

KNIGHT CAPITAL GROUP, INC.

Form 10-Q

August 11, 2008

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008**

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**001-14223**

**Commission File Number**

**KNIGHT CAPITAL GROUP, INC.**

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of incorporation or organization)

**22-3689303**

(I.R.S. Employer Identification Number)

**545 Washington Boulevard, Jersey City, NJ 07310**

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(Address of principal executive offices and zip code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of accelerated filer, large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)  Smaller reporting company

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

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

As of August 11, 2008, the number of shares outstanding of the Registrant's Class A Common Stock was 90,636,040 and there were no shares outstanding of the Registrant's Class B Common Stock.

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**KNIGHT CAPITAL GROUP, INC.**  
**FORM 10-Q QUARTERLY REPORT**  
**For the Quarter Ended June 30, 2008**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****KNIGHT CAPITAL GROUP, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

|  | For the three<br>months ended<br>June 30, |                | For the six<br>months ended<br>June 30, |                |
|--|---|----------------|---|----------------|
|  | 2008                                      | 2007           | 2008                                    | 2007           |
|  | (In thousands, except per share amounts)  |                |   |                |
| <b>Revenues</b>  |   |                |   |                |
| Commissions and fees   | \$ 114,192                                | \$ 106,929     | \$ 227,378                              | \$ 210,788     |
| Net trading revenue  | 85,433                                    | 54,193         | 186,950                                 | 115,830        |
| Asset management fees, net   | 14,420                                    | 29,116         | 29,606                                  | 89,830         |
| Interest, net  | 2,003                                     | 4,169          | 5,816                                   | 9,012          |
| Investment income (loss) and other, net  | 4,023                                     | 6,990          | (1,578)                                 | 17,613         |
| <b>Total revenues</b>  | <b>220,071</b>                            | <b>201,397</b> | <b>448,172</b>                          | <b>443,073</b> |
| <b>Transaction-based expenses</b>  |   |                |   |                |
| Execution and clearance fees   | 23,828                                    | 28,691         | 49,052                                  | 56,101         |
| Soft dollar and commission recapture expense                                       | 15,740                                    | 14,468         | 34,626                                  | 29,005         |
| Payments for order flow and ECN rebates  | 8,300                                     | 12,761         | 17,226                                  | 25,360         |
| <b>Total transaction-based expenses</b>  | <b>47,868</b>                             | <b>55,920</b>  | <b>100,904</b>                          | <b>110,466</b> |
| <b>Revenues, net of transaction-based expenses</b>                                 | <b>172,203</b>                            | <b>145,477</b> | <b>347,268</b>                          | <b>332,607</b> |
| <b>Other direct expenses</b>   |   |                |   |                |
| Employee compensation and benefits   | 83,353                                    | 78,697         | 169,776                                 | 180,930        |
| Communications and data processing   | 11,755                                    | 9,387          | 21,883                                  | 18,086         |
| Professional fees  | 7,581                                     | 3,191          | 12,667                                  | 8,680          |
| Depreciation and amortization  | 6,179                                     | 5,514          | 11,925                                  | 10,916         |
| Occupancy and equipment rentals  | 5,364                                     | 3,550          | 9,376                                   | 7,005          |
| Business development   | 4,553                                     | 4,493          | 8,467                                   | 8,272          |
| Interest expense   | 927                                       | -              | 1,984                                   | 25             |
| Writedown of assets and lease loss accrual   | (1,872)                                   | (1,490)        | (1,872)                                 | (1,490)        |
| Other  | 3,871                                     | 2,275          | 5,293                                   | 5,608          |
| <b>Total other direct expenses</b>   | <b>121,711</b>                            | <b>105,617</b> | <b>239,499</b>                          | <b>238,032</b> |
| <b>Income from continuing operations before income taxes and minority interest</b> | <b>50,492</b>                             | <b>39,860</b>  | <b>107,769</b>                          | <b>94,575</b>  |
| Income tax expense   | 19,967                                    | 15,480         | 43,287                                  | 37,010         |
| <b>Income from continuing operations before minority interest</b>                  | <b>30,525</b>                             | <b>24,380</b>  | <b>64,482</b>                           | <b>57,565</b>  |
| Minority interest expense  | 1,114                                     | -              | 2,568                                   | -              |
| <b>Income from continuing operations</b>   | <b>29,411</b>                             | <b>24,380</b>  | <b>61,914</b>                           | <b>57,565</b>  |
| Loss from discontinued operations, net of tax                                      | -   | -              | -                                       | (1,333)        |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| <b>Net income</b>   | \$ 29,411 | \$ 24,380 | \$ 61,914 | \$ 56,232 |
| Basic earnings per share from continuing operations               | \$ 0.33   | \$ 0.24   | \$ 0.69   | \$ 0.57   |
| Diluted earnings per share from continuing operations             | \$ 0.32   | \$ 0.24   | \$ 0.67   | \$ 0.56   |
| Basic and diluted earnings per share from discontinued operations | \$ -      | \$ -      | \$ -      | \$ (0.01) |
| Basic earnings per share  | \$ 0.33   | \$ 0.24   | \$ 0.69   | \$ 0.56   |
| Diluted earnings per share  | \$ 0.32   | \$ 0.24   | \$ 0.67   | \$ 0.54   |
| Shares used in computation of basic earnings per share            | 90,215    | 99,683    | 90,013    | 100,291   |
| Shares used in computation of diluted earnings per share          | 92,637    | 102,524   | 92,699    | 103,540   |

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

**Table of Contents****KNIGHT CAPITAL GROUP, INC.****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

|  | June 30,<br>2008<br>(Unaudited) | December 31,<br>2007 |
|--|---------------------------------|----------------------|
|  | (In thousands)                  |                      |
| <b>Assets</b>  |                                 |                      |
| Cash and cash equivalents  | \$ 332,686                      | \$ 222,435           |
| Securities owned, held at clearing brokers, at fair value  | 612,821                         | 412,565              |
| Receivable from brokers and dealers  | 235,878                         | 382,544              |
| Asset management fees receivable   | 10,613                          | 27,588               |
| Investment in Deephaven sponsored funds  | 76,454                          | 83,732               |
| Receivable from Deephaven sponsored funds  | -                               | 85,000               |
| Fixed assets and leasehold improvements, at cost, less accumulated depreciation and amortization | 66,327                          | 62,073               |
| Strategic investments  | 84,052                          | 73,704               |
| Goodwill   | 184,240                         | 132,832              |
| Intangible assets, less accumulated amortization   | 72,519                          | 57,845               |
| Deferred compensation investments  | 102,123                         | 85,504               |
| Other assets   | 168,973                         | 129,991              |
| <b>Total assets</b>  | <b>\$ 1,946,686</b>             | <b>\$ 1,755,813</b>  |
| <b>Liabilities and Stockholders Equity</b>   |                                 |                      |
| <b>Liabilities</b>   |                                 |                      |
| Securities sold, not yet purchased, at fair value  | \$ 407,373                      | \$ 335,280           |
| Payable to brokers and dealers   | 142,300                         | 117,001              |
| Accrued compensation expense   | 173,056                         | 228,275              |
| Accrued expenses and other liabilities   | 115,500                         | 119,879              |
| Long term debt   | 140,000                         | 70,000               |
| <b>Total liabilities</b>   | <b>978,229</b>                  | <b>870,435</b>       |
| <b>Commitments and contingent liabilities (Note 17)</b>  |                                 |                      |
| Minority interest  | 3,592                           | -                    |
| <b>Stockholders equity</b>   |                                 |                      |
| Class A Common Stock, \$0.01 par value;  |                                 |                      |
| Shares authorized: 500,000 at June 30, 2008 and December 31, 2007;                               |                                 |                      |
| Shares issued: 153,344 at June 30, 2008 and 150,801 at December 31, 2007;                        |                                 |                      |
| Shares outstanding: 93,909 at June 30, 2008 and 91,536 at December 31, 2007                      |                                 |                      |
|  | 1,533                           | 1,509                |
| Additional paid-in capital   | 620,852                         | 587,025              |
| Retained earnings  | 996,013                         | 934,099              |
| Treasury stock, at cost; 59,435 shares at June 30, 2008 and 59,265 shares at December 31, 2007   | (653,533)                       | (637,255)            |
| <b>Total stockholders equity</b>   | <b>964,865</b>                  | <b>885,378</b>       |
| <b>Total liabilities and stockholders equity</b>   | <b>\$ 1,946,686</b>             | <b>\$ 1,755,813</b>  |

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



**Table of Contents****KNIGHT CAPITAL GROUP, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|   | <b>For the six<br/>months ended<br/>June 30,</b> |             |
|---|--|-------------|
|   | <b>2008</b>                                      | <b>2007</b> |
|   | <b>(In thousands)</b>                            |             |
| <b>Cash flows from operating activities</b>   |  |             |
| Net income  | \$ 61,914  | \$ 56,232   |
| Loss from discontinued operations   | -  | (1,333)     |
| Income from continuing operations   | 61,914   | 57,565      |
| Adjustments to reconcile income from continuing operations to net cash provided by (used in) operating activities |  |             |
| Depreciation and amortization   | 11,925   | 10,916      |
| Stock-based compensation  | 19,014   | 15,759      |
| Deferred rent   | 29   | 196         |
| Writedown of assets and lease loss accrual  | (1,872)  | (1,490)     |
| Unrealized loss (gain) on strategic investments   | 2,093  | (217)       |
| Unrealized loss (gain) on investments in Deephaven sponsored funds  | 5,044  | (13,873)    |
| Minority interest expense   | 2,568  | -           |
| Operating activities from discontinued operations   | -  | (1,333)     |
| (Increase) decrease in operating assets, net of acquisitions and disposals  |  |             |
| Securities owned  | (200,256)  | 271,390     |
| Receivable from brokers and dealers   | 148,594  | (37,918)    |
| Asset management fees receivable  | 16,975   | 56,119      |
| Deferred compensation investments   | (16,619)   | (54,314)    |
| Other assets  | (37,840)   | (47,314)    |
| Increase (decrease) in operating liabilities, net of acquisitions and disposals                                   |  |             |
| Securities sold, not yet purchased  | 72,093   | (276,446)   |
| Payable to brokers and dealers  | 25,299   | 72,672      |
| Accrued compensation expense  | (56,702)   | (58,044)    |
| Accrued expenses and other liabilities  | (17,863)   | (8,780)     |
| Net cash provided by (used in) operating activities   | 34,396   | (15,112)    |
| <b>Cash flows from investing activities</b>   |  |             |
| Redemption of Deephaven sponsored funds   | 87,884   | -           |
| Purchases of fixed assets and leasehold improvements  | (12,363)   | (5,997)     |
| Proceeds from sale of strategic investments   | -  | 5,534       |
| Purchases of strategic investments  | (12,441)   | (4,150)     |
| Purchases of businesses, net of cash acquired   | (28,263)   | (30)        |
| Net cash provided by (used in) investing activities   | 34,817   | (4,643)     |
| <b>Cash flows from financing activities</b>   |  |             |
| Proceeds from long-term debt borrowing  | 70,000   | -           |
| Capital contribution from Deephaven Managing Partners, LLC  | 1,000  | -           |
| Stock options exercised   | 7,657  | 17,901      |
| Income tax benefit on stock awards exercised  | 3,256  | 12,691      |
| Cost of common stock repurchased  | (40,875)   | (100,044)   |
| Net cash provided by (used in) financing activities   | 41,038   | (69,452)    |
| Increase (decrease) in cash and cash equivalents  | 110,251  | (89,207)    |

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|   |            |            |
|---|------------|------------|
| Cash and cash equivalents at beginning of period        | 222,435    | 214,760    |
| Cash and cash equivalents at end of period              | \$ 332,686 | \$ 125,553 |
| Supplemental disclosure of cash flow information:       |            |            |
| Cash paid for interest                                  | \$ 1,949   | \$ 32      |
| Cash paid for income taxes                              | \$ 75,816  | \$ 56,802  |
| Supplemental disclosure of investing activities:        |            |            |
| Goodwill  | \$ 51,407  | \$ 30      |
| Intangible assets                                       | 18,300     | -          |
| Other assets  | 3,911      | -          |
| Accrued expenses and other liabilities                  | (15,355)   | -          |
|   | 58,263     | 30         |
| Issuance of common stock in connection with acquisition | (30,000)   | -          |
| Purchases of businesses, net of cash acquired           | \$ 28,263  | \$ 30      |

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

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**KNIGHT CAPITAL GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Organization and Description of the Business**

Knight Capital Group, Inc. (collectively with its subsidiaries, the Company) has two operating business segments, Global Markets and Asset Management, as well as a Corporate segment. As of June 30, 2008, the Company's business segments comprised the following subsidiaries:

*Global Markets*

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

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

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

Direct Trading Institutional, L.P. (Direct Trading) provides institutions with direct market access trading through Knight Direct EMST<sup>™</sup>, an advanced electronic platform. Direct Trading is a broker-dealer registered with the SEC and is a member of NASDAQ, FINRA and the NFA.

EdgeTrade LLC (EdgeTrade) is an agency-only trade execution and algorithmic software firm that allows buy- and sell-side clients to more effectively source liquidity and manage the trading process as well as maintain anonymity, reduce market impact and lower transaction costs. EdgeTrade is a broker-dealer registered with the SEC and is a member of NASDAQ and FINRA. EdgeTrade was acquired by the Company in January 2008.

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



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**KNIGHT CAPITAL GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

Knight BondPoint, Inc. ( Knight BondPoint ) (formerly known as ValuBond Securities, Inc.) provides electronic access and trade execution products for the retail fixed income market. Knight BondPoint is a broker-dealer registered with the SEC and is a member of FINRA and the Municipal Securities Rulemaking Board ( MSRB ).

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

At the close of business on September 28, 2007 (the Deconsolidation Date ) the Company deconsolidated Direct Edge ECN as it no longer controlled Direct Edge ECN as of that date. The results of Direct Edge ECN s operations have been included in the Consolidated Statements of Operations for the three and six months ended June 30, 2007, when Direct Edge ECN was a wholly-owned subsidiary of the Company. The Company accounts for its interest in Direct Edge Holdings LLC ( Direct Edge Holdings ), the newly formed immediate parent company of Direct Edge ECN (together, Direct Edge ) under the equity method for periods subsequent to the Deconsolidation Date.

*Asset Management*

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

Prior to February 1, 2008, Deephaven was a wholly-owned subsidiary of the Company. On February 1, 2008, the Company contributed its interest in Deephaven to Deephaven Capital Management Holdings LLC ( Deephaven Holdings ) in exchange for a 51% interest in Deephaven Holdings. In addition, certain Deephaven managers acquired a 49% interest in Deephaven Holdings in exchange for the termination of their employment agreements and associated profit sharing bonuses and an equity contribution. See Footnote 16 Deephaven Transaction for a further discussion of Deephaven.

