Merger

In connection with the proposed merger of Archipelago and NYSE, the parties intend to file relevant materials with the SEC, including a joint proxy statement/prospectus regarding the proposed transaction. Such documents, however, are not currently available. INVESTORS ARE URGED TO READ THE JOINT PROXY STATEMENT/PROSPECTUS REGARDING THE PROPOSED TRANSACTION WHEN IT BECOMES AVAILABLE, BECAUSE IT WILL CONTAIN IMPORTANT INFORMATION.

Investors will be able to obtain a free copy of the joint proxy statement/prospectus, as well as other filings containing information about Archipelago and NYSE without charge, at the SEC's website (<http://www.sec.gov>) once such documents are filed with the SEC. Copies of the joint proxy statement/prospectus can also be obtained, without charge, once they are filed with the SEC, by directing a request to Archipelago, Attention: Investor Relations, at 100 S. Wacker Drive, Suite 800, Chicago, Illinois 60606 or calling (888) 514-7284.

Archipelago, NYSE and their respective directors and executive officers and other members of management and employees may be deemed to be participants in the solicitation of proxies from Archipelago stockholders in respect of the proposed transaction. Information regarding Archipelago's directors and executive officers is available in Archipelago's proxy statement for its 2005 annual meeting of stockholders, dated March 31, 2005. Additional information regarding the interests of such potential participants will be included in the joint proxy statement/prospectus and the other relevant

documents filed with the SEC when they become available. This filing (including the exhibits hereto) shall not constitute an offer to sell or the solicitation of an offer to buy any securities, nor shall there be any sale of securities in any jurisdiction in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such jurisdiction. No offering of securities shall be made except by means of a prospectus meeting the requirements of Section 10 of the Securities Act of 1933, as amended.

PART I Financial Information**Item 1. Financial Statements**

Archipelago Holdings, Inc.

Condensed Consolidated Statements of Financial Condition

(In thousands, except per share data)

| | December 31, 2004 | March 31, 2005 (unaudited) |
|---|----------------------|----------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 177,878 | \$ 193,184 |
| Receivables from brokers, dealers and customers, net | 31,400 | 28,192 |
| Receivables from related parties | 41,726 | 37,708 |
| Total current assets | 251,004 | 259,084 |
| Fixed assets, net | 49,495 | 47,808 |
| Goodwill | 131,865 | 131,865 |
| Intangible asset - Pacific Exchange facility agreement | 90,000 | 90,000 |
| Other intangible assets, net | 2,169 | 1,763 |
| Deferred tax asset, net | 1,839 | 1,107 |
| Other assets | 8,076 | 10,932 |
| Total assets | \$ 534,448 | \$ 542,559 |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 36,269 | \$ 21,010 |
| Payables to brokers, dealers and exchanges | 19,408 | 16,509 |
| Payables to related parties | 16,353 | 29,459 |
| Current portion of capital lease obligations | 1,545 | 1,039 |
| Total liabilities | 73,575 | 68,017 |
| Commitments and contingencies | | |
| Stockholders equity | | |
| Common stock, \$.01 par value, 165,000 shares authorized; 47,138 and 47,147 shares issued and outstanding | 471 | 471 |
| Additional paid-in capital | 451,625 | 456,989 |
| Unearned stock-based compensation | (19) | (4,879) |
| Retained earnings | 8,796 | 21,961 |
| Total stockholders equity | 460,873 | 474,542 |
| Total liabilities and stockholders equity | \$ 534,448 | \$ 542,559 |

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

Archipelago Holdings, Inc.

Condensed Consolidated Statements of Operations

(In thousands, except per share data)

(unaudited)

| | Three months ended March 31, | |
|--|---------------------------------|------------------|
| | 2004 | 2005 |
| Revenues | | |
| Transaction fees (\$54,232 and \$45,555 with related parties) | \$ 135,001 | \$ 118,726 |
| Market data fees (\$4,245 and \$6,667 with related parties) | 11,724 | 14,850 |
| Listing fees | 89 | 118 |
| Total revenues | 146,814 | 133,694 |
| Cost of revenues | | |
| Liquidity payments (\$15,333 and \$13,416 with related parties) | 53,204 | 51,938 |
| Routing charges (\$13,872 and \$9,857 with with related parties) | 26,480 | 18,841 |
| Clearance, brokerage and other transaction expenses (\$5,607 and \$1,428 with related parties) | 12,666 | 7,666 |
| Total cost of revenues | 92,350 | 78,445 |
| Gross margin | 54,464 | 55,249 |
| Indirect expenses | | |
| Employee compensation and benefits | 10,333 | 12,504 |
| Depreciation and amortization | 10,732 | 5,421 |
| Communications (\$873 and \$1,268 with related parties) | 4,529 | 5,509 |
| Marketing and promotion (\$8 and \$- with related parties) | 1,746 | 3,075 |
| Legal and professional (\$250 and \$600 with related parties) | 2,303 | 3,133 |
| Occupancy | 976 | 1,444 |
| General and administrative | 1,934 | 3,088 |
| Total indirect expenses | 32,553 | 34,174 |
| Operating income | 21,911 | 21,075 |
| Interest and other, net | 68 | 866 |
| Income before income tax provision | 21,979 | 21,941 |
| Income tax provision | | 8,776 |
| Net income | \$ 21,979 | \$ 13,165 |
| Basic earnings per share (a) | \$ 0.61 | \$ 0.28 |
| Diluted earnings per share (a) | \$ 0.55 | \$ 0.28 |
| Basic weighted average shares outstanding (a) | 36,169 | 47,142 |
| Diluted weighted average shares outstanding (a) | 40,163 | 47,799 |

(a) Adjusted to reflect our reorganization from a Delaware limited liability company to a Delaware corporation on August 11, 2004. See Note 1 to condensed consolidated financial statements.

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

Archipelago Holdings, Inc.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(unaudited)

| | Three months ended March 31, | |
|---|---------------------------------|------------|
| | 2004 | 2005 |
| Cash flows from operating activities | | |
| Net income | \$ 21,978 | \$ 13,165 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 10,325 | 5,015 |
| Amortization of other intangible assets | 407 | 406 |
| Deferred taxes | | 732 |
| Stock-based compensation | 38 | 414 |
| Tax benefit from stock option exercises | | 37 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (11,796) | 7,226 |
| Other assets | (2,517) | (2,857) |
| Accounts payable and accrued expenses | 2,155 | (5,052) |
| Net cash provided by operating activities | 20,590 | 19,086 |
| Cash flows from investing activities | | |
| Additions to fixed assets | (6,286) | (3,328) |
| Net cash used in investing activities | (6,286) | (3,328) |
| Cash flows from financing activities | | |
| Direct costs of initial public offering | (3,144) | |
| Principal payments under capital lease obligations | (626) | (506) |
| Proceeds from exercises of stock options | | 54 |
| Net cash used in financing activities | (3,770) | (452) |
| Net increase in cash and cash equivalents | 10,534 | 15,306 |
| Cash and cash equivalents at beginning of period | 111,815 | 177,878 |
| Cash and cash equivalents at end of period | \$ 122,349 | \$ 193,184 |
| Supplemental disclosures of cash flow information | | |
| Cash paid for: | | |
| Interest | \$ 76 | \$ 23 |
| Income taxes | | 460 |

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

Archipelago Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

March 31, 2005

1. ORGANIZATION AND BASIS OF PRESENTATION

Organization

Archipelago Holdings, Inc. operates the Archipelago Exchange, or ArcaEx® (ArcaEx), the first open all-electronic stock market in the United States for trading in all NYSE, Nasdaq, AMEX and Pacific Exchange-listed stocks. Archipelago Holdings, L.L.C. (Holdings LLC), a Delaware limited liability company and the predecessor to the Company, was organized in January 1999. In July 2000, Holdings LLC entered into a facility services agreement with the Pacific Exchange, Inc. (PCX) which allowed it to establish and operate ArcaEx. The Securities and Exchange Commission's (SEC) approval of ArcaEx was announced in October 2001 and ArcaEx began trading operations for listed securities in March 2002 and for over-the-counter securities in April 2003.

On August 11, 2004, Holdings LLC converted to a Delaware corporation, Archipelago Holdings, Inc. We refer to Archipelago Holdings, Inc. and, prior to its conversion to a Delaware corporation, Holdings LLC, as the Company . On August 19, 2004, the Company completed an initial public offering (IPO) of its common stock. See below discussion of the *Conversion Transaction* and the *Initial Public Offering*.

Through certain subsidiaries, the Company also provides broker execution services to institutions for orders involving Nasdaq and listed securities, as well as introducing broker services for ArcaEx to broker-dealers that do not hold an exchange trading permit (ETP).

Conversion Transaction

On August 11, 2004, prior to the consummation of the IPO, Holdings LLC converted from a Delaware limited liability company to a Delaware corporation, Archipelago Holdings, Inc. As a limited liability company, all income taxes were paid by the members of Holdings LLC. As a corporation, the Company is responsible for the payment of all federal and state corporate income taxes.