*Corporate*

The Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and the corporate investment as a limited partner or non-managing member in the Deephaven Funds. Corporate overhead expenses primarily consist of compensation for certain

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**KNIGHT CAPITAL GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

senior executives and other individuals employed at the corporate holding company, legal and other professional expenses related to corporate matters, directors' fees, investor and public relations expenses and directors' and officers' insurance.

*Discontinued Operations*

The Company completed the sale of its Derivative Markets business to Citigroup Financial Products Inc. ( Citigroup ) in December of 2004. Costs associated with the Derivative Markets segment have been included within discontinued operations for the six months ended June 30, 2007. For a further discussion of the sale of the Company's Derivative Markets business and its associated accounting treatment, see Footnote 13 Discontinued Operations.

**2. Significant Accounting Policies**

*Basis of consolidation and form of presentation*

The accompanying unaudited Consolidated Financial Statements, prepared in conformity with accounting principles generally accepted in the United States of America ( GAAP ), include the accounts of the Company and its subsidiaries and, in the opinion of management, reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim period. All significant intercompany transactions and balances within continuing operations have been eliminated. The Company records Minority interest expense on the Consolidated Statements of Operations, which reflects the portion of earnings of consolidated subsidiaries that are applicable to the minority interest owners.

Certain footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to SEC rules and regulations, although the Company believes that the disclosures herein are adequate to make the information presented not misleading. The nature of the Company's business is such that the results of an interim period are not necessarily indicative of the results for the full year. These unaudited consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007 as filed with the SEC.

Certain reclassifications have been made to the prior periods' Consolidated Financial Statements in order to conform to the current year presentation. Such reclassifications had no effect on previously reported net income.

*Cash and cash equivalents*

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

*Market making and sales activities*

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

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**KNIGHT CAPITAL GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

institutional client orders) and related expenses are also recorded on a trade date basis. The Company's clearing agreements call for payment or receipt of interest income, net of transaction-related interest charged by clearing brokers, for facilitating the settlement and financing of securities transactions. Interest expense, relating to the clearing broker activity, which has been netted against interest income on the Consolidated Statements of Operations, was \$2.0 million and \$6.1 million for the three months ended June 30, 2008 and 2007, respectively, and \$4.3 million and \$12.0 million for the six months ended June 30, 2008 and 2007, respectively.

Dividend income relating to securities owned and dividend expense relating to securities sold, not yet purchased, derived from the Company's market making activities are included as a component of Net trading revenue on the Consolidated Statements of Operations. Net trading revenue includes dividend income of \$3.8 million and \$1.6 million for the three months ended June 30, 2008 and 2007, respectively, and \$7.0 million and \$3.4 million for the six months ended June 30, 2008 and 2007, respectively. Net trading revenue also includes dividend expense of \$3.0 million and \$1.5 million for the three months ended June 30, 2008 and 2007, respectively, and \$5.0 million and \$3.3 million for the six months ended June 30, 2008 and 2007, respectively.

Payments for order flow and ECN rebates represent payments to broker-dealer clients, in the normal course of business, for directing their order flow in U.S. equities to the Company, and rebates for providing liquidity to Direct Edge ECN through the Deconsolidation Date. Soft dollar and commission recapture expense represents payments to or on behalf of institutions in connection with soft dollar and commission recapture programs.

*Asset management fees*

Deephaven earns asset management fees for managing the Deephaven Funds. Management fees, which are received monthly, are recorded as earned and are calculated as a percentage of each Deephaven Fund's monthly net assets.

Incentive allocation fees are earned based upon the performance of the Deephaven Funds and are calculated based upon a percentage of a new high net asset value as defined in the applicable private placement offering memorandum, for the six month performance period ended June 30 or December 31, for some funds, and for the twelve month performance period ended December 31 for other funds. A new high net asset value is defined as the amount by which the net asset value of an investor's account in a particular Deephaven fund exceeds the greater of either the investor's highest previous net asset value in that Deephaven fund or the net asset value at the time the investor made a purchase.

The Company records incentive allocation fees in accordance with Method 2 of Emerging Issues Task Force (EITF) Topic D-96. Under this methodology, the Company recognizes incentive allocation fee income for each interim period based upon the amount that would be due if the investment advisory relationship with the Deephaven Funds were terminated at the end of such period.

Incentive allocation fees may increase or decrease during the year based on the performance of the Deephaven Funds. As such, the incentive allocation fees, in certain circumstances, may be negative for certain periods, but not lower than zero for any six-month performance period ended June 30 or December 31, for some funds, or the twelve month performance period ended

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**KNIGHT CAPITAL GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

December 31 for other funds. Incentive allocation fees are paid upon the close of each six month performance period, or twelve month performance period, as the case may be, and are not subject to repayment (i.e., clawback) once such performance period has closed. If a fund which has a six month performance period incurs losses in the performance period ended December 31, the Company may make the determination, at its sole discretion, to return all or a portion of incentive allocation fees collected for the prior six month performance period ended June 30 of that year.

*Financial instruments and fair value*

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157 *Fair Value Measurements* ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements.

Under SFAS 157, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price ) in an orderly transaction between market participants at the measurement date. SFAS 157 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company s belief about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgment.

Level 2 Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement. Changes in fair value are recognized in earnings each period for financial instruments that are carried at fair value.

The Company s securities owned and securities sold, not yet purchased will generally be classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices or broker or dealer quotations with reasonable levels of price transparency.

The types of instruments that trade in markets that are not considered to be active, but are valued based on quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency are generally classified within Level 2 of the fair value hierarchy. As of June 30, 2008, the Company s Investment in Deephaven sponsored funds, one strategic investment, as well as Deferred compensation investments met the definition of Level 2.

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**KNIGHT CAPITAL GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

Certain instruments are classified within Level 3 of the fair value hierarchy because they trade infrequently and therefore have little or no price transparency. For those instruments that are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management's best estimate is used. At January 1, 2008 and as of June 30, 2008, the Company did not hold any financial instruments that met the definition of Level 3.

In February 2008, FASB Staff Position FAS 157-2 ( FSP FAS 157-2 ) was issued. FSP FAS 157-2 delays the effective date of SFAS 157 for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The delay was intended to allow additional time to consider the effect of various implementation issues that have arisen from the application of SFAS 157. The Company believes that FSP FAS 157-2 will not have a material impact on the Company's Consolidated Financial Statements.

In February 2007, the FASB issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* ( SFAS 159 ), which provides an option for entities to choose to measure many financial instruments and certain other items at fair value. On January 1, 2008, the Company elected not to take the option available under SFAS 159 for the purposes of valuing certain financial instruments at fair value.

*Strategic investments*

Strategic investments include non-controlling equity ownership interests held by the Company or its non-broker-dealer subsidiaries, primarily in financial services-related businesses. The equity method of accounting is used where the Company is considered to exert significant influence on the investee. Investments are held at amortized cost when the Company is not considered to exert significant influence on the investee. Investments in liquid investment funds, including deferred compensation investments in mutual funds, are accounted for at fair value pursuant to SFAS 157.

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

*Goodwill and intangible assets*

The Company applies the provisions of SFAS No. 142 *Goodwill and Other Intangible Assets*, which requires that goodwill and intangible assets with an indefinite useful life be tested for impairment annually or when an event occurs or circumstances change that signify the existence of impairment. Other intangible assets are amortized on a straight line basis over their useful lives and, as required by SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* ( SFAS 144 ), are tested for recoverability whenever events indicate that the carrying amounts may not be recoverable.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

*Treasury stock*

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

*Foreign currencies*

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

*Depreciation, amortization and occupancy*

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

The Company follows SFAS No. 13 *Accounting for Leases*, as amended, and as clarified by EITF and FASB Technical Bulletins, which states that rent expense under operating leases with fixed rent escalations, lease incentives and free rent periods should be recognized on a straight-line basis over the lease term beginning on the date the lessee takes possession of or controls the use of the space, including during free rent periods.

*Lease loss accrual*

It is the Company's policy to identify excess real estate capacity and where applicable, accrue for such future costs. In determining the accrual, a nominal cash flow analysis is performed for lease losses initiated prior to December 31, 2002, the effective date of SFAS No. 146 *Accounting for Costs Associated with Exit or Disposal Activities*, and costs related to the excess capacity are accrued. For lease losses initiated after December 31, 2002, the Company's policy is to accrue future costs related to excess capacity using a discounted cash flow analysis. In the event the Company is able to sublease the excess real estate after recording a lease loss accrual, such lease loss accrual is adjusted to the extent the actual terms of sub-leased property differ from the assumptions used in the calculation of the lease loss accrual.

*Income taxes*

Pursuant to SFAS No. 109, *Accounting for Income Taxes*, the Company records deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities and measures them using the enacted tax

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**(Unaudited)**

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

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

*Discontinued Operations*

In accordance with SFAS 144, the revenues and expenses associated with a separate segment or reporting unit that has been disposed of through closure or sale are included in Loss from discontinued operations, net of tax, on the Consolidated Statements of Operations.

*Stock-based compensation*

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

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

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

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

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**KNIGHT CAPITAL GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

*Use of Estimates*

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

*Recently Issued Accounting Standards*

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS 141(R) ). SFAS 141(R) requires the acquiring entity in a business combination to recognize the acquisition date fair value for all identifiable assets acquired, and liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141(R) changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development and requires the expensing of acquisition-related and restructuring costs as incurred. SFAS 141(R) is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 141(R) on its Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51* ( SFAS 160 ). SFAS 160 states that accounting and reporting for minority interests will be recharacterized as noncontrolling interests and classified as a component of equity. SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. This statement is effective as of the beginning of an entity's first fiscal year beginning after December 15, 2008. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 160 on its Consolidated Financial Statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133* ( SFAS 161 ). SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2008, with early adoption encouraged. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 161 on the Company's Consolidated Financial Statements.

In April 2008, the FASB issued FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP FAS 142-3 ). FSP FAS 142-3 removes the requirement of SFAS No. 142, *Goodwill and Other Intangible Assets* for an entity to consider, when determining the useful life of an acquired intangible asset, whether the intangible asset can be renewed without substantial cost or material modifications to the existing terms and conditions associated with the intangible asset. FSP FAS 142-3 replaces the previous useful-life assessment criteria with a requirement that an entity consider its own experience in renewing similar arrangements. If the entity has no relevant experience, it would

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

consider market participant assumptions regarding renewal. FSP FAS 142-3 is effective for the Company on December 1, 2009. The Company is currently evaluating the potential impact, if any, of the adoption of FSP FAS 142-3 on its Consolidated Financial Statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS 162 ). SFAS 162 identifies a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for nongovernmental entities (the Hierarchy ). The Hierarchy within SFAS 162 is consistent with that previously defined in the AICPA Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* ( SAS 69 ). SFAS 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The adoption of SFAS 162 will not have a material effect on the Consolidated Financial Statements because the Company has utilized the guidance within SAS 69.

In June 2008, the FASB issued FASB Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and therefore need to be included in calculating earnings per share under the two-class method described in SFAS No. 128, *Earnings per Share*. Additionally, FSP EITF 03-6-1 requires companies to treat unvested share-based payment awards that have non-forfeitable rights to dividend or dividend equivalents as a separate class of securities in calculating earnings per share and is effective for financial statements issued for fiscal years beginning after December 15, 2008; early adoption is not permitted. The Company does not expect FSP EITF 03-6-1 to affect its results of operations or earnings per share.

**Table of Contents****KNIGHT CAPITAL GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued****(Unaudited)****3. Fair Value of Financial Instruments**

The Company's financial instruments recorded at fair value have been categorized based upon a fair value hierarchy in accordance with SFAS 157, as described more fully in Footnote 2 Significant Accounting Policies. The following fair value hierarchy table presents information about the Company's financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2008 (in millions):

|  | Assets and Liabilities Measured at Fair Value on a Recurring Basis |          |         |          |
|--|--|----------|---------|----------|
|  | Level 1  | Level 2  | Level 3 | Total    |
| <b>Assets</b>  |  |          |         |          |
| Securities owned, held at clearing brokers, at fair value: |  |          |         |          |
| Equities <sup>(1)</sup>                                    | \$ 606.1   | \$ -     | \$ -    | \$ 606.1 |
| U.S. government obligations                                | 6.7  | -        | -       | 6.7      |
| Investment in Deephaven sponsored funds                    | -  | 76.5     | -       | 76.5     |
| Strategic investment                                       | -  | 28.2     | -       | 28.2     |
| Deferred compensation investments                          | -  | 102.1    | -       | 102.1    |
| Total fair value of financial instrument assets            | \$ 612.8   | \$ 206.8 | \$ -    | \$ 819.6 |
| <b>Liabilities</b>   |  |          |         |          |
| Securities sold, not yet purchased, at fair value:         |  |          |         |          |
| Equities <sup>(1)</sup>                                    | \$ 407.4   | \$ -     | \$ -    | \$ 407.4 |
| Total fair value of financial instrument liabilities       | \$ 407.4   | \$ -     | \$ -    | \$ 407.4 |

<sup>(1)</sup> Equities of \$107.8 million have been netted by their respective long and short positions as of June 30, 2008.

**4. Receivable from and Payable to Brokers and Dealers**

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

|                                  | June 30, 2008 | December 31, 2007 |
|----------------------------------|---------------|-------------------|
| <b>Receivable:</b>               |               |                   |
| Clearing brokers and other       | \$ 144.6      | \$ 207.1          |
| Securities failed to deliver     | 62.5          | 134.3             |
| Deposits for securities borrowed | 28.7          | 41.1              |
|                                  | \$ 235.9      | \$ 382.5          |

Payable:

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|                              |          |          |
|------------------------------|----------|----------|
| Securities failed to receive | \$ 41.6  | \$ 79.5  |
| Clearing brokers and other   | 100.7    | 37.5     |
|                              | \$ 142.3 | \$ 117.0 |

Totals may not add due to rounding.

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(Unaudited)

**5. Investment in Deephaven Sponsored Funds and Asset Management Fees**

Deephaven is the registered investment adviser to, and sponsor of, the Deephaven Funds, which engage in various trading strategies involving equities, debt instruments and derivatives. The Company's investment in the Deephaven Funds is carried at fair value, as disclosed in Footnote 3 Fair Value of Financial Instruments. Of the \$3.3 billion and \$3.9 billion of Deephaven's assets under management as of June 30, 2008 and December 31, 2007, respectively, the Company had corporate investments as a limited partner or non-managing member of \$76.5 million and \$83.7 million, respectively. Deferred compensation investments on the Consolidated Statements of Financial Condition at June 30, 2008 and December 31, 2007 included \$63.2 million and \$49.8 million, respectively, of investments as a limited partner or non-managing member in the Deephaven Funds related to employee and director deferred compensation plans. Separately, certain officers, directors and employees of the Company held direct investments of approximately \$53.2 million and \$27.6 million as limited partners or non-managing members in the Deephaven Funds, in the aggregate, as of June 30, 2008 and December 31, 2007, respectively.