As a result of the reorganization of Holdings LLC from a Delaware limited liability company into a Delaware corporation, the members of Holdings LLC received 0.222222 shares of common stock of the Company for each of their membership interests held by such member in Holdings LLC, which corresponds to a 4.5-for-1 reverse stock split. The weighted average number of shares used in the basic and diluted earnings per share computations gives retroactive effect to the 4.5-for-1 reverse stock split.

As approved by the Company's board of managers on July 16, 2004, the Company made a \$24.6 million cash distribution to the members of Holdings LLC immediately prior to the conversion transaction. The cash distribution permitted the members to pay the taxes that the members owe for their share of the Company's profits in 2004 as a limited liability company through the date of the conversion transaction, calculated primarily based on the highest federal and state income tax rate applicable for the tax withholding purposes to an individual.

Initial Public Offering

On August 19, 2004, the Company completed the IPO of its common stock as a result of which the Company sold 6,325,000 shares of common stock at \$11.50 per share. The Company received net proceeds of \$67.6 million and incurred approximately \$6.8 million in expenses in connection with the IPO. In addition, 6,325,000 shares of common stock were sold in the IPO by certain selling stockholders of the Company, for which the Company received no proceeds. The Company's stock is listed on the Pacific Exchange and is traded on ArcaEx under the symbol AX. A summary of the terms of the IPO can be found in the Company's Registration Statement on Form S-1 (File No. 333-113226), which was declared effective by the SEC on August 12, 2004.

Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries.

The accompanying condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. Management has made estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Management believes that the estimates utilized in preparing its financial statements are reasonable and prudent. Actual results could differ from these estimates.

In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All material intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the prior periods in order to conform to the current period's presentation.

Certain information and footnote disclosures normally included in financial statements have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading.

The condensed consolidated financial statements are unaudited and should be read in conjunction with the Company's audited financial statements as of and for the year ended December 31, 2004, included in the Company's Annual Report on Form 10-K

filed with the SEC on March 23, 2005. Operating results for the three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

2. ACQUISITION OF PCX HOLDINGS, INC. (PCXH)

On January 3, 2005, the Company entered into a definitive agreement with PCXH under which the Company has agreed to acquire PCXH and all of its wholly-owned subsidiaries including the PCX and PCX Equities, Inc. (the PCXH Transaction). The purchase price of the PCXH Transaction is represented by two elements: (i) the aggregate value of 1,645,415 shares of the Company's common stock (determined at the time of execution of the agreement), currently indirectly owned by PCXH through PCX which will be returned to, and either cancelled or held in treasury by the Company after the consummation of the PCXH Transaction, and (ii) \$17.0 million.

At the time of the execution of the definitive agreement, the purchase price of the PCXH Transaction was approximately \$50.7 million, to be paid (i) 80% in cash (or approximately \$40.6 million); and (ii) 20% in shares of the Company's common stock, calculated using the average closing price of the Company's common stock over the ten consecutive days prior to the execution date of the definitive agreement (or approximately \$10.1 million).

However, as a result of the Company's execution of a merger agreement described in Note 3 below, at closing, the purchase price of the PCXH Transaction will be calculated using the average closing price per share of the Company's common stock over the ten consecutive trading days prior to the closing date of the PCXH Transaction, rather than the ten consecutive days prior to the execution date of the definitive agreement. In addition, the final calculation of the purchase price will depend upon several factors and adjustments, including but not limited to: (i) an adjustment relating to any working capital excess or shortfall of PCXH at closing that is either over or under an agreed upon threshold; and (ii) a downward adjustment in the event that any change of control and related payments to certain executives of the seller exceeds approximately \$4.9 million.

Management expects that after consummation of the PCXH Transaction, the Company will be able to offer all-electronic trading of equity securities and options products and to expand and diversify the Company's business lines and products. The consummation of the PCXH Transaction also will result in the Company acquiring the self-regulatory organization of the PCX. Immediately following the announcement of the PCXH Transaction integration planning was initiated by the parties. To date, detailed integration plans have been developed. The PCXH Transaction is subject to approvals from PCXH shareholders and the SEC. The applicable waiting period under the Hart-Scott-Rodino Act for the PCXH Transaction expired on March 7, 2005. The Company anticipates that the PCXH Transaction will close in the third quarter of 2005.

In October 2004, the Company entered into a financial advisory services engagement with a stockholder, under which the stockholder agreed to perform financial advisory services in relation to the PCXH Transaction. The Company has not made any payments under this agreement as of March 31, 2005.

3. SUBSEQUENT EVENT MERGER WITH NEW YORK STOCK EXCHANGE, INC. (NYSE)

On April 20, 2005, the Company entered into a definitive merger agreement with NYSE under which they agreed to combine their businesses and become wholly-owned subsidiaries of a newly-created, for-profit and publicly-traded holding company (the NYSE Transaction) which the parties expect to be named the NYSE Group, Inc. (Holdco).

In the NYSE Transaction:

Through a series of transactions, the current NYSE memberships will be converted into \$300,000 in cash per NYSE membership, and a number of shares of Holdco common stock representing 70% of the entire issued and outstanding shares of Holdco common stock at the closing of the NYSE Transaction, calculated on a fully diluted basis (less any shares of Holdco common stock underlying Holdco restricted stock units reserved for issuance to employees of the NYSE).

Through a single merger with a wholly-owned subsidiary of Holdco, under which the Company will be the surviving entity: (i) each share of the issued and outstanding shares of the Company s common stock will convert automatically into the right to receive one share of Holdco common stock; (ii) all outstanding stock options of the Company, whether vested or unvested, will convert into options to purchase an equivalent number of shares of Holdco common stock; and (iii) all outstanding restricted stock units of the Company will convert into an equal number of restricted stock units of Holdco common stock. The aggregate number of shares (including shares underlying stock options and restricted stock units) to be received by the Company s stockholders will equal 30% of the issued and outstanding shares of Holdco common stock at the closing of the NYSE Transaction, calculated on a fully diluted basis.

Under the terms of the merger agreement, the parties will prepare and file with the SEC proxy materials consisting of a joint proxy statement/prospectus relating to the matters to be submitted to the NYSE members and the Company s stockholders. In addition, Holdco will prepare and file with the SEC a registration statement on Form S-4 with respect to the issuance of its common stock in the NYSE Transaction. The consummation of the NYSE Transaction is subject to a number of customary closing conditions, including the receipt of approval by the NYSE members and the Company s stockholders as well as certain government approvals, including the SEC, and the expiration or termination of the applicable waiting period under the Hart-Scott-Rodino Act. The Company anticipates that the NYSE Transaction will close in the first quarter of 2006.

The merger agreement contains customary representations and warranties,

including the representation that each party has received: (i) the requisite approval of its board of directors to enter into the merger agreement; and (ii) an opinion of its financial advisor stating, to the effect that the consideration to be received in the transaction is fair from a financial point of view.

The merger agreement also contains customary termination provisions which, under certain circumstances in the event of a termination under the merger agreement, may subject the parties to liability for the payment of termination fees and reimbursement of expenses in an amount up to \$40.0 million, and includes a provision which permits either party to terminate the merger agreement if the transaction fails to close by February 1, 2006 (unless extended under the terms of the merger agreement). Either party may extend the term of the merger agreement without the consent of the other party for two separate three-month periods (with the first period ending on May 1, 2006 and the second ending on August 1, 2006), provided that the only conditions that remain to be satisfied are the receipt of the approvals of either the NYSE members, the Company's stockholders or any regulatory entity, and outstanding litigation.

The parties expect that the combined businesses will bring together the strength of NYSE's auction market and the speed and innovation of the Company and its technology and management. The parties believe this combination will create a strong and dynamic enterprise with diverse products that will be well positioned to compete in the industry and possess enhanced growth potential.

Following the closing of the NYSE Transaction, the parties expect that the board of directors of Holdco will consist of fourteen members who satisfy the NYSE independence requirements, three of whom will be designated by the Company and agreed to by NYSE, and the remaining eleven members will be the directors of the NYSE immediately prior to the effective time of the NYSE Transaction. The Chief Executive Officer of NYSE immediately prior to the effective time of the NYSE Transaction will be the Chief Executive Officer of Holdco.

In April 2005, the Company entered into a letter agreement with a stockholder under which the stockholder agreed to perform certain services in relation to the proposed merger of the Company and NYSE which included facilitating discussions between the parties and providing certain valuation analysis. The Company agreed to pay the stockholder a transaction fee of \$3.5 million in cash upon consummation of the NYSE Transaction. The Company also agreed to reimburse the stockholder for one-half of the stockholder's reasonable out-of-pocket expenses (including the fees and disbursements of attorneys plus any sales, use or similar taxes) in an amount not to exceed \$50,000 without the prior written consent of the Company. In the event the NYSE Transaction is terminated or not consummated, the Company will pay a transaction fee to be mutually agreed upon between the parties. The Company has not made any payments under this agreement as of March 31, 2005.