Asset management fees represent fees earned by Deephaven for sponsoring and managing the Deephaven Funds as well as fees earned from separately managed accounts. These fees consist of management fees, calculated as fixed percentages of assets under management, and incentive allocation fees, generally calculated as a percentage of the funds' and managed accounts year-to-date profits, if any. Incentive allocation fees may be negative in certain interim periods if the funds or managed accounts lose money for such period; however, such fees will not be negative on a year-to-date basis. Management fees were \$9.2 million and \$10.1 million, for the three months ended June 30, 2008 and 2007, respectively, and \$19.0 million and \$21.5 million, for the six months ended June 30, 2008 and 2007, respectively. Incentive allocation fees were \$5.2 million and \$19.0 million, for the three months ended June 30, 2008 and 2007, respectively, and \$10.6 million and \$68.4 million, for the six months ended June 30, 2008 and 2007, respectively.

Included in Investment income (loss) and other, net on the Company's Consolidated Statements of Operations are the results from the Company's corporate investments as a limited partner or non-managing member in the Deephaven Funds. These results were earnings of \$2.0 million and \$6.3 million for the three months ended June 30, 2008 and 2007, respectively, and a loss of \$5.0 million and earnings of \$14.2 million for the six months ended June 30, 2008 and 2007, respectively.

**6. Strategic Investments**

Strategic investments of \$84.1 million at June 30, 2008 consisted of a \$28.2 million short-term investment in a liquid investment fund carried at fair value pursuant to SFAS 157, \$43.8 million in eight limited liability companies, limited partnership investments and a corporation accounted for under the equity method, \$5.5 million in equity of two private companies representing less than 20% equity ownership, which are held at cost and \$6.5 million in three debt instruments which are also held at cost. See Footnote 2 Significant Accounting Policies for a discussion of valuation of Strategic investments. Included in the \$43.8 million investment in limited liability companies at June 30, 2008 is a \$21.2 million equity investment in Direct Edge, which is described further in Footnote 9 Direct Edge ECN.

Strategic investments of \$73.7 million at December 31, 2007 consisted of a \$30.8 million short-term investment in a liquid investment fund carried at fair value, \$37.4 million in eight limited liability

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**(Unaudited)**

companies, limited partnership investments and a corporation accounted for under the equity method and \$5.5 million in equity of two private companies representing less than 20% equity ownership, which are held at cost. Included in the \$37.4 million investment in limited liability companies at December 31, 2007 is a \$19.1 million equity investment in Direct Edge.

**7. Goodwill and Intangible Assets**

Goodwill and intangible assets with indefinite useful lives are tested for impairment annually or when an event occurs or circumstances change that signify the existence of impairment. As part of the test for impairment, the Company considers the profitability of the respective segment or reporting unit, an assessment of the fair value of the respective segment or reporting unit as well as the overall market value of the Company compared to its net book value. In June 2008, the Company tested for the impairment of goodwill and intangible assets and concluded that there was no impairment. Amortizable intangibles are tested for recoverability whenever events indicate that the carrying amounts may not be recoverable. No events occurred in 2007 or during the six months ended June 30, 2008 that would indicate that the carrying amounts of the Company's amortizable intangibles may not be recoverable.

The goodwill balances of \$184.2 million and \$132.8 million at June 30, 2008 and December 31, 2007, respectively, relate to the Global Markets business segment. Goodwill increased by \$51.4 million during the six months ended June 30, 2008, due to the acquisition of EdgeTrade. Goodwill primarily represents the Company's purchases of the businesses now operating as KCM, Direct Trading, Hotspot, Donaldson, Knight BondPoint and EdgeTrade.

The Company had intangible assets, net of accumulated amortization, of \$72.5 million and \$57.8 million at June 30, 2008 and December 31, 2007, respectively, all included within the Global Markets business segment. Intangible assets increased by \$14.7 million during the six months ended June 30, 2008, due primarily to the acquisition of EdgeTrade, offset, in part, by amortization expense. Intangible assets primarily represent client relationships and are being amortized over their remaining useful lives, the majority of which have been determined to range from 4 to 24 years. The weighted average remaining life of the Company's intangible assets at June 30, 2008 is approximately 15 years.

The Company recorded amortization expense, related to its intangible assets of \$1.8 million and \$1.4 million for the three months ended June 30, 2008 and 2007, respectively, and \$3.6 million and \$2.9 million for the six months ended June 30, 2008 and 2007, respectively. As of June 30, 2008, the estimated amortization expense relating to the intangible assets for each of the next five years approximates \$3.9 million for the remainder of 2008, \$7.2 million in 2009, \$6.9 million in 2010, \$6.8 million 2011, \$6.4 million in 2012 and \$5.0 million in 2013.

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The chart below summarizes the Company's Goodwill and Intangible assets, net of accumulated amortization, as of June 30, 2008 and December 31, 2007 (in millions):

|  |                          | June 30,<br>2008 | December 31,<br>2007 |
|--|--------------------------|------------------|----------------------|
| <b>Goodwill</b>  |                          |                  |                      |
| Purchase of Trimark business                             |                          | \$ 10.1          | \$ 10.1              |
| Purchase of Tradetech business                           |                          | 3.0              | 3.0                  |
| Purchase of Donaldson business                           |                          | 3.6              | 3.6                  |
| Purchase of remaining shares in Knight Roundtable Europe |                          | 2.5              | 2.5                  |
| Purchase of Direct Trading business                      |                          | 43.8             | 43.8                 |
| Purchase of Hotspot business                             |                          | 55.7             | 55.7                 |
| Purchase of Knight BondPoint business                    |                          | 14.2             | 14.2                 |
| Purchase of EdgeTrade business                           |                          | 51.4             |                      |
| <b>Total</b>   |                          | <b>\$ 184.2</b>  | <b>\$ 132.8</b>      |
| <br>   |                          |                  |                      |
|  |                          | June 30,<br>2008 | December 31,<br>2007 |
| <b>Intangible Assets <sup>(1)</sup></b>                  |                          |                  |                      |
| Customer relationships <sup>(2)</sup>                    | Gross carrying amount    | \$ 59.1          | \$ 51.9              |
|  | Accumulated amortization | (11.2)           | (9.1)                |
|  | Net carrying amount      | \$ 47.8          | \$ 42.8              |
| Trade names <sup>(3)</sup>                               | Gross carrying amount    | \$ 14.0          | \$ 9.7               |
|  | Accumulated amortization | (1.2)            | (0.9)                |
|  | Net carrying amount      | \$ 12.8          | \$ 8.8               |
| Other <sup>(4)</sup>                                     | Gross carrying amount    | \$ 16.1          | \$ 9.2               |
|  | Accumulated amortization | (4.1)            | (2.9)                |
|  | Net carrying amount      | \$ 11.9          | \$ 6.3               |
| <b>Total</b>   | Gross carrying amount    | <b>\$ 89.1</b>   | <b>\$ 70.8</b>       |
|  | Accumulated amortization | <b>(16.6)</b>    | <b>(13.0)</b>        |
|  | Net carrying amount      | <b>\$ 72.5</b>   | <b>\$ 57.8</b>       |

(1) - The weighted average remaining life of the Company's intangible assets at June 30, 2008 is approximately 15 years.

(2) -

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Customer relationships primarily relate to the Donaldson, Direct Trading, Hotspot and EdgeTrade acquisitions. The weighted average remaining life is approximately 15 years as of June 30, 2008 and 16 years as of December 31, 2007. Lives may be reduced depending upon actual retention rates.

- (3) - Trade names relate to the acquisitions of Donaldson, Direct Trading, Hotspot and EdgeTrade. The weighted average remaining life is approximately 21 years as of June 30, 2008 and 25 years as of December 31, 2007.
- (4) - Other includes technology, non-compete agreements and domain name rights acquired by the Company. The weighted average remaining life is approximately six years as of June 30, 2008 and five years as of December 31, 2007.

Totals may not add due to rounding.

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**(Unaudited)**

**8. Long Term Debt**

On October 9, 2007, the Company entered into a three-year \$140.0 million credit agreement ( Credit Agreement ) with a consortium of banks led by JPMorgan Chase Bank, N.A. ( JPM ). The Credit Agreement includes a three-year delayed-draw senior secured term loan facility of \$70.0 million and a three-year senior secured revolving facility of \$70.0 million. The proceeds of the credit facilities may be used to finance share repurchases, finance selective acquisitions and for general corporate purposes. These credit facilities are repayable in full on October 3, 2010. Interest on the credit facilities is paid quarterly.

During the fourth quarter of 2007, the Company borrowed \$70.0 million under the three year delayed-draw senior secured term loan facility. During the second quarter of 2008, the Company borrowed \$70.0 million under the senior secured revolving facility, bringing the total amount borrowed at June 30, 2008, to \$140.0 million.

Under the terms of the Credit Agreement, the Company has the option to choose an interest rate based on either the JPM Prime Rate or the LIBOR rate. As of June 30, 2008, the \$140.0 million loan facilities bear interest at 4.06% per annum, which is based on the three month LIBOR rate plus 1.25% and will reset at the prevailing rate in September 2008. Approximately \$0.8 million and \$1.8 million respectively, of interest expense was recorded for the three and six months ended June 30, 2008, respectively.

The Company is charged a commitment fee of 0.3% on the unused portion of the credit facilities. For the three and six months ended June 30, 2008, the Company recorded commitment fees of approximately \$0.1 million, which has been included in Other expenses on the Consolidated Statements of Operations.

Under the Credit Agreement, substantially all of the Company s material subsidiaries, other than its foreign subsidiaries, registered broker-dealer subsidiaries and subsidiaries thereof, guarantee the repayment of loans made pursuant to the credit facilities. Pursuant to the Credit Agreement, the credit facilities have been secured by substantially all of the assets of the Company.

The Credit Agreement includes customary representations, warranties, affirmative and negative covenants (including, among others, limitations on certain payments, investments and transactions) and events of default. It also contains financial covenants tied to the maintenance of financial ratios and metrics. These obligations may limit certain activities of the Company, including, but not limited to, certain mergers, acquisitions or dispositions of assets, repurchases of shares and payment of dividends, each above certain thresholds as set forth in the Credit Agreement.

**9. Direct Edge ECN**

After the close of business July 23, 2007 and September 28, 2007 (the latter being the Deconsolidation Date ), Direct Edge Holdings issued equity interests to Citadel Derivatives Group LLC ( Citadel ) in exchange for cash. Immediately following the September 28, 2007 issuance to Citadel, the Company and Citadel sold a portion of their equity interests in Direct Edge Holdings to The Goldman Sachs Group, Inc. for cash.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

As a result of these transactions, the Company no longer controls Direct Edge and, as such, as of the Deconsolidation Date, it is no longer a consolidated subsidiary. The Company's investment in Direct Edge is accounted for under the equity method following the Deconsolidation Date, and is included in Strategic investments on the Consolidated Statements of Financial Condition.

As Direct Edge was a subsidiary of the Company prior to the Deconsolidation Date, the results of its operations through the Deconsolidation Date are included in the Consolidated Statements of Operations for the three and six months ended June 30, 2007. For periods following the Deconsolidation Date, the Company's share of Direct Edge's income and losses are included in Investment income (loss) and other, net on the Consolidated Statements of Operations.

**10. Stock-Based Compensation**

The Company has established the Knight Capital Group, Inc. 1998 Long Term Incentive Plan, the Knight Capital Group, Inc. 1998 Nonemployee Director Stock Option Plan, the Knight Capital Group, Inc. 2003 Equity Incentive Plan and the Knight Capital Group, Inc. 2006 Equity Incentive Plan (the 2006 Plan) (collectively, the Stock Plans). The purpose of the Stock Plans is to provide long-term incentive compensation to employees and directors of the Company. The Stock Plans are administered by the Compensation Committee of the Company's Board of Directors, and allow for the grant of options, stock appreciation rights (2006 Plan only), restricted stock and restricted stock units (collectively, the awards), as defined by the Stock Plans. The Stock Plans limit the number of awards that may be granted to a single individual as well as limit the amount of options, stock appreciation rights (2006 Plan only) or shares of restricted stock or restricted stock units that may be awarded. As of June 30, 2008, the Company has not issued any stock appreciation rights.

*Restricted Shares and Restricted Stock Units*

Eligible employees and directors receive restricted shares and/or restricted stock units, (collectively restricted awards) as a portion of their total compensation. Restricted awards generally vest over three years. The Company has the right to fully vest employees in their restricted awards upon retirement and in certain other circumstances. Restricted awards are otherwise canceled if employment is terminated before the end of the relevant vesting period. The Company measures compensation cost related to restricted awards based on the market value of the Company's common stock at the date of grant, which the Stock Plans define as the average of the high and low sales price on the business day prior to the grant date. The Company recorded compensation expense of \$6.8 million and \$6.4 million, for the three months ended June 30, 2008 and 2007, respectively, and \$17.1 million and \$12.7 million, for the six months ended June 30, 2008 and 2007, respectively, relating to restricted awards, the majority of which has been included in Employee compensation and benefits on the Consolidated Statements of Operations.

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The following table summarizes restricted awards activity during the six months ended June 30, 2008 (shares and units in thousands):

|                                | Restricted Shares |  | Restricted Stock Units |  |
|--------------------------------|-------------------|--|------------------------|--|
|                                | Number of Shares  | Weighted-Average Grant date Fair Value | Number of Units        | Weighted-Average Grant date Fair Value |
| Outstanding at January 1, 2008 | 3,648.9           | \$ 15.19                               | -                      | \$ -                                   |
| Granted                        | 1,657.6           | 16.67                                  | 26.5                   | 18.10                                  |
| Vested                         | (1,543.6)         | 12.21                                  | -                      | -                                      |
| Surrendered                    | (55.5)            | 16.53                                  | -                      | -                                      |
| Outstanding at June 30, 2008   | 3,707.4           | \$ 17.07                               | 26.5                   | \$ 18.10                               |

There is \$49.4 million of unamortized compensation related to the unvested restricted awards outstanding at June 30, 2008. The cost of these unvested restricted awards is expected to be recognized over a weighted average life of 2.0 years.

*Stock Options*

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

The fair value of each option granted is estimated as of its respective grant date using the Black-Scholes option-pricing model. Stock options granted have exercise prices equal to the market value of the Company's common stock at the date of grant as defined by the Stock Plans. The principal assumptions utilized in valuing options and the methodology for estimating such model inputs include: 1) risk-free interest rate estimate is based on the yield of U.S. zero coupon securities with a maturity equal to the expected life of the option; 2) expected volatility estimate is based on several factors including implied volatility of market-traded options on the Company's common stock on the grant date and the historical volatility of the Company's common stock; and 3) expected option life estimate is based on internal studies of historical experience and projected exercise behavior based on different employee groups and specific option characteristics, including the effect of employee terminations. Based on the results of the model, the weighted-average fair value of the stock options granted during the quarter ended June 30, 2007 was \$5.75 per option. There were no options granted for the quarter ended June 30, 2008.