4. FIXED ASSETS

Fixed assets consisted of the following:

| | December 31, 2004 | | March 31, 2005 |
|--|------------------------------|----|---------------------------|
| | (In thousands) | | |
| Software, including software development costs | \$ 44,511 | \$ | 45,643 |
| Computers and equipment | 43,131 | | 45,212 |
| Leasehold improvements | 18,770 | | 18,819 |
| Equipment under capital leases | 18,070 | | 18,070 |
| Routers | 5,524 | | 5,572 |
| Furniture and fixtures | 3,074 | | 3,092 |
| | 133,080 | | 136,408 |
| Accumulated depreciation and amortization | (83,585) | | (88,600) |
| | \$ 49,495 | \$ | 47,808 |

The Company capitalized software development costs of approximately \$0.8 million for the three months ended March 31, 2005.

5. GOODWILL AND OTHER INTANGIBLE ASSETS**Goodwill**

In March 2002, the Company acquired REDIBook in a transaction accounted for as a purchase business combination. Approximately \$20.8 million of the \$150.5 million purchase price was assigned to the net tangible and intangible assets acquired, with the remaining value of \$129.7 million ascribed to goodwill. In August 2004, the Company issued contingent consideration to former REDIBook members in the form of 192,194 shares of the Company's common stock valued at \$11.50 per share and recorded \$2.2 million of additional goodwill.

PCX Exchange Facility Agreement

In May 2001, the Company acquired the right to operate as the exclusive equity trading facility of PCX Equities, Inc. including the rights to certain revenue streams comprised primarily of transaction fees, market data fees, and listing fees, for an aggregate consideration of \$90.0 million consisting of a \$40.0 million cash payment and 10.8% equity interest in the Company. The Company determined that this intangible asset had an indefinite life and, as such, it is not subject to amortization.

Other Intangible Assets

In October 2002, the Company acquired Globenet Securities, Inc. and the net assets of its parent, Globenet Capital Corporation in a transaction accounted for as an asset acquisition. The Company assigned \$4.9 million to an intangible asset related to the technology acquired. This intangible asset is amortized over three years from the implementation of the technology in May 2003. The Company recorded approximately \$0.4 million in amortization on this intangible asset for both the three months ended March 31, 2004 and the three months ended March 31, 2005. As of March 31, 2005, the net book value of this intangible asset was approximately \$1.8 million.

6. RELATED PARTY TRANSACTIONS

The following is a summary of the related party transactions involving the Company and certain former members (i.e., owners of Holdings LLC prior to the IPO) and current stockholders (i.e., stockholders of the Company after the IPO), PCX and other affiliates as part of its operations:

| | Three months ended March 31, | |
|---|---------------------------------|-----------|
| | 2004 | 2005 |
| | (In thousands) | |
| Revenues | | |
| Transaction fees earned from stockholders/former members and affiliates(1) | \$ 54,232 | \$ 45,555 |
| Market data fees received from PCX (net of amounts shared with customers of \$3,644 and \$5,759) (2) | 4,245 | 6,667 |
| Cost of revenues | | |
| Liquidity payments to stockholders/former members and affiliates(1) | 15,333 | 13,416 |
| Routing charges: | | |
| Routing fees paid to stockholder/former member(3) | 13,008 | 9,289 |
| Routing fees for listed securities paid to stockholders/former members(4) | 864 | 568 |
| Clearance, brokerage and other transaction expenses: | | |
| Clearing services provided by a stockholder/former member(5) | 3,672 | 644 |
| Clearing services provided by an affiliated clearing broker(5) | 1,255 | |
| Regulatory services fees paid to PCX(6) | 1,613 | 1,954 |
| Registered representative fees received from PCX(6) | (933) | (1,170) |
| Indirect expenses | | |
| Communications: | | |
| Back office services provided by an affiliate(7) | 300 | 300 |
| Software related services provided by an affiliate (net of amounts charged to customers of \$686 and \$499) (8) | 573 | 968 |
| Marketing and promotion: | | |
| Business development costs(9) | 8 | |
| Legal and professional: | | |
| Professional fees for services provided by an affiliate(10) | 250 | 450 |
| Consulting fees for services from a firm whose principal serves a director of the Company (11) | | 150 |

-
- (1) Certain stockholders/former members of Holdings LLC and affiliates execute transactions through ArcaEx, and previously through the Company's ECN, and are charged a transaction service fee by the Company for such activities. Liquidity payments are made to stockholders/former members of Holdings LLC and affiliates in relation to such transaction fees.
- (2) The Company participates in the consolidation, dissemination and sale of market data in U.S. exchange-listed securities and Nasdaq-listed securities through ArcaEx. In connection with that, the Company receives market data fees, based on the level of trading activity on ArcaEx, for providing data to centralized aggregators that in turn sell the data to third-party consumers. PCX is a direct participant in the plans governing the consolidation and dissemination of market data and as a direct participant in these plans collects tape revenues for trading activities on ArcaEx. Under the terms of the facility services agreement, the Company is entitled to all tape revenues earned in connection with trading activities on ArcaEx.
- (3) A stockholder/former member of Holdings, LLC receives routing fees for trades executed through ArcaEx, that ultimately route through to the stockholder/former member's ECN.
- (4) Certain stockholders/former members of Holdings LLC provide routing services for listed securities through the New York Stock Exchange, Inc. on behalf of the Company.
- (5) The Company clears its transactions for institutional customers through an affiliated clearing broker and transactions for non-institutional customers through a stockholder/former member of Holdings LLC/clearing broker.
- (6) Under the terms of the facility services agreement, PCX provides certain regulatory services to the Company in return for regular payments as negotiated between the parties. Also, PCX forwards registered representative fees received from the NASD to the Company.
- (7) An affiliate provides back-office services to Wave Securities, L.L.C. (Wave). The services include offering and managing connectivity to alternative execution venues, clearing technology, as well as reporting to the NASD's Order Audit Trail Systems through which NASD members are required to report information regarding Nasdaq transactions.
- (8) An affiliate provides software related services to the Company, a portion of which is charged to the Company's customers.

(9) The Company paid rental fees for the yacht that it leases for certain business development functions, which is operated by the domestic partner of a sister of a member of management.

(10) An affiliate provides software related services to the Company.

(11) The Company signed an agreement on June 1, 2004 with a consulting firm whose principal serves as a director. The consulting agreement provides for a minimum fee of \$150,000 per quarter and has a one-year term.

An affiliate provided software development services to the Company in the amount of \$1.0 million for the three months ended March 31, 2004.

In the opinion of management, transactions were made at prevailing rates, terms and conditions and do not involve more than the normal risk of collectibility or present other unfavorable features.

7. STOCK-BASED COMPENSATION

The Company accounts for stock option grants to employees in accordance with Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees , and, accordingly, recognizes compensation expense using the intrinsic value method. Under the intrinsic value method, stock-based compensation, if any, is measured as the excess of the estimated fair value of the Company s stock over the option exercise price.

The Company adopted the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure . Had compensation expense for the Company s stock option plans been determined based upon fair value consistent with SFAS No. 123, the Company s net income and earnings per share would have been changed to the following pro forma amounts:

| | Three months ended March 31, | |
|---|---------------------------------------|-----------|
| | 2004 | 2005 |
| | (in thousands, except per share data) | |
| Net income, as reported | \$ 21,979 | \$ 13,165 |
| Add: Stock-based employee compensation cost included in net income | 38 | 248 |
| Deduct: Stock-based employee compensation cost determined under the fair value based method for all awards, net of related tax effects of \$135 and \$383 | 190 | 574 |
| Net income, pro forma | \$ 21,827 | \$ 12,839 |
| Earnings per share: | | |
| Basic, as reported | \$ 0.61 | \$ 0.28 |
| Basic, pro forma | \$ 0.60 | \$ 0.27 |
| Diluted, as reported | \$ 0.55 | \$ 0.28 |
| Diluted, pro forma | \$ 0.54 | \$ 0.27 |

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

| | Three months ended March 31, | |
|--------------------------|---------------------------------|-------|
| | 2004 | 2005 |
| Dividend yield | | |
| Expected volatility | 30.0% | 30.0% |
| Risk-free interest rate | 3.8% | 4.2% |
| Expected life (in years) | 7 | 7 |

The Black-Scholes option pricing model was developed for use in estimating the value of traded options that have no vesting restrictions and are fully transferable. In addition, option pricing models require the input of highly subjective assumptions. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the estimate, in management's opinion, the existing valuation models may not provide a reliable measure of the fair value of the Company's employee stock options.

The above pro forma information gives effect to the Company's conversion into a Delaware corporation as if it occurred at the beginning of the periods presented. In addition, the pro forma information was tax effected at combined federal, state and local rates of 41.5% and 40.0% for the three months ended March 31, 2004 and 2005, respectively.

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R) (revised 2004), Share-Based Payment , requiring that compensation cost associated with share-based payment transactions be recognized in financial statements. This cost is to be measured at the fair value of the instrument issued. SFAS No. 123(R) covers a wide range of share-based compensation arrangements including

stock options, restricted stock plans, performance based awards, share appreciation rights and employee stock purchase plans. Statement No. 123(R) replaces the former SFAS No. 123 and supersedes APB No. 25. The Company plans to adopt SFAS No. 123(R) on January 1, 2006 using the modified-prospective method. The Company is currently evaluating the option pricing model to be utilized and the overall impact of the adoption of SFAS No. 123(R). The adoption of the fair value method will have an impact on the Company's results of operations, although it will have no impact on the Company's overall financial condition.

8. COMPUTATION OF EARNINGS PER SHARE

The following is a reconciliation of the basic and diluted earnings per share computations:

| | Three months ended March 31, | |
|--|---------------------------------|-----------|
| | 2004 | 2005 |
| (In thousands, except per share data) | | |
| Net income | \$ 21,979 | \$ 13,165 |
| Shares of common stock and common stock equivalents: | | |
| Weighted average shares used in basic computation | 36,169 | 47,142 |
| Dilutive effect of: | | |
| Preferred shares converted to common in August 2004 | 3,732 | |
| Stock options and restricted stock units | 262 | 657 |
| Weighted average shares used in diluted computation | 40,163 | 47,799 |
| Basic earnings per share | \$ 0.61 | \$ 0.28 |
| Diluted earnings per share | \$ 0.55 | \$ 0.28 |

At March 31, 2004 and 2005, approximately 1.4 million and 0.5 million securities, respectively, were excluded from the computation of diluted earnings per share because their effect would have been antidilutive.

9. SEGMENT REPORTING

The Company operates in two reportable segments: Transaction Execution Services and Agency Brokerage Services.

Transaction Execution Services consist primarily of transaction execution services, market data services on a real-time or summary basis and, through the Company's alliance with PCX, a trading venue for issuers of equity securities, exchange traded funds and structured products. Under PCX rules, issuers are listed on PCX for trading on ArcaEx. The customers in this segment are required to hold an ETP or be a broker-dealer introduced to ArcaEx by an ETP. An ETP holder must be a broker-dealer.

Agency Brokerage Services are provided through Wave and consist of order execution services, on an agency basis, for orders received from institutions involving primarily Nasdaq and listed securities. This segment provides institutions that are not ETP holders or are not sponsored by ETP holders access to all U.S. Nasdaq and exchange-listed securities markets through ArcaEx.

Revenues are generated primarily in the United States of America. Revenues derived from one stockholder/former member of Holdings LLC and its affiliates represented approximately 10.0% and 9.0%, of the consolidated revenues for the three months ended March 31, 2004 and 2005, respectively. All of the Company's long lived assets are located in the United States.

Summarized financial information concerning the Company's reportable segments is as follows (in thousands):

| Three months ended March 31, | Transaction Execution Services | Agency Brokerage Services | Eliminations | Consolidated |
|--------------------------------------|--------------------------------------|---------------------------------|--------------|--------------|
| 2004 | | | | |
| Revenues | \$ 132,945 | \$ 15,698 | \$ (1,829) | \$ 146,814 |
| Cost of revenues | 84,892 | 9,287 | (1,829) | 92,350 |
| Gross margin | 48,053 | 6,411 | | 54,464 |
| Indirect expenses | 28,506 | 4,047 | | 32,553 |
| Operating income | 19,547 | 2,364 | | 21,911 |
| 2005 | | | | |
| Revenues | \$ 123,165 | \$ 11,891 | \$ (1,362) | \$ 133,694 |
| Cost of revenues | 72,625 | 7,182 | (1,362) | 78,445 |
| Gross margin | 50,540 | 4,709 | | 55,249 |
| Indirect expenses | 29,842 | 4,332 | | 34,174 |
| Operating income | 20,698 | 377 | | 21,075 |
| Identifiable assets (as of March 31) | 521,964 | 30,062 | (9,467) | 542,559 |

In 2004, the Company revised its methodology for allocating certain expenses between the segments to reflect the fact that Agency Brokerage Services had built out its own infrastructure and therefore relies less on Company shared services. Indirect costs allocated to Agency Brokerage Services were \$1.5 million for both the three months ended March 31, 2004 and 2005.

10. NET CAPITAL REQUIREMENTS

Wave, Archipelago Securities, L.L.C. (ARCAS) and Archipelago Trading Services, Inc. (ATSI) are registered broker-dealers and are subject to net capital requirements under SEC Rule 15c3-1. Wave and ATSI compute their net capital using the basic method. Under this method, these subsidiaries must maintain minimum net capital (as defined) and the ratio of aggregate indebtedness (as defined) to net capital may not exceed 15 to 1. ARCAS computes its net capital under the alternative method. This method requires that minimum net capital not be less than the greater of \$250,000 or 2% of aggregate debit items arising from customer transactions.

As of March 31, 2005, these subsidiaries were in compliance with their respective net capital requirements and their net capital, net capital in excess of required net capital, and ratio of aggregate indebtedness to net capital were as follows (in thousands, except ratios):

| | | |
|---|----|-----------|
| Net capital | | |
| Wave | \$ | 12,198 |
| ARCAS | | 8,481 |
| ATSI | | 3,372 |
| Net capital in excess of required net capital | | |
| Wave | \$ | 11,370 |
| ARCAS | | 8,231 |
| ATSI | | 3,220 |
| Ratio of aggregate indebtedness to net capital | | |
| Wave | | 1.02 to 1 |
| ARCAS | | N/A |
| ATSI | | .68 to 1 |

Advances to affiliates, dividend payments and other equity withdrawals are subject to certain notification and other provisions of the net capital rule of the SEC and other regulatory bodies.

The Company's international broker-dealer subsidiaries are subject to capital adequacy requirements promulgated by authorities of the countries in which they operate. As of March 31, 2005, these subsidiaries had met their local capital adequacy requirements.

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

You should read the following discussions together with the condensed consolidated financial statements and related notes as well as the forward looking statements included elsewhere in this report.

Executive Overview

We operate ArcaEx, the first open, all-electronic stock market in the United States for trading in NYSE-, Nasdaq-, AMEX- and PCX-listed equity securities, exchange-traded funds and other exchange-listed securities. During the three months ended March 31, 2004 and 2005, our customers executed 101.3 million and 115.7 million transactions in U.S. equity securities through ArcaEx, respectively, representing 37.8 billion and 35.8 billion shares. Our trading platforms and services have been designed to enhance the speed and quality of trade execution for our customers. Our trading platforms provide our customers with fast electronic execution and open, direct and anonymous market access. The technological capabilities of our trading systems, together with our trading rules, have allowed us to create a pool of liquidity that is available to our customers internally on ArcaEx and externally through other market centers. We also operate The ArcaEdge®, a broker-dealer sponsored trading platform designed to bring the benefits of ArcaEx' fast electronic execution, transparency and open market access to the trading of small-cap equity securities.

We earn revenues and generate cash from transaction fees collected in connection with trade execution (whether matched internally or routed out) on ArcaEx. We also generate revenues from fees collected for introducing broker-dealers that do not hold an ArcaEx electronic trading permit (ETP). In addition, we receive market data fees, based on the level of trading activity on ArcaEx, for providing data to centralized aggregators that in turn sell the data to third-party consumers. Through our alliance with PCX, we also collect listing fees from companies and index providers that list on PCX as a trading venue for their equity securities, exchange-traded funds and other structured products. Through our wholly-owned subsidiary, Wave Securities, L.L.C., we offer and derive revenues from fees collected in connection with agency brokerage services for institutional customers seeking to access ArcaEx and other U.S. market centers electronically.

Our business is dependent on the liquidity (i.e., the number and range of buy orders and sell orders posted on our system and available to our customers) of ArcaEx. As a result, our most significant cost of generating revenues is the cost of liquidity, which we pay for in one of two ways. First, to enhance the liquidity of our system, we pay a small fee per share (denominated in tenths of a cent per share) to participants, referred to as liquidity providers, that post buy orders and sell orders on the Archipelago system, when the quote is executed against, or hit, by liquidity takers purchasing or selling securities internally on our system. Second, as part of our best execution business model, we incur routing charges when the Archipelago system does not have the best buy or sell

order in the market for a security that a customer is trying to buy or sell on our system. In that case, we will route the customer's order to the external market center that displays the best buy order or sell order. The external market center will charge us a fee per share (denominated in tenths of a cent per share) for routing to its system.

Making liquidity payments and incurring routing charges are part of the costs we incur to generate revenues through increased liquidity on the Archipelago system. We seek to offset these costs by increased trade execution on the Archipelago system. Our cost of liquidity generally fluctuates based on (i) trading volumes and (ii) the per share fee we pay liquidity providers for trades executed internally on ArcaEx or the per share routing charge we pay to external market centers for outbound trades.

We also incur clearance, brokerage and related transaction expenses, which primarily include transaction expenses paid to clearing entities for clearing and settlement, service fees paid per trade to exchanges for trade execution. As the operator of a facility of PCX Equities, Inc., we do not incur clearing charges for internally matched trades executed on ArcaEx by our customers. As a result, our clearing costs are lower for trades executed internally on ArcaEx. If we route a trade to an external market center, we bear clearing and settlement costs.

In addition to our direct cost of revenues, we incur the following indirect expenses:

employee compensation and benefits expenses, which include salaries, incentive compensation and related employee benefits and taxes as well as amortization of stock-based compensation;

depreciation and amortization expenses, which result primarily from the depreciation of the fixed assets we purchase, including computer software and hardware used in the development of our trading systems;

communications expenses, which consist primarily of costs for our network connection with our customers and our data centers, as well as connectivity to various other market centers;

marketing and promotion expenses, which consist primarily of media, print and other advertising expenses as well as customer marketing expenses;

legal and professional expenses, which consist primarily of legal and accounting expenses;

occupancy expenses, which consist primarily of rental expenses; and

general and administrative expenses, which include travel and entertainment expenses and other administrative expenses and general

office costs.