The Company recorded compensation expense of \$0.8 million and \$1.4 million, for the three months ended June 30, 2008 and 2007, respectively, and \$1.9 million and \$3.0 million, for the six months ended June 30, 2008 and 2007, respectively, relating to stock options, all of which was recorded in Employee compensation and benefits on the Consolidated Statements of Operations.



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The following table summarizes stock option activity during the six months ended June 30, 2008 (stock options in thousands):

|  | <b>Number of<br/>Stock Options</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Price</b> |
|--|------------------------------------|---|
| Outstanding at January 1, 2008                 | 5,715.7                            | \$ 12.16  |
| Granted at market value                        | 300.0                              | 16.93   |
| Exercised                                      | (915.7)                            | 8.48  |
| Surrendered                                    | (34.2)                             | 8.25  |
| Outstanding at June 30, 2008                   | 5,065.8                            | \$ 13.13  |
| Vested at June 30, 2008                        | 4,941.8                            | \$ 13.06  |
| Available for future grants at June 30, 2008 * | 10,430.3                           |   |

\* represents both options and restricted awards available for grant

There is \$3.7 million of unrecognized compensation related to unvested stock options outstanding at June 30, 2008. The cost of these unvested awards is expected to be recognized over a weighted average life of 1.4 years.

**11. Writedown of Assets and Lease Loss Accrual**

The Writedown of assets and lease loss accrual was a benefit of \$1.9 million and \$1.5 million during the three and six months ended June 30, 2008 and 2007, respectively. These benefits were primarily related to adjustments of previously recognized lease losses with respect to the Company's 545 Washington Boulevard property in Jersey City, N.J. During the second quarters of both 2008 and 2007, the Company entered into sub-lease agreements for portions of the premises for which it had previously recorded a lease loss accrual. The lease loss accrual was adjusted based on the difference between the actual terms of the sub-lease and the assumptions previously used in the calculation of the lease loss accrual.

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(Unaudited)

**12. Income Taxes**

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

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

|  | For the three months ended<br>June 30, |       | For the six months ended<br>June 30, |       |
|--|--|-------|--------------------------------------|-------|
|  | 2008                                   | 2007  | 2008                                 | 2007  |
| U.S. federal statutory income tax rate                                   | 35.0%                                  | 35.0% | 35.0%                                | 35.0% |
| U.S. state and local income taxes, net of U.S. federal income tax effect | 5.4%                                   | 3.6%  | 6.0%                                 | 3.8%  |
| Nondeductible charges and other, net                                     | -0.9%                                  | 0.2%  | -0.8%                                | 0.3%  |
| Actual income tax rate   | 39.5%                                  | 38.8% | 40.2%                                | 39.1% |

Effective January 1, 2007 the Company adopted FIN 48. The Company recognized no material adjustment in the liability for unrecognized income tax benefits as a result of the implementation of FIN 48. At the adoption date of January 1, 2007, the Company had \$0.9 million of unrecognized tax benefits and at June 30, 2008, the Company had \$0.7 million of unrecognized tax benefits, all of which would affect the Company's effective tax rate if recognized.

As of June 30, 2008, the Company is subject to U.S. Federal income tax examinations for the tax years 2005 and 2006, and to non-U.S. income tax examinations for the tax years 2002 through 2005. In addition, the Company is subject to state and local income tax examinations in various jurisdictions for the tax years 2000 through 2006. The final outcome of these examinations is not yet determinable. However, the Company anticipates that adjustments to the unrecognized tax benefits, if any, will not result in a material change to the results of operations or financial condition.

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

**13. Discontinued Operations**

The Company completed the sale of its Derivative Markets business to Citigroup in December 2004. In accordance with SFAS 144, the results of the Derivative Markets business segment, the revenues and expenses associated with these businesses as well as all costs associated with the sale transaction have been included in Loss from discontinued operations, net of tax on the Consolidated Statements of Operations for all periods presented.

In 2006, the Company received a request from the staff of the SEC for voluntary production of certain documentation related to options activities of its former Derivative Markets business segment



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which, prior to its sale by the Company in December 2004, was primarily operated through Knight Financial Products LLC. The Company believes this request is part of a broader review by the staff of the SEC regarding certain trading practices in the options industry during the period 1999 to 2005. The Company responded to this request and is cooperating with the staff of the SEC and certain regional exchanges to resolve this matter. During the first quarter of 2007, the Company recorded a charge of \$1.3 million, net of tax relating to this matter. During the third quarter of 2007, the Company increased its charge relating to this matter from \$1.3 million to \$1.4 million, net of tax. This charge has been reported in Loss from discontinued operations, net of tax on the Consolidated Statements of Operations.

The revenues and results of operations of the discontinued operations for the six months ended June 30, 2007 are summarized as follows (in millions):

|   | <b>Six months ended<br/>June 30, 2007</b> |
|---|---|
| Revenues                                      | \$ -                                      |
| Pre-tax loss from discontinued operations     | \$ (2.0)                                  |
| Income tax benefit                            | 0.6                                       |
| Loss from discontinued operations, net of tax | \$ (1.3)                                  |

Totals may not add due to rounding.

**14. Earnings per Share**

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

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the three and six months ended June 30, 2008 and 2007 (in millions, except per share data):

|  | <b>For the three months ended June 30,</b> |                                 |                                   |                                 |
|--|--|---------------------------------|-----------------------------------|---------------------------------|
|  | <b>2008</b>                                |                                 | <b>2007</b>                       |                                 |
|  | <b>Numerator /<br/>net income</b>          | <b>Denominator /<br/>shares</b> | <b>Numerator /<br/>net income</b> | <b>Denominator /<br/>shares</b> |
| Income and shares used in basic calculations   | \$ 29.4                                    | 90.2                            | \$ 24.4                           | 99.7                            |
| Effect of dilutive stock based awards          | -  | 2.4                             | -                                 | 2.8                             |
| Income and shares used in diluted calculations | \$ 29.4                                    | 92.6                            | \$ 24.4                           | 102.5                           |
| Basic earnings per share                       |  | \$ 0.33                         |                                   | \$ 0.24                         |

|                            |    |      |    |      |
|----------------------------|----|------|----|------|
| Diluted earnings per share | \$ | 0.32 | \$ | 0.24 |
|----------------------------|----|------|----|------|

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(Unaudited)

|  | For the six months ended June 30, |                         |                           |                         |
|--|-----------------------------------|-------------------------|---------------------------|-------------------------|
|  | 2008                              |                         | 2007                      |                         |
|  | Numerator /<br>net income         | Denominator /<br>shares | Numerator /<br>net income | Denominator /<br>shares |
| Income and shares used in basic calculations   | \$ 61.9                           | 90.0                    | \$ 56.2                   | 100.3                   |
| Effect of dilutive stock based awards          | -                                 | 2.7                     | -                         | 3.2                     |
| Income and shares used in diluted calculations | \$ 61.9                           | 92.7                    | \$ 56.2                   | 103.5                   |
| Basic earnings per share                       |                                   | \$ 0.69                 |                           | \$ 0.56                 |
| Diluted earnings per share                     |                                   | \$ 0.67                 |                           | \$ 0.54                 |

The above calculations exclude options that could potentially dilute EPS in the future but were antidilutive for the periods presented. The number of such options excluded was approximately 1.2 million and 1.3 million for the three and six months ended June 30, 2008, respectively, and 1.0 million and 0.8 million for the three and six months ended June 30, 2007, respectively.

**15. Significant Clients and Investors**

The Company considers significant clients to be those clients who account for 10% or more of the total U.S. equity dollar value traded by the Company during the period. No clients accounted for more than 10% of the Company's U.S. equity dollar value traded during the three and six months ended June 30, 2008 and 2007.

The Company considers significant investors to be those investors who account for 10% or more of assets under management in the Deephaven Funds. Two significant investors accounted for a total of 25.9% of the Deephaven Funds' assets under management as of June 30, 2008 and one significant investor accounted for 10.8% as of December 31, 2007.

**16. Deephaven Transaction**

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

Effective January 1, 2007, the Deephaven Managers were also granted an option (the Option), exercisable after January 1, 2008 and until December 31, 2012, and conditioned on meeting certain requirements, to obtain a 49% interest in a new limited liability company (Deephaven Holdings) to



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

which the Company's interests in Deephaven would be contributed in exchange for the termination of their new employment agreements and associated profit-sharing bonuses. The agreement also provided that in the event of a change of control of the Company prior to December 31, 2012, the Deephaven Managers would have the option (the Change of Control Option), in exchange for the termination of their 2006 Employment Agreements and associated profit-sharing bonuses, to obtain a 51% interest in Deephaven or, if the Option had already been exercised, to increase their 49% interest resulting from the exercise of the Option by an additional 2%. Following any exercise of the Option or Change of Control Option by the Deephaven Managers, pre-tax earnings prior to profit sharing would be allocated between Knight and the Deephaven Managers in the same manner as under the 2006 Employment Agreements.

*Exercise of Option by Deephaven Managers*

On January 10, 2008, Deephaven Managing Partners, LLC (Deephaven Partners), an entity owned and controlled by the Deephaven Managers, provided notice to the Company that it was exercising the Option.

On February 1, 2008, after regulatory and contractual approvals were received, the Company completed the transaction whereby the Company contributed its interest in Deephaven to Deephaven Holdings and Deephaven Partners acquired a 49% interest in Deephaven Holdings in exchange for the termination of the Deephaven Managers' 2006 Employment Agreements and associated profit sharing bonuses and an equity contribution of \$1 million to Deephaven Holdings by Deephaven Partners (the Deephaven Transaction). The Deephaven Transaction did not affect or result in any change to Deephaven's role as investment manager to the funds it currently manages, or to the manner in which Deephaven carries out its duties as investment manager to those funds.

As part of the Deephaven Transaction, the Company and Deephaven Partners entered into a new Limited Liability Company Agreement (the New LLC Agreement) for Deephaven Holdings. In addition, the 2006 Employment Agreements terminated and were replaced by new long-term employment agreements between Deephaven Holdings and each of the Deephaven Managers (the New Employment Agreements). The New Employment Agreements do not include the profit-sharing bonuses provided under the 2006 Employment Agreements; however, the Deephaven Managers continue to be entitled to participate in certain profit pools relating to specific Deephaven funds. Following the Deephaven Transaction, pre-tax earnings are allocated between the Company and, through Deephaven Partners, the Deephaven Managers in a similar manner as under the 2006 Employment Agreements. Profit-sharing bonuses under the 2006 Employment Agreements had been reported in Employee compensation and benefits on the Company's Consolidated Statements of Operations. As a result of the Deephaven Transaction, beginning in February 2008, profits or losses allocated to the Deephaven Managers are instead reported as Minority interest expense on the Company's Consolidated Statements of Operations and included as Minority interest on the Company's Consolidated Statements of Financial Condition. Minority interest expense of \$1.1 million and \$2.6 million recorded for the three and six months ended June 30, 2008, respectively, represents the accrual for the one-time 2008 minimum distribution to the Deephaven Managers pursuant to the New LLC Agreement.

Under the New LLC Agreement, the Company owns 51% of the shares in Deephaven Holdings, and Deephaven Partners owns 49% of the shares. The Company is entitled to appoint a majority of the

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued**

**(Unaudited)**

Board of Managers of Deephaven Holdings until such time as the Change of Control Option is exercised, at which time Deephaven Partners will be entitled to appoint a majority of the Board of Managers.

Under the New LLC Agreement, certain corporate actions will require approval of a super-majority of members of the Board of Managers, including representatives of both Deephaven Partners and the Company. Neither party is permitted to transfer any of its interests in Deephaven Holdings to any unaffiliated third person without the consent of the other party. Any sale of Deephaven Holdings requires either (x) the consent of the holders of 75% of the shares or (y) if the aggregate consideration is in excess of \$450 million, the approval of only Deephaven Partners (subject to a right of first refusal for the benefit of the Company). Pursuant to the New LLC Agreement, proceeds from any sale or liquidation of Deephaven or Deephaven Holdings will be allocated among the Company and Deephaven Partners based upon a formula that takes into account their capital accounts at the time of such sale or liquidation and relative profit sharing percentages over a defined period of time.

For additional information on the transaction, see the Company's Annual Report on Form 10-K for the year ended December 31, 2007. See Footnote 17 Commitments and Contingent Liabilities for a discussion of the closing of the Deephaven Event Fund.

**17. Commitments and Contingent Liabilities**

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

As described in Footnote 2 Significant Accounting Policies, if a Deephaven fund which has a six-month performance period incurs losses in the performance period ended December 31, the Company may make the determination, at its sole discretion, to return all or a portion of incentive allocation fees collected for the prior six month performance period ending June 30 of that year. As of June 30, 2008 the performance period ending December 31 is still ongoing, therefore, substantially all of the \$10.6 million of incentive allocation fees recorded through this date could potentially be reversed by the end of the respective performance period, as applicable. The actual amount, if any, to be reversed will ultimately depend upon the performance of the Deephaven Funds in 2008.

The Company leases office space under noncancelable operating leases. Certain office leases contain fixed dollar-based escalation clauses. Rental expense from continuing operations under the office leases was \$2.7 million and \$2.2 million for the three months ended June 30, 2008 and 2007, respectively, and is included in Occupancy and equipment rentals on the Consolidated Statements of

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Operations. For the six months ended June 30, 2008 and 2007, rental expense from continuing operations was \$5.2 million and \$4.5 million, respectively. The Company has sublet a portion of its excess office space to third parties.

The Company leases certain computer and other equipment under noncancelable operating leases and has entered into guaranteed employment contracts with certain of its employees. As of June 30, 2008, future minimum rental commitments under all noncancelable office, computer and equipment leases ( Gross Lease Obligations ), Sublease Income and guaranteed employment contracts longer than one year ( Other Obligations ) were as follows (in millions):

|                                     | <b>Gross Lease<br/>Obligations</b> | <b>Sublease<br/>Income</b> | <b>Net Lease<br/>Obligations</b> | <b>Other<br/>Obligations</b> |
|-------------------------------------|------------------------------------|----------------------------|----------------------------------|------------------------------|
| Six months ending December 31, 2008 | \$ 6.9                             | \$ 0.5                     | \$ 6.4                           | \$ 5.9                       |
| Year ending December 31, 2009       | 16.0                               | 1.0                        | 15.0                             | 6.1                          |
| Year ending December 31, 2010       | 16.4                               | 0.9                        | 15.5                             | 0.6                          |
| Year ending December 31, 2011       | 16.6                               | 0.9                        | 15.7                             | -                            |
| Year ending December 31, 2012       | 16.8                               | 1.0                        | 15.7                             | -                            |
| Thereafter through October 31, 2021 | 118.4                              | 6.0                        | 112.4                            | -                            |
|                                     | <b>\$ 191.2</b>                    | <b>\$ 10.4</b>             | <b>\$ 180.7</b>                  | <b>\$ 12.6</b>               |

During the normal course of business, the Company collateralizes certain leases or other contractual obligations through letters of credit or segregated funds held in escrow accounts. As of June 30, 2008, the Company has provided a letter of credit for \$6.0 million, collateralized by U.S. Treasury Bills, as a guarantee for one of the Company's lease obligations.

*Closing of Deephaven Event Fund*

On January 31, 2008, Deephaven announced that it had concluded that it is in the best interests of investors in the Deephaven Event Fund LLC and the Deephaven Event Fund Ltd. (collectively, the Event Fund) that the Event Fund return investors' capital. The decision to return investors' capital in the Event Fund occurred after a review by Deephaven of the Event Fund and the Event Fund's viability given the current macro-economic environment, performance over the preceding nine months, declining investor interest in event-driven investment strategies and significant levels of redemption requests in the Event Fund. Substantive changes in macro-economic circumstances in the U.S. have resulted in a reduction in the types of opportunities that Deephaven would ordinarily pursue as components of the Event Fund's core event-driven strategy and the conclusion that the Event Fund's core investment strategy is unlikely to produce the type of investment results Deephaven and its investors might expect over the short and intermediate term. As a result, redemptions in the Event Fund were suspended with immediate effect and Deephaven began an orderly process to reduce trading positions to cash and return investors' capital as promptly as reasonably practicable. As of February 1, 2008, and through the period of time Deephaven is returning investors' capital, no management or incentive allocation fee will be charged to investors in the Event Fund.

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On January 14, 2008, the Company completed the acquisition of EdgeTrade, a privately-held firm for \$58.2 million comprising \$28.2 million in cash and approximately 2.3 million shares of unregistered Knight common stock valued at \$30.0 million. EdgeTrade is an agency-only trade execution and algorithmic software firm that allows buy- and sell-side clients to more effectively source liquidity and manage the trading process as well as maintain anonymity, reduce market impact and lower transaction costs. The following table summarizes the estimated fair values of the assets acquired and liabilities assumed (in millions):

|  |    |        |
|--|----|--------|
| Agreed purchase price                  | \$ | 59.5   |
| Adjustment for working capital         |    | (2.0)  |
| Adjusted purchase price                |    | 57.5   |
| Acquisition costs                      |    | 0.7    |
| Purchase of business                   | \$ | 58.2   |
| Cash                                   | \$ | 1.0    |
| Goodwill                               |    | 51.4   |
| Intangible assets                      |    | 17.3   |
| Other assets                           |    | 3.9    |
| Accrued expenses and other liabilities |    | (15.4) |
| Purchase of business                   | \$ | 58.2   |

**19. Business Segments**

The Company currently has two operating business segments, Global Markets and Asset Management as well as a Corporate segment. The Global Markets segment provides market access and trade execution services in nearly every U.S. equity security and a large number of international securities, futures, options, foreign exchange and fixed income. The Global Markets segment offers high quality trade executions through natural liquidity, capital facilitation and trading technology, with comprehensive products and services that support alpha creation and capital formation. The Asset Management segment consists of investment management and sponsorship of the Deephaven Funds. The Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and the Company's corporate investment as a limited partner or non-managing member in the Deephaven Funds. Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses relating to corporate matters, directors' fees, investor and public relations expenses and directors' and officers' insurance.

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(Unaudited)

The Company's revenues, income (loss) from continuing operations before income taxes and minority interest ( Pre-tax earnings ) and total assets by segment are summarized below (in millions).

|  | Global Markets | Asset Management | Corporate | Consolidated Total |
|--|----------------|------------------|-----------|--------------------|
| <b>For the three months ended June 30, 2008:</b> |                |                  |           |                    |
| Revenues   | \$ 201.3       | \$ 14.5          | \$ 4.2    | \$ 220.1           |
| Pre-tax earnings <sup>(1)</sup>                  | 64.4           | (6.8)            | (7.2)     | 50.5               |
| Total assets                                     | 1,608.2        | 129.8            | 208.7     | 1,946.7            |
| <b>For the three months ended June 30, 2007:</b> |                |                  |           |                    |
| Revenues   | \$ 165.3       | \$ 29.4          | \$ 6.8    | \$ 201.4           |
| Pre-tax earnings                                 | 32.7           | 6.3              | 0.9       | 39.9               |
| Total assets                                     | 1,435.7        | 196.6            | 126.6     | 1,758.9            |
| <b>For the six months ended June 30, 2008:</b>   |                |                  |           |                    |
| Revenues   | \$ 422.4       | \$ 29.7          | \$ (4.0)  | \$ 448.2           |
| Pre-tax earnings <sup>(1)</sup>                  | 143.4          | (9.5)            | (26.1)    | 107.8              |
| Total assets                                     | 1,608.2        | 129.8            | 208.7     | 1,946.7            |
| <b>For the six months ended June 30, 2007:</b>   |                |                  |           |                    |
| Revenues   | \$ 337.9       | \$ 90.6          | \$ 14.6   | \$ 443.1           |
| Pre-tax earnings                                 | 68.8           | 25.2             | 0.5       | 94.6               |
| Total assets                                     | 1,435.7        | 196.6            | 126.6     | 1,758.9            |

Totals may not add due to rounding.

(1) - Asset Management excludes \$1.1 million and \$2.6 million in Minority interest expense for the three and six months ended June 30, 2008, respectively.

**20. Subsequent Event**

On July 11, 2008, the Company acquired Libertas Holdings LLC, a boutique institutional fixed income brokerage firm, for \$50 million in cash and approximately 1.5 million shares of unregistered Knight common stock valued at \$25 million. Upon acquisition, Libertas Holdings LLC was renamed Knight Libertas Holdings LLC and its U.S. broker-dealer subsidiary was renamed Knight Libertas LLC (together with its affiliates, Libertas ). The \$50 million in cash is subject to an adjustment based on actual working capital at Libertas as of the closing of the transaction and the unregistered Knight common stock is subject to certain contractual transfer restrictions.

The terms of the agreement also include a potential earn-out of up to \$75 million of unregistered Knight common stock based on the future performance of Libertas during the three-year period following the closing of the transaction.

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Libertas is a riskless principal fixed income broker-dealer specializing in high-yield, distressed, and asset- and mortgage-backed securities. Libertas also provides clients with proprietary research reports on companies and target sectors. The results of Libertas will be included within the Global Markets segment beginning with the third quarter of 2008.

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

The following discussion of our results of operations should be read in conjunction with our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007 as filed with the U.S. Securities and Exchange Commission ( SEC ). This discussion contains forward-looking statements that involve risks and uncertainties, including those discussed in our Form 10-K. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth elsewhere in this document and in our Form 10-K.

Certain statements contained in this Quarterly Report on Form 10-Q, including without limitation, those under Management's Discussion and Analysis of Financial Condition and Results of Operations herein ( MD&A ), Quantitative and Qualitative Disclosures About Market Risk in Part I, Item 3, and Legal Proceedings in Part II, Item 1, and the documents incorporated by reference, may constitute forward-looking statements. These forward-looking statements are not historical facts, and are based on current expectations, estimates and projections about the Company's industry, management's beliefs and certain assumptions made by management, many of which, by their nature, are inherently uncertain and beyond our control. Accordingly, readers are cautioned that any such forward-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict including, without limitation, risks associated with the costs, integration, performance and operation of the businesses acquired, or that may be acquired in the future, by the Company. Since such statements involve risks and uncertainties, the actual results and performance of the Company may turn out to be materially different from the results expressed or implied by such forward-looking statements. Given these uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. Unless otherwise required by law, the Company also disclaims any obligation to update its view of any such risks or uncertainties or to announce publicly the result of any revisions to the forward looking statements made in this report. Readers should carefully review the risks and uncertainties disclosed in the Company's reports with the SEC including, without limitation, those detailed under Certain Factors Affecting Results of Operations within MD&A herein and under Risk Factors in the Company's Annual Report on Form 10-K, and in other reports or documents the Company files with, or furnishes to, the SEC from time to time. This discussion should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto contained in this Form 10-Q, and in other reports or documents the Company files with, or furnishes to, the SEC from time to time.

***Executive Overview***

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

**Global Markets** Our Global Markets business provides market access and trade execution services in nearly every U.S. equity security and a large number of international securities, futures, options, foreign exchange and fixed income. We offer high quality trade executions through natural liquidity, capital facilitation and trading technology, with comprehensive products and services that support alpha creation and capital formation.

**Asset Management** Our Asset Management business, Deeptaven Capital Management ( Deeptaven ), is a global, multi-strategy alternative investment manager focused on

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delivering attractive risk-adjusted returns with low correlation to the broader markets for institutions and private clients. Assets under management were \$3.3 billion as of July 1, 2008, down from \$4.2 billion as of July 1, 2007. For additional information regarding the Asset Management segment, refer to the Deephaven section of this MD&A.

The Company's Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and our corporate investment as a limited partner or non-managing member in funds managed by the Asset Management segment (the Deephaven Funds). Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses related to corporate matters, directors' fees, investor and public relations expenses and directors' and officers' insurance.

In December 2004, the Company completed the sale of one of its business segments, Derivative Markets, to Citigroup Financial Products Inc. In accordance with accounting principles generally accepted in the United States of America (GAAP), the results of this segment have been included within discontinued operations. For a further discussion of the sale of the Company's Derivative Markets business, see Footnote 13 Discontinued Operations included in Part I, Item 1 Financial Statements of this Form 10-Q.

The following table sets forth: (i) Revenues, (ii) Expenses, (iii) Minority interest expense and (iv) Pre-tax earnings (loss) after minority interest expense of our segments and on a consolidated basis (in millions):

|   | For the three months ended |               | For the six months ended |               |
|---|----------------------------|---------------|--------------------------|---------------|
|   | June 30, 2008              | June 30, 2007 | June 30, 2008            | June 30, 2007 |
| <b>Global Markets</b>                                   |                            |               |                          |               |
| Revenues  | \$ 201.3                   | \$ 165.3      | \$ 422.4                 | \$ 337.9      |
| Expenses  | 136.9                      | 132.6         | 279.0                    | 269.0         |
| Pre-tax earnings  | 64.4                       | 32.7          | 143.4                    | 68.8          |
| <b>Asset Management</b>                                 |                            |               |                          |               |
| Revenues  | 14.5                       | 29.4          | 29.7                     | 90.6          |
| Expenses  | 21.3                       | 23.1          | 39.2                     | 65.4          |
| Pre-tax (loss) earnings                                 | (6.8)                      | 6.3           | (9.5)                    | 25.2          |
| Minority interest expense                               | 1.1                        | -             | 2.6                      | -             |
| Pre-tax (loss) earnings after minority interest expense | (7.9)                      | 6.3           | (12.1)                   | 25.2          |
| <b>Corporate</b>  |                            |               |                          |               |
| Revenues  | 4.2                        | 6.8           | (4.0)                    | 14.6          |
| Expenses  | 11.4                       | 5.9           | 22.2                     | 14.1          |
| Pre-tax (loss) earnings                                 | (7.2)                      | 0.9           | (26.1)                   | 0.5           |
| <b>Consolidated</b>                                     |                            |               |                          |               |
| Revenues  | 220.1                      | 201.4         | 448.2                    | 443.1         |
| Expenses  | 169.6                      | 161.5         | 340.4                    | 348.5         |
| Pre-tax earnings  | 50.5                       | 39.9          | 107.8                    | 94.6          |
| Minority interest expense                               | 1.1                        | -             | 2.6                      | -             |
| Pre-tax earnings after minority interest expense        | \$ 49.4                    | \$ 39.9       | \$ 105.2                 | \$ 94.6       |

Totals may not add due to rounding.



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Consolidated Revenues for the three months ended June 30, 2008 increased \$18.7 million, or 9.3% from the same period a year ago, while Consolidated Expenses increased \$8.0 million, or 5.0%. Overall, Consolidated Pre-tax earnings after minority interest expense for the three months ended June 30, 2008 increased \$9.5 million, or 23.8% from the same period a year ago.

Consolidated Revenues for the six months ended June 30, 2008 increased \$5.1 million, or 1.2% from the same period a year ago, while Consolidated Expenses decreased \$8.1 million, or 2.3%. Overall, Consolidated Pre-tax earnings after minority interest expense for the six months ended June 30, 2008 increased \$10.6 million, or 11.2% from the same period a year ago.

The changes in our Pre-tax earnings after minority interest expense by segment from the three and six months ended June 30, 2007 to the three and six months ended June 30, 2008 are summarized as follows:

**Global Markets** Our Pre-tax earnings from Global Markets for the three months ended June 30, 2008 increased by \$31.8 million, or 97.1%, from the comparable period in 2007. Our Pre-tax earnings from Global Markets for the six months ended June 30, 2008 increased by \$74.6 million, or 108.3%, from the comparable period in 2007. These increases are primarily due to higher U.S. equity dollar value traded, greater trade volumes and improved margins offset, in part, by lower revenue capture per U.S. equity dollar value traded.

**Asset Management** Our Pre-tax results after minority interest expense from Asset Management for the three months ended June 30, 2008 decreased by \$14.2 million from the comparable period in 2007. Our Pre-tax results after minority interest expense from Asset Management for the six months ended June 30, 2008 decreased by \$37.3 million from the comparable period in 2007. These decreases are primarily due to lower incentive allocation fees as a result of lower fund returns and lower management fees as a result of a decrease in assets under management, offset in part by a decrease in profitability-based bonuses. Asset Management revenues for the three and six months ended June 30, 2008 were adversely impacted by the announced closing of the Event Fund, as described further under the heading "Deephaven" in this MD&A.

**Corporate** Our Pre-tax results from our Corporate segment for the three and six months ended June 30, 2008 decreased by \$8.0 million and \$26.7 million, respectively, from the comparable period in 2007, primarily due to lower returns on our corporate investment as a limited partner or non-managing member in the Deephaven Funds.