On August 11, 2004 we converted from a limited liability company to a C corporation in connection with the consummation of our Initial Public Offering (IPO). Please refer to Note 1 Organization and Basis of Presentation under the sub-headings Conversion Transaction and Initial Public Offering for further discussion in our unaudited financial statements.

For financial reporting purposes, our business is divided into two reportable segments: transaction execution services and agency brokerage services. Our transaction execution business includes trade execution on the Archipelago system as well as fees we receive for market data and from issuers with equity securities listed on the Pacific Exchange for trading on ArcaEx. Our trade execution customers are required to hold an ETP or be a broker-dealer introduced to ArcaEx by an ETP holder in order to trade on ArcaEx. An ETP holder must be a broker-dealer. Our agency brokerage services are provided through Wave Securities, L.L.C., our broker-dealer subsidiary, and consist of order execution services, on an agency basis, for orders received exclusively from institutions involving primarily Nasdaq and listed securities. This segment provides institutions that are not ETP holders or are not sponsored by ETP holders access to all U.S. Nasdaq and exchange-listed securities markets through ArcaEx.

Business Development

Acquisition of PCX Holdings, Inc. (PCXH)

Edgar Filing: ARCHIPELAGO HOLDINGS INC - Form 10-Q

On January 3, 2005, we entered into a definitive agreement to acquire PCXH and all of its wholly-owned subsidiaries for approximately \$50.7 million, consisting of approximately \$40.6 million in cash and approximately \$10.1 million in stock, subject to working capital and certain other possible adjustments. As a result of our merger agreement with the New York Stock Exchange, Inc. (see *Merger with New York Stock Exchange, Inc.* below), the purchase price of PCXH will be calculated upon consummation of the acquisition using the average closing price per share of our common stock over the ten consecutive trading days prior to the closing date of the PCXH acquisition, rather than the ten consecutive days prior to the execution date of the our definitive agreement with PCXH.

We expect that after consummation of the PCXH acquisition, we will be able to offer all-electronic trading of equity securities and options products and will be able to expand and diversify our business lines and products. The consummation of the PCXH acquisition also will result in our acquisition of the self-regulatory organization (SRO) of the PCX. This transaction is subject to approvals from PCXH shareholders as well as the Securities and Exchange Commission (SEC) and other regulatory entities. We anticipate that the PCXH acquisition will close in the third quarter of 2005.

Merger with New York Stock Exchange, Inc. (NYSE)

On April 20, 2005, we entered into a definitive merger agreement with NYSE

under which, each of Archipelago and NYSE will operate as a wholly-owned subsidiary under a newly-created, for-profit and publicly-traded holding company, which the parties expect to be named the NYSE Group, Inc. (Holdco). Under the terms of the merger agreement, we will be the surviving entity of a merger with a newly created for-profit Delaware corporation and wholly-owned subsidiary of Holdco. In this transaction, each share of the issued and outstanding shares of our common stock will convert automatically into the right to receive one share of Holdco common stock, with the aggregate amount of such shares of Holdco common stock equaling 30% of the issued and outstanding shares of common stock of Holdco at the closing.

The parties expect that the combined businesses will bring together the strength of the NYSE's auction market and our speed and innovation. The parties believe this combination will create a strong and dynamic enterprise with diverse products that will be well positioned to compete in the industry and possess enhanced growth potential.

The consummation of the transaction is subject to the receipt of approval by the members of the NYSE and our stockholders as well as certain government approvals, including the SEC. We anticipate that our merger with NYSE will close in the first quarter of 2006.

The merger agreement contains customary representations and warranties and conditions to closing, including the representation that each party has received: (i) the requisite approval of its board of directors to enter into the merger agreement; and (ii) an opinion of its financial advisor stating, to the effect that the consideration to be received in the transaction is fair from a financial point of view. The merger agreement also contains customary termination provisions which, under certain circumstances in the event of a termination under the merger agreement, may subject the parties to liability for the payment of termination fees or reimbursement of expenses in an amount up to \$40.0 million, and includes a provision which permits either party to terminate the agreement if the transaction fails to close by February 1, 2006. Either party may extend the term of the merger agreement without the consent of the other party for two separate three-month periods (with the first period ending on May 1, 2006 and the second ending on August 1, 2006), provided that the only conditions that remain to be satisfied are the receipt of the approvals of either the NYSE members, our stockholders or any regulatory entity, and outstanding litigation.

Adoption of Regulation NMS

On April 6, 2005, the SEC voted to adopt Regulation NMS, which contains proposals designed to change the regulatory structure of the U.S. equity markets, each of which were disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

Regulation NMS will change the current formula for allocating revenues generated by market data fees to market centers that produce the data for investors (the Market Data Rule), as well as create Rules 610 (the Intermarket Access Rule), 611

(the Order Protection Rule) and 612 (the Sub-Penny Pricing Rule) under the Exchange Act of 1934. The final release for Regulation NMS is currently pending, however the final release is expected to include the following provisions:

Market Data Rule

Allocate market data revenues to market centers based on the value of the quotes and trades for all securities.

Give market centers and their members the ability to distribute their own data independently with or without fees.

Require market centers to provide their best bids and offers and last sale information for consolidated dissemination through the joint-industry plans.

Require the SROs governing the market data consolidation systems to create advisory committees composed of non-SRO representatives to the joint industry plans.

Intermarket Access Rule

Allow for the use of private linkages, rather than mandating a collective linkage facility to facilitate order interaction between markets.

Establish a limit on the access fees charged by trading centers when incoming orders execute against their displayed quotes at the best bid or offer to \$0.003 per share (30 cents per 100 share order) or, if the price of the best bid or offer is less than \$1.00, to no more than 0.3% of the quotation price per share.

Require SROs to establish and enforce rules that prohibit members from displaying quotes that internally lock or cross the automated quotes of other trading centers. A locked market occurs when the price to buy a stock is the same as the price to sell the stock. A crossed market occurs when the price to buy (sell) a stock is higher (lower) than the price to sell (buy) a stock.

Order Protection Rule

Require broker-dealers to make available, for protection under the trade through rule, the best bids and offers across all markets.

Protect bids and offers displayed on an automated market from being traded through by any market. An automated market is essentially one that executes an incoming order on an immediate basis without human intervention.

Not protect bids and offers displayed on a non-automated market from being traded through by any market.

Include exceptions such as intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations, and flickering quotations with multiple prices displayed in a single second.

Require SROs to establish and enforce rules that are designed to reasonably prevent trade throughs in accordance with these rules.

Sub-Penny Pricing Rule

Prohibit electronic communications networks, exchanges, market makers and alternative trading systems from displaying, ranking or accepting quotes in NMS securities that are priced in increments of less than a penny, unless the stock price is less than \$1.00, in which case, the minimum increment would be \$0.0001.

The SEC has stated that the final release for Regulation NMS will provide for extended compliance dates, specifically: (i) compliance with the Intermarket Access Rule and Order Protection Rule would begin with a small group of representative NMS stocks, with the first phase beginning on April 10, 2006 and ending on June 9, 2006; (ii) on June 12, 2006, trading centers would be required to begin trading all NMS stocks pursuant to the requirements of the Intermarket Access Rule and Order Protection Rule; (iii) the compliance date for the Sub-Penny Pricing Rule would be July 1, 2005; and (iv) the compliance date for the Market Data Rule would be July 3, 2006.

We continue to analyze the potential impact of the adoption of Regulation NMS to our business and results of operations, however, we believe that when implemented: (i) the amount of transaction fees we earn, which represented over 89.5% of our total revenues for the year ended December 31, 2004, could potentially decrease; and (ii) the impairment of market centers' ability to increase revenues through higher pricing of transaction fees could have a material adverse effect on the revenues and operating results of all market centers, including our business.

Our preliminary analysis assumes, however, that trading volumes and our market share of the U.S. equities market remain constant and does not give effect to changes investors may make in their trading patterns as a result of, or in response to, Regulation NMS.

Nasdaq proposed acquisition of Instinet Group, Inc.

On April 25, 2005, The Nasdaq Stock Market, Inc. and a consortium of investors entered into a definitive agreement to acquire Instinet Group, Inc. This transaction, if consummated, would combine two large competitors with whom we compete for business, including our transaction-based services. Currently, we cannot predict the potential impact of this transaction on our industry in general, including liquidity, market share and price competition, or specifically to our business or future results of operations.

Key Statistical Information

Our revenues and gross margin are directly impacted by trading volumes of U.S. equity securities on the Archipelago system. Our profitability depends to a significant extent on our ability to attract and retain trading volumes, both in absolute terms and relative to other market centers. We derive revenues on both a per-share basis and a per-transaction basis, depending upon the source of revenue. The transaction fees we receive for trade execution and the payments we make to liquidity providers are determined on a per-share basis. Market data fees for exchange-listed securities are determined on a per-transaction basis, and market data fees for Nasdaq-listed securities are determined on a combination of share volume and transaction volume.