***Certain Factors Affecting Results of Operations***

We may experience significant variation in our future results of operations. These fluctuations may result from numerous factors, many of which are outside of our control. These factors include, among other things, introductions of or enhancements to trade execution services by us or our competitors; the value of our securities positions and our ability to manage the risks attendant thereto; the volume of our market-making activities; the dollar value of securities traded; the composition of our order flow; volatility in the securities markets; our market share with institutional and broker-dealer clients; the performance and size of, and volatility in, our quantitative market-making and program trading portfolios; the performance of our international operations and costs associated with our international expansion; our ability to manage personnel, overhead and other expenses, including our occupancy expenses under our office leases and expenses and charges relating to legal and regulatory proceedings; the strength of our client relationships; changes in payments for order flow and clearing, execution and regulatory transaction costs; the level of assets under management and fund returns; performance of the asset management investment strategies; the addition or loss of executive management and sales and trading, technology and asset management professionals; legislative, legal

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and regulatory changes; legal and regulatory matters; geopolitical risk; the amount and timing of capital expenditures, acquisitions and divestitures; the integration, performance and operation of acquired businesses; the incurrence of costs associated with acquisitions and dispositions; investor sentiment; technological changes and events; seasonality; competition; and market and economic conditions.

Such factors may also have an impact on our ability to achieve our strategic objectives, including, without limitation, increases in our market share, growth and profitability in our Global Markets segment and increases in our fund returns and assets under management in our Asset Management segment. If demand for our services declines in either of our two operating business segments due to any of the above factors, and we are unable to adjust our cost structure on a timely basis, our operating results could be materially and adversely affected. As a result of the foregoing factors, period-to-period comparisons of our revenues and operating results are not necessarily meaningful and such comparisons cannot be relied upon as indicators of future performance. There also can be no assurance that we will be able to continue or be able to return to the rates of revenue growth that we have experienced in the past or that we will be able to improve our operating results.

### ***Trends***

#### ***Global Economic Trends***

Our businesses are affected by many factors in the global financial markets and worldwide economic conditions. These factors include the growth level of gross domestic product in the U.S., Europe and Asia, and the existence of transparent, efficient and liquid equity markets and level of trading volumes.

Global economic growth continued to slow during the second quarter of 2008. Equity markets experienced high levels of volatility and decreased volumes. Concerns about future economic growth, higher oil prices, lower consumer confidence and continued lack of liquidity in the credit markets continued to challenge the U.S. economy and the equity markets.

#### ***Trends Affecting Our Company***

We believe that our businesses are affected by the aforementioned global economic trends as well as more specific trends. Some of the specific trends that impact our operations, financial condition and results of operations are:

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

Equity transaction volumes executed by broker-dealers have fluctuated over the past few years due to retail investor sentiment, market conditions and a variety of other factors, resulting in a shift of product mix. Equity transaction volumes may not be sustainable and are not predictable.

There has been consolidation among market centers over the past several years, and several regional exchanges have entered into joint ventures with broker-dealers to create their own alternative trading systems (i.e., ECNs) and compete within the OTC and listed trading venues. In addition, there are many new entrants into the market, including Alternative

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Trading Systems (ATs) and dark liquidity pools. Further, many broker-dealers are offering their own internal crossing networks. These factors continue to create further fragmentation in the marketplace.

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

Market structure changes, competition and technology advancements, have also led to a dramatic increase in electronic message traffic. These increases in message traffic place heavy strains on the technology resources, bandwidth and capacities of market participants.

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

There has been continued scrutiny of market-makers, specialists and hedge funds by the regulatory and legislative authorities. New legislation or modifications to existing regulations and rules could occur in the future and could materially impact the Company's revenues and profitability. For example, FINRA proposed rules regarding the OTC Bulletin Board markets which would require that all non-NASDAQ securities be subject to limit order protection. Also, further amendments to Regulation SHO and related short sale rules, could make it much more difficult for market makers to sell securities short.

There continues to be growth in equity electronic trading, as evidenced by increased volumes in direct market access platforms, algorithmic and program trading, and ECNs and dark liquidity pools. In addition, electronic trading continues to expand to other asset classes, including options, currencies and fixed income. The expansion of electronic trading may result in the growth of innovative electronic products and competition for order flow.

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

The macro-economic environment and market conditions have had an adverse impact on the profitability of alternative investment entities, resulting in volatile earnings and investor redemptions across the industry.

## ***Income Statement Items***

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

### ***Revenues***

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

Revenues on transactions for which we charge explicit commissions or commission equivalents, which include the majority of our institutional client orders, are included within Commissions and fees.



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Commissions and fees are primarily affected by changes in our equity transaction volumes with institutional clients, changes in commission rates, the growth of Direct Trading (Knight Direct EMS™), Hotspot, Knight BondPoint and EdgeTrade and the growth of our soft dollar and commission recapture activity.

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

Asset management fees, net represent fees earned by Deephaven for sponsoring and managing the Deephaven Funds as well as fees earned from separately managed accounts. These fees consist of management fees, calculated as fixed percentages of assets under management, and incentive allocation fees, generally calculated as a percentage of the funds' and managed accounts' year-to-date profits, if any. Incentive allocation fees may be negative in certain interim periods if the funds or managed accounts lose money for such period; however, such fees will not be negative on a year-to-date basis.

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

Investment income (loss) and other, net primarily represents income earned, net of losses, related to our corporate investment as a limited partner or non-managing member in the Deephaven Funds and our strategic investments. Such income or loss is primarily affected by the level of our corporate investment in the Deephaven Funds and rates of return earned by the Deephaven Funds as well as the performance and activity of our strategic investments.

### *Transaction-based expenses*

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

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

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

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Payments for order flow and ECN rebates represent payments to broker-dealer clients, in the normal course of business, for directing to us their order flow in U.S. equities, and for the three and six months ended June 30, 2007, rebates for providing liquidity to Direct Edge ECN. Payments for order flow and ECN rebates fluctuate as we modify our rates and as our percentage of clients whose policy is not to accept payments for order flow varies. Payments for order flow and ECN rebates also fluctuate based on U.S. equity share volume, our profitability and the mix of market orders and limit orders.

### *Other direct expenses*

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

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

As more fully described under the heading *Deephaven* in this MD&A, in 2007 and until the consummation of the Deephaven Transaction, the majority of compensation in Asset Management was determined by formulas based upon the profitability of the Asset Management segment, subject to certain minimum guaranteed payments.

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

Professional fees consist primarily of legal, accounting and consulting fees.

Depreciation and amortization expense results from the depreciation of fixed assets, which consist of computer hardware, furniture and fixtures, and the amortization of purchased software, capitalized software development costs, acquired intangible assets and leasehold improvements. We depreciate our fixed assets and amortize our capitalized software development costs and acquired intangible assets on a straight-line basis over their expected useful lives. We amortize leasehold improvements on a straight-line basis over the lesser of the life of the improvement or the remaining term of the lease.

Occupancy and equipment rentals consist primarily of rent and utilities related to rented premises and office equipment.

Business development consists primarily of costs related to marketing, conferences and relationship management.

Minority interest expense primarily represents the amounts distributable to the Deephaven Managers, pursuant to the Deephaven Holdings LLC agreement and for the three and six months ended June 30, 2008, includes an accrual for a one-time minimum guaranteed distribution for 2008. For a discussion regarding the Deephaven Transaction, see the heading *Deephaven* in this MD&A.

**Table of Contents****Three Months Ended June 30, 2008 and 2007****Continuing Operations***Revenues**Global Markets*

|   | For the three<br>months ended June 30, |                 | Change         | % of Change  |
|---|--|-----------------|----------------|--------------|
|   | 2008                                   | 2007            |                |              |
| Commissions and fees (millions)                                   | \$ 114.2                               | \$ 106.9        | \$ 7.3         | 6.8%         |
| Net trading revenue (millions)                                    | 85.4                                   | 54.2            | 31.2           | 57.6%        |
| Interest, net (millions)  | 0.9                                    | 4.1             | (3.2)          | -78.1%       |
| Investment income and other, net (millions)                       | 0.8                                    | -               | 0.8            | NM           |
| <b>Total Revenues from Global Markets (millions)</b>              | <b>\$ 201.3</b>                        | <b>\$ 165.3</b> | <b>\$ 36.0</b> | <b>21.8%</b> |
| U.S. equity dollar value traded (\$ billions)                     | 1,104.7                                | 650.6           | 454.1          | 69.8%        |
| U.S. equity trades executed (millions)                            | 118.4                                  | 72.7            | 45.7           | 62.8%        |
| Nasdaq and Listed equity shares traded (billions)                 | 34.8                                   | 25.8            | 9.0            | 34.6%        |
| OTC Bulletin Board and Pink Sheet shares traded (billions)        | 206.1                                  | 233.3           | (27.2)         | -11.7%       |
| Average revenue capture per U.S. equity dollar value traded (bps) | 1.3                                    | 1.6             | (0.3)          | -20.4%       |

NM- Not meaningful

Total revenues from the Global Markets segment, which primarily comprises Commissions and fees and Net trading revenue from our domestic businesses, increased 21.8% to \$201.3 million for the three months ended June 30, 2008, from \$165.3 million for the comparable period in 2007. Revenues for the three months ended June 30, 2008, were positively impacted by higher dollar value traded, greater trade volumes, improved results from electronic quantitative trading efforts and the addition of EdgeTrade, offset by a decrease in revenue capture per U.S. equity dollar value traded, lower share volume in OTC Bulletin Board and Pink Sheet shares and the deconsolidation of Direct Edge ECN in 2007.

Average revenue capture per U.S. equity dollar value traded was 1.3 basis points ( bps ) for the second quarter of 2008, down 20.4% from 1.6 bps in the second quarter of 2007. The primary driver for the decrease in revenue capture was a change in the mix of our order flow due to a significant increase in Nasdaq and Listed volumes from an expanded broker-dealer client base as well as a decrease in OTC Bulletin Board and Pink Sheet shares traded. Average revenue capture per U.S. equity dollar value traded is calculated as the total of net domestic trading revenues plus U.S. institutional commissions and commission equivalents (included in Commissions and fees), less certain transaction-related regulatory fees (included in Execution and clearance fees), (collectively Core Equity Revenues ) divided by the total dollar value of the related equity transactions. Core Equity Revenues were \$144.5 million and \$106.8 million for the three months ended June 30, 2008 and 2007, respectively. Core Equity Revenues do not include revenues from KEMIL s European institutional business, Donaldson, Direct Trading (Knight Direct EMS<sup>TM</sup>), Direct Edge ECN, Hotspot, Knight BondPoint and EdgeTrade.

**Table of Contents***Asset Management*

|   | For the three<br>months ended June 30, |                |                  |               |
|---|--|----------------|------------------|---------------|
|   | 2008                                   | 2007           | Change           | % of Change   |
| Incentive allocation fees (millions)                            | \$ 5.2                                 | \$ 19.0        | \$ (13.8)        | -72.5%        |
| Management fees (millions)                                      | 9.2                                    | 10.1           | (0.9)            | -9.2%         |
| Interest income and other (millions)                            | 0.1                                    | 0.3            | (0.2)            | -69.4%        |
| <b>Total Revenues from Asset Management (millions)</b>          | <b>\$ 14.5</b>                         | <b>\$ 29.4</b> | <b>\$ (14.9)</b> | <b>-50.6%</b> |
| Average month-end balance of assets under management (millions) | \$ 3,406.3                             | \$ 3,970.0     | \$ (563.7)       | -14.2%        |
| Quarterly fund return to investors*                             | 2.8%                                   | 2.0%           | 0.8%             | 40.0%         |

\* Quarterly fund return represents the blended quarterly return across all assets under management in the Deephaven Funds. Total revenues from the Asset Management segment, which primarily consist of management fees and incentive allocation fees, decreased 50.6% to \$14.5 million for the three months ended June 30, 2008, from \$29.4 million for the comparable period in 2007. The decrease is primarily due to substantially lower incentive allocation fees as a result of negative blended fund returns for year-to-date 2008 and a decrease in management fees due to lower average assets under management. Although the blended quarterly fund return increased compared to the prior year's second quarter, incentive allocation fees were lower as the majority of the Deephaven Funds had negative returns on a year-to-date basis, and Deephaven was, therefore, unable to earn incentive allocation fees on such funds. Asset Management fees were also adversely affected by the announced closing of the Event Fund during the first quarter of 2008. As of February 1, 2008, and through the period of time Deephaven is returning investors' capital, no management or incentive allocation fee is being charged to investors in the Event Fund.

The average month-end balance of assets under management for the three months ended June 30, 2008 was \$3.4 billion, down from \$4.0 billion for the comparable period in 2007. The blended quarterly fund return across all assets under management in the Deephaven Funds for the three months ended June 30, 2008 was a gain of 2.8%, up from a gain of 2.0% for the comparable period in 2007.

*Corporate*

|   | For the three<br>months ended June 30, |               |                 |               |
|---|--|---------------|-----------------|---------------|
|   | 2008                                   | 2007          | Change          | % of Change   |
| <b>Total Revenues from Corporate (millions)</b> | <b>\$ 4.2</b>                          | <b>\$ 6.8</b> | <b>\$ (2.5)</b> | <b>-37.5%</b> |

Average corporate investment balance in the Deephaven Funds (millions)

|  |         |          |            |        |
|--|---------|----------|------------|--------|
|  | \$ 76.6 | \$ 200.3 | \$ (123.7) | -61.8% |
|--|---------|----------|------------|--------|

Total revenues from the Corporate segment, which primarily represent our returns from our corporate investment as a limited partner or non-managing member in the Deephaven Funds and other strategic investments, decreased to \$4.2 million for the three months ended June 30, 2008, from \$6.8 million for the comparable period in 2007. Income from our corporate investment in the Deephaven Funds decreased to \$2.0 million for the three months ended June 30, 2008, from \$6.3 million for the comparable period in 2007. The decrease in the average corporate investment in the Deephaven Funds is primarily a result of redemptions of \$120.0 million since June 30, 2007.

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**Table of Contents***Transaction-based expenses*

Execution and clearance fees decreased 16.9% to \$23.8 million for the three months ended June 30, 2008, from \$28.7 million for the comparable period in 2007, primarily due to the deconsolidation of Direct Edge ECN in 2007 and lower clearing rates offset in part, by higher trade volumes. As a percentage of total revenue, Execution and clearance fees decreased to 10.8% for the three months ended June 30, 2008, from 14.2% for the comparable period in 2007. These costs decreased as a percentage of revenue primarily due to the deconsolidation of Direct Edge, which had higher transaction-based expenses as a percentage of revenue, and lower clearing rates offset, in part, by lower asset management fees, which have no associated transaction-based expenses. Execution and clearance fees fluctuate based on changes in transaction volumes, regulatory fees and operational efficiencies and scale. Soft dollar and commission recapture expense increased 8.8% to \$15.7 million for the three months ended June 30, 2008, from \$14.5 million for the comparable period in 2007, due to higher soft dollar volumes.

Payments for order flow and ECN rebates decreased to \$8.3 million for the three months ended June 30, 2008, from \$12.8 million for the comparable period in 2007. As a percentage of total revenue, Payments for order flow and ECN rebates decreased to 3.8% for the three months ended June 30, 2008, from 6.3% for the comparable period in 2007. This expense decreased primarily due to the deconsolidation of Direct Edge ECN and a decrease in profitability-based rebates paid to broker-dealer clients offset, in part, by lower asset management fees, which have no associated transaction-based expenses.

*Other direct expenses*

Employee compensation and benefits expense increased 5.9% to \$83.4 million for the three months ended June 30, 2008, from \$78.7 million for the comparable period in 2007. As a percentage of total revenue, Employee compensation and benefits decreased to 37.9% for the three months ended June 30, 2008, from 39.1% for the comparable period in 2007. The increase on a dollar basis was primarily due to higher profitability and an increase in the number of employees offset, in part, by lower Asset Management revenues and lower profitability-based bonuses at Deephaven. The number of full time employees increased to 946 at June 30, 2008, from 851 at June 30, 2007, primarily due to growth in our Global Markets business as well as the acquisition of EdgeTrade, offset by the reduction in headcount due to the deconsolidation of Direct Edge. Employee compensation and benefits expense fluctuates, for the most part, based on changes in our revenues, profitability and the number of employees.

As more fully described under the heading *Deephaven* below, for periods after February 1, 2008, profitability-based compensation payable to certain senior Deephaven managers is no longer reported as a component of compensation expense but is instead reported as Minority interest expense on the Consolidated Statements of Operations.

All other direct expenses increased by 42.5% or \$11.4 million to \$38.4 million for the three months ended June 30, 2008 from \$26.9 million for the comparable period in 2007. Communications and data processing expense increased primarily due to higher market data and connectivity expenses within our Global Markets segment. Professional fees increased due to higher legal expenses, which have fluctuated based on the activity relating to our various legal proceedings. Depreciation and amortization expense increased primarily due to fixed asset purchases, capitalized software development costs and acquired intangible assets. Occupancy and equipment rentals expense increased primarily due to the costs associated with our international expansion efforts. Interest expense increased due to borrowings under our credit facilities. Other expenses increased due to higher recruiting and director fees.

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For the three months ended June 30, 2008, Minority interest expense of \$1.1 million relates to the second quarter's accrual for the one-time 2008 minimum guaranteed distribution to certain senior Deephaven managers pursuant to the Limited Liability Company Agreement for Deephaven Holdings.

Our effective tax rates from continuing operations of 39.5% and 38.8% for the three months ended June 30, 2008 and 2007, respectively, differed from the federal statutory rate of 35% primarily due to state and local income taxes and non-deductible charges.

**Six Months Ended June 30, 2008 and 2007****Continuing Operations***Revenues**Global Markets*

|  | For the six months ended June 30, |                 | Change         | % of Change  |
|--|-----------------------------------|-----------------|----------------|--------------|
|  | 2008                              | 2007            |                |              |
| Commissions and fees (millions)                      | \$ 227.4                          | \$ 210.8        | \$ 16.6        | 7.9%         |
| Net trading revenue (millions)                       | 186.9                             | 115.8           | 71.1           | 61.4%        |
| Interest, net (millions)                             | 3.1                               | 8.4             | (5.3)          | -62.8%       |
| Investment income and other, net (millions)          | 4.9                               | 2.8             | 2.1            | 73.6%        |
| <b>Total Revenues from Global Markets (millions)</b> | <b>\$ 422.4</b>                   | <b>\$ 337.9</b> | <b>\$ 84.5</b> | <b>25.0%</b> |

|   |         |         |        |        |
|---|---------|---------|--------|--------|
| U.S. equity dollar value traded (\$ billions)                     | 2,128.8 | 1,213.1 | 915.7  | 75.5%  |
| U.S. equity trades executed (millions)                            | 225.5   | 139.6   | 85.9   | 61.5%  |
| Nasdaq and Listed equity shares traded (billions)                 | 68.4    | 49.6    | 18.8   | 38.0%  |
| OTC Bulletin Board and Pink Sheet shares traded (billions)        | 371.2   | 452.1   | (80.9) | -17.9% |
| Average revenue capture per U.S. equity dollar value traded (bps) | 1.4     | 1.8     | (0.4)  | -21.5% |

Total revenues from the Global Markets segment, which primarily comprises Commissions and fees and Net trading revenue from our domestic businesses, increased 25.0% to \$422.4 million for the six months ended June 30, 2008, from \$337.9 million for the comparable period in 2007. Revenues for the six months ended June 30, 2008, were positively impacted by higher dollar value traded, greater trade volumes, improved results from electronic quantitative trading efforts and the addition of EdgeTrade, offset by a decrease in revenue capture per U.S. equity dollar value traded, lower share volume in OTC Bulletin Board and Pink Sheet shares and the deconsolidation of Direct Edge ECN in 2007.

Average revenue capture per U.S. equity dollar value traded was 1.4 basis points ( bps ) for the six month ended June 30, 2008, down 21.5% from 1.8 bps for the comparable period in 2007. The primary driver for the decrease in revenue capture was a change in the mix of our order flow due to a significant increase in Nasdaq and Listed volumes from an expanded broker-dealer client base as well as a decrease in OTC Bulletin Board and Pink Sheet shares traded. Core Equity Revenues were \$299.9 million and \$217.8 million for the six months ended June 30, 2008 and 2007, respectively. Core Equity Revenues do not include revenues from KEMIL's European institutional business, Donaldson, Direct Trading (Knight Direct EMS™), Direct Edge ECN, Hotspot, Knight BondPoint and EdgeTrade.

**Table of Contents***Asset Management*

|   | For the six<br>months ended June 30, |                | Change           | % of Change   |
|---|--------------------------------------|----------------|------------------|---------------|
|   | 2008                                 | 2007           |                  |               |
| Incentive allocation fees (millions)                            | \$ 10.6                              | \$ 68.4        | \$ (57.7)        | -84.5%        |
| Management fees (millions)                                      | 19.0                                 | 21.5           | (2.5)            | -11.6%        |
| Interest income and other (millions)                            | 0.1                                  | 0.8            | (0.7)            | -88.0%        |
| <b>Total Revenues from Asset Management (millions)</b>          | <b>\$ 29.7</b>                       | <b>\$ 90.6</b> | <b>\$ (60.9)</b> | <b>-67.2%</b> |
| Average month-end balance of assets under management (millions) | \$ 3,491.1                           | \$ 4,020.9     | \$ (529.8)       | -13.2%        |
| Year-to-date fund return to investors *                         | -5.4%                                | 7.0%           | NM               | NM            |

\* Year-to-date fund return represents the blended return across all assets under management in the Deephaven Funds.  
NM- Not meaningful

Total revenues from the Asset Management segment, which primarily consist of management fees and incentive allocation fees, decreased 67.2% to \$29.7 million for the six months ended June 30, 2008, from \$90.6 million for the comparable period in 2007. The decrease is primarily due to substantially lower incentive allocation fees as a result of negative blended fund returns in 2008 and a decrease in management fees due to lower average assets under management. Asset Management fees were also adversely affected by the announced closing of the Event Fund during the first quarter of 2008. As of February 1, 2008, and through the period of time Deephaven is returning investors' capital, no management or incentive allocation fee is being charged to investors in the Event Fund.

The average month-end balance of assets under management for the six months ended June 30, 2008 was \$3.5 billion, down from \$4.0 billion for the comparable period in 2007. The blended fund return across all assets under management in the Deephaven Funds for the six months ended June 30, 2008 was a loss of 5.4%, down from a gain of 7.0% for the comparable period in 2007.

*Corporate*

|  | For the six<br>months ended June 30, |                | Change           | % of Change |
|--|--------------------------------------|----------------|------------------|-------------|
|  | 2008                                 | 2007           |                  |             |
| <b>Total Revenues from Corporate (millions)</b>                        | <b>\$ (4.0)</b>                      | <b>\$ 14.6</b> | <b>\$ (18.6)</b> | <b>NM</b>   |
| Average corporate investment balance in the Deephaven Funds (millions) | \$ 77.2                              | \$ 196.8       | \$ (119.6)       | -60.8%      |

NM- Not meaningful

Total revenues from the Corporate segment, which primarily represent our returns from our corporate investment as a limited partner or non-managing member in the Deephaven Funds and other strategic investments, decreased to a loss of \$4.0 million for the six months ended June 30, 2008, from a gain of \$14.6 million for the comparable period in 2007. Income from our corporate investment in the Deephaven Funds decreased to a loss of \$5.0 million for the six months ended June 30, 2008, from a gain of \$14.2 million for the comparable period in 2007. The decrease in the average corporate investment in the Deephaven Funds is primarily a result of redemptions of \$120.0 million since June 30, 2007.



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**Table of Contents***Transaction-based expenses*

Execution and clearance fees decreased 12.6% to \$49.1 million for the six months ended June 30, 2008, from \$56.1 million for the comparable period in 2007, primarily due to the deconsolidation of Direct Edge ECN in 2007 and lower clearing rates offset in part, by higher trade volumes. As a percentage of total revenue, Execution and clearance fees decreased to 10.9% for the six months ended June 30, 2008, from 12.7% for the comparable period in 2007. These costs decreased as a percentage of revenue primarily due to the deconsolidation of Direct Edge, which had higher transaction-based expenses as a percentage of revenue, and lower clearing rates offset, in part, by lower asset management fees, which have no associated transaction-based expenses. Execution and clearance fees fluctuate based on changes in transaction volumes, regulatory fees and operational efficiencies and scale. Soft dollar and commission recapture expense increased 19.4% to \$34.6 million for the six months ended June 30, 2008, from \$29.0 million for the comparable period in 2007, due to higher soft dollar volumes.

Payments for order flow and ECN rebates decreased to \$17.2 million for the six months ended June 30, 2008, from \$25.4 million for the comparable period in 2007. As a percentage of total revenue, Payments for order flow and ECN rebates decreased to 3.8% for the six months ended June 30, 2008, from 5.7% for the comparable period in 2007. These decreases were primarily due to the deconsolidation of Direct Edge ECN and a decrease in profitability-based rebates paid to broker-dealer clients offset, in part, by lower asset management fees, which have no associated transaction-based expenses.

*Other direct expenses*

Employee compensation and benefits expense decreased 6.2% to \$169.8 million for the six months ended June 30, 2008, from \$180.9 million for the comparable period in 2007. As a percentage of total revenue, Employee compensation and benefits decreased to 37.9% for the six months ended June 30, 2008, from 40.8% for the comparable period in 2007. The decrease on a dollar basis was primarily due to lower profitability-based bonuses at Deephaven, partially offset by an increase in the number of employees and increased profitability in our Global Markets segment. The number of full time employees increased to 946 at June 30, 2008, from 851 at June 30, 2007, primarily due to growth in our Global Markets business as well as the acquisition of EdgeTrade, offset by the reduction in headcount due to the deconsolidation of Direct Edge. Employee compensation and benefits expense fluctuates, for the most part, based on changes in our revenues, profitability and the number of employees.

As more fully described under the heading *Deephaven* below, for periods after February 1, 2008, profitability-based compensation payable to certain senior Deephaven managers is no longer reported as a component of compensation expense but is instead reported as Minority interest expense on the Consolidated Statements of Operations.

All other direct expenses increased by 22.1% or \$12.6 million to \$69.7 million for the six months ended June 30, 2008 from \$57.1 million for the comparable period in 2007. Communications and data processing expense increased primarily due to higher market data and connectivity expenses within our Global Markets segment. Professional fees increased due to higher legal expenses, which have fluctuated based on the activity relating to our various legal proceedings. Depreciation and amortization expense increased primarily due to fixed asset purchases, capitalized software development costs and acquired intangible assets. Occupancy and equipment rentals expense increased primarily due to the costs associated with our international expansion efforts and the relocation of other offices within our Global Markets segment. Interest expense increased due to borrowings under our credit facilities.

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For the six months ended June 30, 2008, Minority interest expense of \$2.6 million, relates to the year-to-date accrual for the one-time 2008 minimum guaranteed distribution to certain senior Deephaven managers pursuant to the Limited Liability Company Agreement for Deephaven Holdings.

Our effective tax rates from continuing operations of 40.2% and 39.1% for the six months ended June 30, 2008 and 2007, respectively, differed from the federal statutory rate of 35% primarily due to state and local income taxes and non-deductible charges.

### ***Deephaven***

#### *Exercise of Option by Deephaven Managers*

In connection with entering into new long-term employment agreements (the 2006 Employment Agreements ) in December 2006, three senior managers of Deephaven (the Deephaven Managers ) were granted an option ( the Option ) to obtain a 49% interest in a new limited liability company ( Deephaven Holdings ) to which our interests in Deephaven would be contributed. The Option became exercisable after January 1, 2008 upon Deephaven having met certain requirements regarding minimum assets under management and employee retention.

On January 10, 2008, Deephaven Managing Partners, LLC ( Deephaven Partners ), an entity owned and controlled by the Deephaven Managers, provided notice to the Company that it was exercising the Option.

On February 1, 2008, after regulatory and contractual approvals were received, the Company completed the transaction whereby the Company contributed its interest in Deephaven to Deephaven Holdings and Deephaven Partners acquired a 49% interest in Deephaven Holdings in exchange for the termination of the Deephaven Managers 2006 Employment Agreements and associated profit sharing bonuses and an equity contribution of \$1 million to Deephaven Holdings by Deephaven Partners (the Deephaven Transaction ). The Deephaven Transaction did not affect or result in any change to Deephaven s role as investment manager to the funds it currently manages, or to the manner in which Deephaven carries out its duties as investment manager to those funds.

As part of the Deephaven Transaction, the Company and Deephaven Partners entered into a new Limited Liability Company Agreement (the New LLC Agreement ) for Deephaven Holdings. In addition, the 2006 Employment Agreements terminated and were replaced by new long-term employment agreements between Deephaven Holdings and each of the Deephaven Managers (the New Employment Agreements ). The New Employment Agreements do not include the profit-sharing bonuses provided under the 2006 Employment Agreements; however, the Deephaven Managers continue to be entitled to participate in certain profit pools relating to specific Deephaven funds. Following the Deephaven Transaction, pre-tax earnings are allocated between the Company and, through Deephaven Partners, the Deephaven Managers in a similar manner as under the 2006 Employment Agreements. Profit-sharing bonuses under the 2006 Employment Agreements had been reported in Employee compensation and benefits on our Consolidated Statements of Operations. As a result of the Deephaven Transaction, beginning in February 2008, profits or losses allocated to the Deephaven Managers are instead reported as Minority interest expense on our Consolidated Statements of Operations and included as Minority interest on our Consolidated Statements of Financial Condition. Minority interest expense of \$1.1 million and \$2.6 million represents the accrual for the one-time 2008 minimum distribution to the Deephaven Managers pursuant to the New LLC Agreement during the three and six months ended June 30, 2008, respectively.