The following table presents unaudited key transaction volume information, as well as selected operating information, for the periods presented. A description of how we calculate our market share, our trading volumes and other operating measures is set forth below.

Edgar Filing: ARCHIPELAGO HOLDINGS INC - Form 10-Q

| | Three months ended March 31, | |
|--|---------------------------------|-----------|
| | 2004 | 2005 |
| Trading Days | 62 | 61 |
| Total U.S. market volume (millions of shares)(1) | 269,448 | 262,846 |
| Our total U.S. market volume (millions of shares)(1) | 37,750 | 35,830 |
| Our share of total U.S. market volume(1)(2) | 14.01% | 13.63% |
| % of handled shares matched internally(3) | 10.50% | 10.84% |
| % of handled shares routed out(3) | 3.51% | 2.79% |
| Total volume of Nasdaq-listed securities (millions of shares) | 126,314 | 122,238 |
| Our total volume of Nasdaq-listed securities (millions of shares) | 32,239 | 28,768 |
| Our share of total volume of Nasdaq-listed securities(2) | 25.52% | 23.53% |
| % of handled shares matched internally(3) | 19.16% | 18.68% |
| % of handled shares routed out(3) | 6.36% | 4.85% |
| Total volume of NYSE-listed securities (millions of shares) | 123,068 | 125,194 |
| Our volume in NYSE-listed securities (millions of shares) | 1,972 | 3,126 |
| Our share of total volume of NYSE-listed securities(2) | 1.60% | 2.50% |
| % of handled shares matched internally(3) | 0.95% | 1.82% |
| % of handled shares routed out(3) | 0.65% | 0.68% |
| Total volume of AMEX-listed securities (millions of shares) | 20,066 | 15,415 |
| Our volume in AMEX-listed securities (millions of shares) | 3,539 | 3,936 |
| Our share of total volume of AMEX-listed securities(2) | 17.64% | 25.53% |
| % of handled shares matched internally(3) | 14.50% | 21.98% |
| % of handled shares routed out(3) | 3.14% | 3.55% |
| Our ETF volume (millions of shares) | 3,046 | 4,943 |
| Our U.S. equity transaction volume (thousands of transactions) | 101,274 | 115,746 |
| Our average U.S. equity transaction size (shares per transaction) | 373 | 310 |
| Our average U.S. equity transactions per day (thousands of transactions) | 1,633 | 1,897 |
| Our average transaction-related revenue (per share)(4) | \$ 0.0036 | \$ 0.0033 |
| Our average transaction-related cost of revenue (per share)(5) | \$ 0.0021 | \$ 0.0020 |
| Our average transaction-related gross margin (per share)(6) | \$ 0.0015 | \$ 0.0013 |
| % of customer order volume matched internally(7) | 85.5% | 88.4% |
| % of customer order volume routed out(7) | 14.5% | 11.6% |

(1) U.S. market volume is calculated based on the number of shares of equity securities traded on the NYSE, AMEX and Nasdaq, including exchange-traded funds, as reported in the consolidated tape. The consolidated tape is the system that continuously provides the last sale price and volume of securities transactions in listed securities to the public.

(2) Our market share is calculated based on the number of shares handled on the Archipelago system as a percentage of total volume.

Edgar Filing: ARCHIPELAGO HOLDINGS INC - Form 10-Q

(3) Represents our share of the total volume of such securities handled on ArcaEx that was either matched internally on ArcaEx or routed out to an external market center.

(4) The per share amount is calculated based on our total revenues derived from

transaction fees of \$135.0 million and \$118.7 million for the three months ended March 31, 2004 and 2005, respectively.

(5) The per share amount is calculated based on our cost of revenues derived from transaction fees, which consist of routing charges and liquidity payments of \$79.7 million and \$70.8 million for the three months ended March 31, 2004 and 2005, respectively, and our total U.S. market volume for the relevant period. The cost of revenue from transaction fees used in the per share computation does not include clearance, brokerage and other transaction expenses.

(6) The per share amount is calculated based on our net revenues received from transaction fees, and our total U.S. market volume for the relevant period.

(7) The percentage of customer order volume matched internally is calculated by dividing the volume of customer orders executed within our internal liquidity pool (including the volume of both buy orders and sell orders) by the total volume of customer orders (again including the volume of both buy orders and sell orders when such orders are matched internally). The percentage of customer orders routed out is calculated by dividing the volume of customer orders routed to other market centers by the total volume of customer orders.

For purposes of calculating our volume, we include all shares that are handled on the Archipelago system. Handled shares include both shares that are bought or sold within our internal liquidity pool and shares that are routed to external markets for execution. We count every transaction handled by the Archipelago system once; we do not count both sides of any transaction. For example, if a customer's 10,000 share buy order is matched with another customer's 10,000 share sell order in our internal liquidity pool, our handled volume will be 10,000 shares. As another example, if one of our customers sends us an order to buy 10,000 shares and the best price for that order is displayed at another market center, we will route that order to the other market center for execution. The other market center will report a 10,000 share transaction in the consolidated tape, and our handled volume will be 10,000 shares. As a result, the 10,000 shares we report as handled by us in this example are also handled by the external market center.

In computing the percentage of customer order volume matched internally and the percentage of customer order volume routed out, we calculate the percentage based on the volume of individual customer orders, not the volume of matched trades (i.e., only counting one side of a matched transaction). For example, we calculate two customer orders matched internally on our system as two customer orders matched internally, and we include the volume of both the buy order and the sell order in computing our percentages of customer order volume matched internally and routed out. We calculate one customer order routed to an external market center (which will be matched with an order at that other market center) as one outbound trade or one customer order. We calculate one customer order routed to us from an external market center and matched with an order on our system as one inbound trade or one customer order.

Transactions in Nasdaq and exchange-listed securities are reported in the consolidated tape, a high-speed system that continuously provides last sale price and volume in listed securities. Our handled volume is higher than our volume reported to the centralized aggregators for inclusion in the consolidated tape for two reasons. First, we do not report trades routed to another market center to the centralized aggregators of this data. Instead, the destination market center reports these trades. For example, if a customer's 10,000 share buy order is routed to another market center for execution, our handled volume will be 10,000 shares, but we will not report the trade. Second, our handled volume includes odd lot transactions, generally defined as trades of fewer than 100 shares, which, by rule, we do not report to the centralized aggregators for inclusion in the consolidated tape. For example, if one of our customers buys 50 shares, our handled volume will be 50 shares but we will not report this trade.

For purposes of calculating our market share, we use the volume of shares that are handled on the Archipelago system (as described above) as the numerator, and the aggregate volume of shares reported by all securities exchanges and associations in the consolidated tape as the denominator. Our market share may be expressed as:

Number of shares handled on the Archipelago system

Overall market volume as reported in the consolidated tape

As an alternative method of calculating market share, we could include in the numerator of the above formula only transactions that we report in the consolidated tape. This would exclude shares routed to other market centers and odd-lot transactions from our market share calculation.

For purposes of calculating the percentage of handled shares matched internally or routed out, we count all shares that are handled on the Archipelago system as described above. We count every transaction handled by the Archipelago system once; we do not count both sides of any transaction. Therefore, if five trades are executed on ArcaEx for 10,000 shares each, three of which are routed out, we will have handled 50,000 shares and our percentage of that share volume matched internally would be 40% and routed out would be 60%.

Alternatively, for the purpose of calculating the percentage of customer order volume matched internally or routed out, we count each customer order exactly once. If two customers' orders are matched within our internal liquidity pool, we count the volume of both the buy order and the matched sell order. On the other hand, if a customer's order is routed to another market center and matched with an order posted at that other market center, we count only the volume of the order routed out.

Results of Operations*Three Months Ended March 31, 2005 versus Three Months Ended March 31, 2004*

The following table sets forth our consolidated statements of operations data for the periods presented:

| | Three months ended March 31, | | Amount Change Favorable (Unfavorable) | Percentage Change Favorable (Unfavorable) | Percentage of Revenues | | |
|---|------------------------------|-----------------------|---------------------------------------|---|------------------------|--------|--|
| | 2004 | 2005 (In millions) | | | 2004 | 2005 | |
| Revenues | | | | | | | |
| Transaction fees | \$ 135.0 | \$ 118.7 | \$ (16.3) | (12.1)% | 91.9% | 88.8% | |
| Market data fees | 11.7 | 14.9 | 3.2 | 27.4% | 8.0% | 11.1% | |
| Listing fees | 0.1 | 0.1 | | % | 0.1% | 0.1% | |
| Total revenues | 146.8 | 133.7 | (13.1) | (8.9)% | 100.0% | 100.0% | |
| Cost of revenues | | | | | | | |
| Liquidity payments | 53.2 | 51.9 | 1.3 | 2.4% | 36.2% | 38.8% | |
| Routing charges | 26.5 | 18.8 | 7.7 | 29.1% | 18.1% | 14.1% | |
| Clearance, brokerage and other transaction expenses | 12.7 | 7.7 | 5.0 | 39.4% | 8.7% | 5.8% | |
| Total cost of revenues | 92.4 | 78.4 | 14.0 | 15.2% | 63.0% | 58.7% | |
| Gross margin | 54.4 | 55.3 | 0.9 | 1.7% | 37.0% | 41.3% | |
| Indirect expenses | | | | | | | |
| Employee compensation and benefits | 10.3 | 12.5 | (2.2) | (21.4)% | 7.0% | 9.3% | |
| Depreciation and amortization | 10.7 | 5.4 | 5.3 | 49.5% | 7.3% | 4.0% | |
| Communications | 4.5 | 5.5 | (1.0) | (22.2)% | 3.1% | 4.1% | |
| Marketing and promotion | 1.7 | 3.1 | (1.4) | (82.4)% | 1.2% | 2.3% | |
| Legal and professional | 2.3 | 3.1 | (0.8) | (34.8)% | 1.6% | 2.3% | |
| Occupancy | 1.0 | 1.4 | (0.4) | (40.0)% | 0.7% | 1.0% | |
| General and administrative | 2.0 | 3.2 | (1.2) | (60.0)% | 1.4% | 2.4% | |
| Total indirect expenses | 32.5 | 34.2 | (1.7) | (5.2)% | 22.3% | 25.4% | |
| Operating income | 21.9 | 21.1 | (0.8) | (3.7)% | 14.7% | 15.9% | |
| Interest and other, net | 0.1 | 0.8 | 0.7 | 700.0% | 0.1% | 0.6% | |
| Income before income tax provision | 22.0 | 21.9 | (0.1) | (0.5)% | 14.8% | 16.5% | |
| Income tax provision | | 8.8 | (8.8) | (100.0)% | % | 6.6% | |
| Net income | \$ 22.0 | \$ 13.1 | \$ (8.9) | (40.5)% | 14.8% | 9.9% | |

Highlights

For the three months ended March 31, 2005, our income before income tax provision was \$21.9 million, consistent with \$22.0 million for the three months ended March 31, 2004. We managed to achieve nearly the same level of income before income tax provision despite the fact that our total U.S. market volume declined to 35.8 billion shares for the three months ended March 31, 2005 from 37.8 billion shares for the three months ended March 31, 2004, a 5.3% decrease. Our results of operations for the period primarily reflect the following principal factors:

More liquidity posted on ArcaEx. The percentage of customer orders

matched internally increased to 88.4% from 85.5% while the percentage of shares routed to other market centers for execution declined to 11.6% from 14.5%, resulting in a change in the amount and mix of our cost of revenues:

Liquidity payments declined to \$51.9 million for the three months ended March 31, 2005 from \$53.2 million for the three months ended March 31, 2004. As a percentage of total revenues, liquidity payments increased to 38.8% from 36.2%.

Routing charges declined to \$18.8 million, or 14.1% of total revenues, from \$26.5 million, or 18.1% of total revenues.

Clearance, brokerage and other transaction expenses declined to \$7.7 million, or 5.8% of total revenues, from \$12.7 million, or 8.7% of total revenues.

Improved gross margin. Despite the decline of our total revenues, gross margin increased to \$55.3 million for the three months ended March 31, 2005 from \$54.4 million for the three months ended March 31, 2004. Consequently, our gross margin percentage increased to 41.3% from 37.0% for the respective periods. The improvement was primarily the result of our higher internal match rate of customer orders and a greater contribution of market data fees to our total revenues.

Revenues

Our total revenues declined \$13.1 million or 8.9% to \$133.7 million for the three months ended March 31, 2005 from \$146.8 million for the three months ended March 31, 2004.

Transaction fees declined by \$16.3 million or 12.1% to \$118.7 million for the three months ended March 31, 2005 from \$135.0 million for the comparable period a year ago. The decline in transaction fees was primarily due to (i) the 5.1% decrease in our total U.S. market volume and (ii) to the \$3.8 million decrease of the revenues derived from our agency brokerage services segment from \$15.7 million for the three months ended March 31, 2004 to \$11.9 million for the three months ended March 31, 2005.

Market data fees increased \$3.2 million or 27.4% to \$14.9 million for the three months ended March 31, 2005 from \$11.7 million for the three months ended March 31, 2004. Market data fees derived from trading Nasdaq-listed securities increased from \$7.4 million to \$8.2 million. Market data fees derived from trading Amex-listed securities increased from \$3.8 million to \$6.0 million. Market data fees derived from trading NYSE-listed securities increased from \$0.5 million to \$0.7 million.

For the three months ended March 31, 2005, revenues from listing fees were \$0.1 million, unchanged from \$0.1 million for the three months ended March 31, 2004.

Cost of Revenues

Our total cost of revenues declined to \$78.4 million for the three months ended March 31, 2005 from \$92.4 million for the three months ended March 31, 2004, a \$14.0 million or 15.2% decrease. As a percentage of total revenues, our cost of revenues declined to 58.7% from 63.0% for the respective periods.

Liquidity payments declined \$1.3 million to \$51.9 million for the three months ended March 31, 2005 from \$53.2 million for the comparable period a year ago. This decrease was the result of lower trading volumes period-over-period partially offset by the increase in the internal match rate to 88.4% (with 11.6% routed out to other market centers for execution) from 85.5% (with 14.5% routed out to other market centers for execution).

Routing charges declined to \$18.8 million for the three months ended March 31, 2005 from \$26.5 million for the three months ended March 31, 2004, a \$7.7 million or 29.1% decrease. This decline primarily reflects lower routed volume (as the percentage of customer orders matched internally increased period-over-period) and lower routing costs per share as a result of certain cost management initiatives.

Clearance, brokerage and other transaction expenses declined to \$7.7 million for the three months ended March 31, 2005 from \$12.7 million for the comparable period a year ago, a \$5.0 million or 39.4% decrease. This decline was the result of the decrease of our total U.S. market volume and the decrease in the relative number of trades subject to clearing costs due to the lower percentage of orders routed out, as well as the reduction of our clearing costs following the recent self-clearing of the trading activity of our introducing broker and routing broker businesses.

Our agency brokerage services segment accounted for \$7.2 million of our costs of revenues for the three months ended March 31, 2005 compared to \$9.3 million of our cost of revenues for the three months ended March 31, 2004. The decreased contribution of this segment to our consolidated cost of revenues was primarily driven by lower revenues.

Gross Margin

Gross margin increased by \$0.9 million, or 1.7%, to \$55.3 million for the three months ended March 31, 2005 from \$54.4 million for the three months ended March 31, 2004. Our gross margin percentage increased to 41.3% from 37.0% for the respective periods. Despite declining revenues, our gross margin improved as a result of the higher internal match rate of customer orders and the greater contribution of market data fees to our total revenues.

Indirect Expenses

Total indirect expenses increased by \$1.7 million, or 5.2%, to \$34.2 million for the three months ended March 31, 2005 from \$32.5 million for the three months ended March 31, 2004. Total indirect expenses increased as a percentage of total revenues to 25.4% from 22.3%. This increase was chiefly associated with the following:

a \$2.2 million increase in employee compensation and benefits as a result of increased staffing and the amortization of certain employee stock-based compensation expense;

a \$1.4 million increase in marketing and promotion expense due primarily to increased advertising based on the timing of our campaigns;

a \$1.0 million increase in communications expense that is mainly the result of our operation of a new data center in New Jersey; and

a \$1.2 million increase in general and administrative expenses primarily in relation to higher insurance premiums and additional expenses incurred as a public company.

The aggregate \$5.8 million effect of these increases was offset by a \$5.3 million reduction of depreciation and amortization. In June 2003, we determined that certain software and computer equipment would be retired by March 31, 2004 and, therefore, we accelerated depreciation on these assets. For the three months ended March 31, 2004, we recorded an additional \$3.9 million in relation to such acceleration.

Interest and Other

Interest and other income and expenses increased by \$0.7 million to \$0.8 million for the three months ended March 31, 2005. The increase was primarily due to increased average cash balances and interest earning assets, and a reduction of interest expenses incurred in connection with a note payable which we fully repaid in April 2004.

Income Tax Provision

For the three months ended March 31, 2005, we provided for income taxes at a 40.0% blended rate. For the three months ended March 31, 2004, we were treated as a partnership for federal, state and local income tax purposes. As a result, all items of income, expense, gain or loss were generally reportable on the tax returns of our members.

Net Income

As a result of the foregoing, we reported net income for the three months ended March 31, 2005 of \$13.1 million, a decrease of \$8.9 million from the \$22.0 million net income we reported for the comparable period a year ago.

Liquidity and Capital Resources

Historically, our primary sources of liquidity have been cash provided by operations and proceeds generated from the sale of our common equity and preferred shares. On August 19, 2004, we completed the sale of 6,325,000 shares of common stock at \$11.50 per share in our IPO, for which we received net proceeds of \$67.6 million. We incurred approximately \$6.8 million in expenses related to our IPO. Certain former members of Holdings LLC sold another 6,325,000 million shares to the public, for which we received no proceeds. We intend to use the net proceeds from our IPO for general corporate purposes, including providing additional funds for our operations and to expand and diversify our products and service offerings.

On January 3, 2005, we entered into a definitive agreement to acquire PCXH and all of its wholly-owned subsidiaries. At the time of the execution of the definitive agreement, the purchase price was approximately \$50.7 million, to be paid (i) 80% in cash (or approximately \$40.6 million); and (ii) 20% in shares of our common stock, calculated using the average closing price of our common stock over the ten consecutive days prior to the execution date of the definitive agreement (or approximately \$10.1 million). However, as a result of our execution of a merger agreement with the NYSE, at closing, the purchase price will be calculated using the average closing price per share of our common stock over the ten consecutive trading days prior to the closing date of the PCXH acquisition, rather than the ten consecutive days prior to the execution date of the definitive agreement. In addition, the final calculation of the purchase price will depend upon several factors and adjustments, including but not limited to: (i) an adjustment relating to any working capital excess or shortfall of PCXH at closing that is either over or under an agreed upon threshold; and (ii) a downward adjustment in the event that any change of control and related payments to certain executives of the seller exceeds approximately \$4.9 million.

In connection with our contemplated merger with NYSE, at closing, we will be required to have at least \$150.0 million in cash. In addition, we anticipate that we will incur substantial merger expenses consisting primarily of legal, accounting and other advisory fees. For the month of April 2005, we incurred merger and acquisition expenses of approximately \$7.5 million, including \$3.5 million to be paid to a stockholder upon consummation of our merger with NYSE for services performed in relation to the proposed transaction.

Our principal liquidity requirements are for working capital, capital expenditures and general corporate purposes. Our capital expenditures have historically related primarily to developing our trading platforms, which included investments in software development and hardware, as well as building our data centers. In addition to the anticipated acquisition of PCXH, we estimate that our capital expenditures for 2005 will be approximately \$23.0 million for continued development of our trading platforms, and the development of new products and services, including market data products.

At March 31, 2005, we had cash and cash equivalents of \$193.2 million, an increase of \$15.3 million as compared to December 31, 2004. For the three months ended

March 31, 2005, we provided cash of \$19.1 million from our operating activities, consisting of net income of \$13.2 million and the \$5.9 million net effect of non-cash items and changes in working capital. We used \$3.3 million in investing activities to purchase fixed assets and develop software and used \$0.5 million to make principal payments under a capital lease obligation.

We believe that cash flows from operating activities, together with net proceeds from our IPO, should be sufficient for us to fund our current operations for at least the next twelve months. If this proves insufficient, we intend to seek additional financing in the credit or capital markets, although we may be unsuccessful in obtaining additional financing on acceptable terms or at all.

Our broker-dealer subsidiaries are subject to regulatory requirements intended to ensure their respective general financial soundness and liquidity, which require that they comply with certain minimum capital requirements. These regulations, which differ in the United States, the United Kingdom and Canada the three countries in which our broker-dealer subsidiaries do business generally prohibit a broker-dealer subsidiary from repaying borrowings from us or our affiliates, paying cash dividends, making loans to us or our affiliates or otherwise entering into transactions that would result in a significant reduction in its regulatory net capital position without prior notification or approval of its principal regulator. Our capital structure is designed to provide each of our subsidiaries with capital and liquidity consistent with its business and regulatory requirements.

Seasonality

Our business experiences seasonal fluctuations, reflecting reduced trading activity during summer months, particularly in August.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We provided a discussion of our market risk in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2004. For the three months ended March 31, 2005, there was no substantive change in our market risk.

Item 4. Controls and Procedures

Evaluation of Disclosure 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 our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. 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. No significant changes were made in our internal controls or in other factors that could significantly

affect these controls subsequent to the date of their evaluation.

PART II Other Information

Item 1. Legal Proceedings

We provided a discussion of material pending litigation matters relating to our company and our Chairman and Chief Executive Officer in Item 3 of Part I of our Annual Report on Form 10-K for the year ended December 31, 2004. For the three months ended March 31, 2005, there were no material developments with regard to the matters reported in our Annual Report for the year ended December 31, 2004 and no other matters were reportable during the period. However, with respect to the *Nasdaq Litigation*, previously described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, on April 16, 2005, Judge Denise Cote of the Southern District Court of New York issued an order suspending the matter for nine months due to the fact that significant pending corporate transactions might affect the parties' interest in the case.

In addition to the matters described in our Annual Report for the year ended December 31, 2004, from time to time we are involved in various legal proceedings arising in the ordinary course of our business. We do not believe, based on currently available information, that the results of any of these proceedings will have a material adverse effect on our operating results or financial condition.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) Unregistered Sale of Equity Securities

Between January 1, 2005 and March 31, 2005, we granted: (i) options to purchase 192,943 shares of our common stock at a purchase price of \$19.30 per share to certain of our officers; (ii) 288,849 restricted stock units to certain of our officers and key employees; and (iii) 14,797 restricted stock units to our non-management directors under our 2004 Stock Incentive Plan. These transactions were effected under Rule 701 of the Securities Exchange Act of 1933, as amended, as transactions by an issuer under compensatory benefit plans and contracts relating to compensation within the parameters required by Rule 701.

(b) Use of Proceeds

All of the net initial public offering proceeds remain invested in short-term marketable securities pending application of the funds to general corporate purposes. There has been no material change in the planned use of the initial public offering proceeds as described in our final Prospectus dated August 12, 2004 filed with the SEC pursuant to Rule 424(b).

Item 3. Defaults Upon Senior Securities.

None.

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

We did not submit any matters to stockholders to vote upon between January 1, 2005 and March 31, 2005.

Item 5. Other Information.

The audit committee of our Board of Directors approved all of the non-audit services performed by Ernst & Young LLP, our independent auditors, during the period covered by this report.

Item 6. Exhibits

(a) Exhibits

- 2.1 Exchange Agreement, dated as of January 17, 2002, among Archipelago Holdings, L.L.C., REDIBook ECN L.L.C. and the parties named therein.*
- 2.2 Contribution Agreement, dated as of November 12, 2003, between Archipelago Holdings, L.L.C. and GAP Arca Holdings, Inc.*
- 2.3 Agreement and Plan of Merger, dated as of February 27, 2004, between Archipelago Holdings, L.L.C. and GAP Archa Holdings, Inc.*
- 2.4 Letter Agreement, dated February 27, 2004, among GAP-W, L.L.C., Archipelago Holdings, L.L.C. and GAP Archa Holdings, Inc.*
- 2.5 Contribution Agreement, dated July 12, 2000, among Archipelago Holdings, L.L.C., Pacific Exchange, Inc. and PCX Equities, Inc.*
- 2.6 Agreement and Plan of Merger, dated January 3, 2005, among Archipelago Holdings, Inc., New Apple Acquisitions Corporation and PCX Holdings, Inc.**
- 2.7 Agreement and Plan of Merger dated as of April 20, 2005, by and among the New York Stock Exchange, Inc., Archipelago Holdings, Inc., and such other parties that become signatories thereto pursuant to the terms thereof. ***
- 3.1 Form of Certificate of Incorporation of Archipelago Holdings, Inc.*
- 3.2 Form of Bylaws of Archipelago Holdings, Inc.*
- 3.3 Ninth Amended and Restated Limited Liability Company Agreement of Archipelago Holdings, L.L.C.*
- 3.4 Amendment No.1 to Ninth Amended and Restated Limited Liability Company Agreement of Archipelago Holdings, L.L.C.*
- 4.1 Specimen Certificate of Common Stock.*

- 4.2 Registration Rights Agreement, dated November 12, 2003, among Archipelago Holdings, L.L.C., General Atlantic Partners 77, L.P., GAP Coinvestment Partners II, L.P., GapStar, L.L.C., GAPCO GmbH & Co. KG, GAP-W, L.L.C., GAP Archa Holdings, Inc., and the Class A Members of the Archipelago Holdings, L.L.C. and the affiliates of certain of such Class A Members.*
- 10.1 Letter Agreement between Goldman Sachs & Co. and Archipelago Holdings, Inc. **
- 10.2 Annual Director Compensation Agreement +
- 10.3 Form Employee Restricted Stock Unit Award Agreement + +
- 10.4 Letter Agreement between Goldman, Sachs & Co. and Archipelago Holdings, Inc. ***
- 31.1 Rule 13a-14(a) Certification (CEO).
- 31.2 Rule 13a-14(a) Certification (CFO).
- 32.1 Section 1350 Certifications.

* Incorporated by reference to the corresponding Exhibit to the Registrant's registration statement on Form S-1 (No.333-113226).

** Incorporated by reference to the corresponding Exhibit to the Registrant's Form 8-K filed with the SEC on January 4, 2005.

*** Incorporated by reference to the corresponding Exhibit to the Registrant's report on Form 8-K filed with the SEC on April 26, 2005

+ Incorporated by reference from Exhibit 10.1 to the Registrant's Form 8-K filed with the SEC on February 3, 2005.

++ Incorporated by reference from Exhibit 10.1 to the Registrant's Form 8-K filed with the SEC on February 10, 2005.

Signature

Pursuant to the requirements of the Securities Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on May 16, 2005.

ARCHIPELAGO HOLDINGS, INC.

By: /s/ NELSON CHAI
Nelson Chai
Chief Financial Officer