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Under the New LLC Agreement, we own 51% of the shares in Deephaven Holdings, and Deephaven Partners owns 49% of the shares. As previously disclosed by us in a Form 8-K filing dated December 22, 2006, and subsequent regulatory filings, in the event of a change of control of the Company prior to December 31, 2012, Deephaven Partners will have the option (the Change of Control Option ) to increase its 49% interest by an additional 2%. Upon any exercise of the Change of Control Option, we will be obligated to transfer ownership of 2% of the shares to Deephaven Partners. We are entitled to appoint a majority of the Board of Managers of Deephaven Holdings until such time as the Change of Control Option is exercised, at which time Deephaven Partners will be entitled to appoint a majority of the Board of Managers.

Under the New LLC Agreement, certain corporate actions will require approval of a super-majority of members of the Board of Managers, including representatives of both Deephaven Partners and us. Neither party is permitted to transfer any of its interests in Deephaven Holdings to any unaffiliated third person without the consent of the other party. Any sale of Deephaven Holdings requires either (x) the consent of the holders of 75% of the shares or (y) if the aggregate consideration is in excess of \$450 million, the approval of only the Deephaven Partners (subject to a right of first refusal for the benefit of the Company). Pursuant to the New LLC Agreement, proceeds from any sale or liquidation of Deephaven or Deephaven Holdings will be allocated among the Company and Deephaven Partners based upon a formula that takes into account their capital accounts at the time of such sale or liquidation and relative profit sharing percentages over a defined period of time.

### *Closing of Deephaven Event Fund*

On January 31, 2008, Deephaven announced that it had concluded that it was in the best interests of investors in the Deephaven Event Fund LLC and the Deephaven Event Fund Ltd. (collectively, the Event Fund ) that the Event Fund return investors' capital. As of January 1, 2008, Deephaven managed approximately \$4.0 billion in assets, of which approximately \$781 million was invested in the Event Fund.

The decision to return investors' capital in the Event Fund occurred after a review by Deephaven of the Event Fund and the Event Fund's viability given the current macro-economic environment, performance over the preceding nine months, declining investor interest in event-driven investment strategies and significant levels of redemption requests in the Event Fund. Substantive changes in macro-economic circumstances in the U.S. have resulted in a reduction in the types of opportunities that Deephaven would ordinarily pursue as components of the Event Fund's core event-driven strategy and the conclusion that the Event Fund's core investment strategy is unlikely to produce the type of investment results Deephaven and its investors might expect over the short and intermediate term. As a result, redemptions in the Event Fund were suspended, and Deephaven began an orderly process to reduce trading positions to cash and return investors' capital as promptly as reasonably practicable. As of February 1, 2008, and through the period of time Deephaven is returning investors' capital, no management or incentive allocation fee will be charged to investors in the Event Fund.

### **Discontinued Operations**

Loss from discontinued operations, net of tax, was \$1.3 million for the six months ended June 30, 2007. See Footnote 13 Discontinued Operations, included in Part I, Item 1 Financial Statements of this Form 10-Q for a further discussion.

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### **Subsequent Event**

On July 11, 2008, we acquired Libertas Holdings LLC, a boutique institutional fixed income brokerage firm, for \$50 million in cash and approximately 1.5 million shares of unregistered Knight common stock valued at \$25 million. Upon acquisition, Libertas Holdings LLC was renamed Knight Libertas Holdings LLC and its U.S. broker-dealer subsidiary was renamed Knight Libertas LLC (together with its affiliates, Libertas ). The \$50 million in cash is subject to an adjustment based on actual working capital at Libertas as of the closing of the transaction and the unregistered Knight common stock is subject to certain contractual transfer restrictions.

The terms of the agreement also include a potential earn-out of up to \$75 million of unregistered Knight common stock based on the future performance of Libertas during the three-year period following the closing of the transaction.

Libertas is a riskless principal fixed income broker-dealer specializing in high-yield, distressed, and asset- and mortgage-backed securities. Libertas also provides clients with proprietary research reports on companies and target sectors. The results of Libertas will be included within the Global Markets segment beginning with the third quarter of 2008.

### ***Financial Condition, Liquidity and Capital Resources***

#### *Financial Condition*

We have historically maintained a highly liquid balance sheet, with a substantial portion of our total assets consisting of cash, highly liquid marketable securities, short term receivables and corporate investments as a limited partner or non-managing member in our Deephaven Funds. As of June 30, 2008, we had \$1.9 billion in assets, 60.7% of which consisted of cash or assets readily convertible into cash, principally receivables from brokers and dealers and securities owned. Receivables from brokers and dealers include interest bearing cash balances held with clearing brokers, including, or net of, amounts related to securities transactions that have not yet reached their contracted settlement date, which is generally within three business days of the trade date. Securities owned principally consist of equity securities that trade in NASDAQ, on the OTC Bulletin Board and on the NYSE and AMEX markets.

Asset management fees receivable includes incentive allocation fees and management fees earned for sponsoring and managing the Deephaven Funds. Deferred compensation investments consists of investments held by us, including investments as a limited partner or non-managing member in the Deephaven Funds, related to deferred compensation plans for the benefit of Knight's employees and directors. Other assets primarily represent net deferred tax assets, deposits and miscellaneous receivables.

Total assets increased \$190.9 million, or 10.9%, from \$1.8 billion at December 31, 2007 to \$1.9 billion at June 30, 2008. The majority of the increase in assets relates to increases in Securities owned, held at clearing brokers, at fair value and Cash and cash equivalents offset, in part, by decreases in Receivable from brokers and dealers. Securities owned, held at clearing brokers, at fair value increased by \$200.3 million, or 48.5% from \$412.6 million at December 31, 2007, to \$612.8 million at June 30, 2008, due to an increase in the size of the securities inventory utilized in our market making activities and trade execution services. Our securities inventory fluctuates based on trading volumes, market conditions and our pre-determined risk limits. Cash and cash equivalents increased by \$110.3 million, or 49.6%, from \$222.4 million at December 31, 2007, to \$332.7 million at June 30, 2008, primarily due to our borrowing of the remaining \$70.0 million under our credit facilities. Receivable from brokers and dealers decreased by \$146.7 million, or 38.3% from \$382.5 million at December 31, 2007, to \$235.9 million at June 30, 2008, due to timing relating to trade date versus settlement date differences.

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Total liabilities increased \$107.8 million, or 12.4%, from \$870.4 million at December 31, 2007 to \$978.2 million at June 30, 2008. The majority of the increase in liabilities relates to increases in Securities sold, not yet purchased, at fair value and Long term debt, offset, in part, by a decrease in Accrued compensation expense. Long term debt increased by \$70.0 million, from \$70.0 million at December 31, 2007, to \$140.0 million at June 30, 2008, due to our borrowing of the remaining \$70.0 million under our credit facilities. Accrued compensation expense decreased by \$55.2 million, or 24.2%, from \$228.3 million at December 31, 2007 to \$173.1 million at June 30, 2008, primarily due to the payment of 2007 year-end bonuses accrued at December 31, 2007, offset by the accrual of 2008 bonus expense for the first half of 2008. Stockholders' equity increased by \$79.5 million, from \$885.4 million at December 31, 2007 to \$964.9 million at June 30, 2008. The increase in Stockholders' equity from December 31, 2007 was a result of our net income earned during the six months ended June 30, 2008 and the issuance of common stock related to the acquisition of EdgeTrade offset by common stock repurchases during the period.

*Liquidity and Capital Resources*

We have financed our business primarily through cash generated by operations, the proceeds from our stock issuances, the proceeds of the sale of our Derivative Markets segment in 2004 and the proceeds from our borrowing of \$140.0 million under our credit facilities. At June 30, 2008, we had net current assets, which consist of net assets readily convertible into cash less current liabilities, of approximately \$353.8 million. Additionally, our corporate investment as a limited partner or non-managing member in the Deephaven Funds was \$76.5 million at June 30, 2008. The majority of this investment can be liquidated upon request to Deephaven subject to a 90-day written notification period and monthly redemption limits.

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

We have acquired several businesses over the last two years. In January 2008, we completed the acquisition of EdgeTrade Inc. for \$58.2 million comprising \$28.2 million in cash and approximately 2.3 million shares of unregistered Knight common stock valued at \$30.0 million.

Income from continuing operations before income taxes and minority interest expense was \$50.5 million and \$39.9 million for the three months ended June 30, 2008 and 2007, respectively. Included in these amounts were certain non-cash expenses such as stock-based compensation and depreciation and amortization. Stock-based compensation was \$7.7 million and \$7.8 million for the three months ended June 30, 2008 and 2007, respectively. Depreciation expense was \$1.9 million and \$1.7 million for the three month periods ended June 30, 2008 and 2007, respectively. Amortization expense from continuing operations, which related to software, software development costs, intangible assets and leasehold improvements, was \$4.3 million and \$3.8 million for the three months ended June 30, 2008 and 2007, respectively.

Capital expenditures related to our continuing operations were \$6.0 million and \$4.2 million during the three months ended June 30, 2008 and 2007, respectively. There were no purchases of strategic investments for the three months ended June 30, 2008. Purchases of strategic investments were \$1.8 million for the three months ended June 30, 2007. Strategic investments and acquisition expenditures primarily relate to outside investments and acquisitions of businesses in support of the development and growth of our business. Our corporate investment as a limited partner or non-managing member in the Deephaven Funds increased by \$2.7 million during the three months ended June 30, 2008, primarily due to gains on our investment.

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At its July 17, 2007 meeting, the Board of Directors authorized a \$505.0 million increase to our stock repurchase program, bringing the total to \$1.0 billion. We repurchased 400,900 shares under the stock repurchase program during the second quarter of 2008 for \$7.1 million. Through June 30, 2008, we had repurchased 61.0 million shares for \$656.0 million under our stock repurchase program. We may repurchase shares from time to time in open market transactions, accelerated stock buyback programs, tender offers, privately negotiated transactions or by other means. Repurchases may also be made under a Rule 10b5-1 plan. The timing and amount of repurchase transactions will be determined by our management based on an evaluation of market conditions, share price, legal requirements and other factors. The program may be suspended, modified or discontinued at any time without prior notice. We caution that there are no assurances that any further repurchases may actually occur. We had approximately 93.9 million shares of Class A Common Stock outstanding as of June 30, 2008.

Our U.S. registered broker-dealers are subject to regulatory requirements intended to ensure the general financial soundness and liquidity of broker-dealers and require the maintenance of minimum levels of net capital, as defined in SEC Rule 15c3-1. These regulations also prohibit a broker-dealer from repaying subordinated borrowings, paying cash dividends, making loans to its parent, affiliates or employees, or otherwise entering into transactions which would result in a reduction of its total net capital to less than 120% of its required minimum capital. Moreover, broker-dealers are required to notify the SEC and FINRA prior to repaying subordinated borrowings, paying dividends and making loans to its parent, affiliates or employees, or otherwise entering into transactions, which, if executed, would result in a reduction of 30% or more of its excess net capital (net capital less minimum requirement). The SEC has the ability to prohibit or restrict such transactions if the result is detrimental to the financial integrity of the broker-dealer. As of June 30, 2008, all of our broker-dealers were in compliance with the applicable regulatory net capital rules. The following table sets forth the net capital levels and requirements for the following significant regulated broker-dealer subsidiaries at June 30, 2008, as filed in their respective regulatory filings (in millions):

| Entity         | Net Capital | Net Capital Requirement | Excess Net Capital |
|----------------|-------------|-------------------------|--------------------|
| KEM            | \$ 65.9     | \$ 7.2                  | \$ 58.8            |
| KCM            | 82.9        | 2.0                     | 80.8               |
| Direct Trading | 12.6        | 0.5                     | 12.1               |

In addition, our foreign registered broker-dealer is subject to certain financial resource requirements of the FSA. The following table sets forth the financial resource requirement at June 30, 2008 (in millions):

| Entity | Financial Resources | Resource Requirement | Excess Financial Resources |
|--------|---------------------|----------------------|----------------------------|
| KEMIL  | \$ 33.3             | \$ 17.7              | \$ 15.6                    |

**Off-Balance Sheet Arrangements**

As of June 30, 2008, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

**Critical Accounting Policies**

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

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

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

Goodwill of \$184.2 million as of June 30, 2008 is all related to our Global Markets segment. Goodwill is primarily related to the purchases of our listed equities market-maker, KCM, and the businesses now operating as Donaldson, Direct Trading, Hotspot, Knight BondPoint and EdgeTrade. We performed our annual test for impairment of goodwill in the second quarter of 2008 and determined that goodwill was not impaired at that time. As part of our test for impairment, we considered the profitability of the applicable reporting unit, an assessment of fair value of the reporting unit based on various valuation methodologies, as well as the overall market value of the Company, compared to the Company's book value. We believe there was no impairment of the goodwill balance at June 30, 2008.

Intangible assets, less accumulated amortization, of \$72.5 million as of June 30, 2008 are all attributable to our Global Markets segment. Substantially all intangible assets resulted from the purchases of the businesses of Donaldson, Direct Trading, Hotspot, Knight BondPoint and EdgeTrade. These assets, which primarily consist of customer relationships, are being amortized on a straight-line basis over their useful lives, the majority of which have been determined to range from 4 to 24 years. We performed our annual test for impairment of intangible assets in the second quarter of 2008 and determined that intangible assets were not impaired at that time. Amortizable intangibles are tested for recoverability whenever events indicate that the carrying amounts may not be recoverable. No events occurred in 2007 or during the six months ended June 30, 2008 that would indicate that the carrying amounts of our amortizable intangibles may not be recoverable.

*Financial Instruments and Fair Value* In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS 157 *Fair Value Measurements ( SFAS 157 )*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements.

Under SFAS 157, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price ) in an orderly transaction between market participants at the measurement date. SFAS 157 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our beliefs about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgment.

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Level 2 Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement. Changes in fair value are recognized in earnings each period for financial instruments that are carried at fair value.

Our securities owned and securities sold, not yet purchased will generally be classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices or broker or dealer quotations with reasonable levels of price transparency.

The types of instruments that trade in markets that are not considered to be active, but are valued based on quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency are generally classified within Level 2 of the fair value hierarchy. As of June 30, 2008, our Investment in Deephaven sponsored funds, one strategic investment, as well as Deferred compensation investments met the definition of Level 2.

Certain instruments are classified within Level 3 of the fair value hierarchy because they trade infrequently and therefore have little or no price transparency. For those instruments that are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management's best estimate is used. At January 1, 2008 and as of June 30, 2008, we did not hold any financial instruments that met the definition of Level 3.

In February 2008, FASB Staff Position FAS 157-2 ( FSP FAS 157-2 ) was issued. FSP FAS 157-2 delays the effective date of SFAS 157 for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The delay was intended to allow additional time to consider the effect of various implementation issues that have arisen from the application of SFAS 157. We believe that FSP FAS 157-2 will not have a material impact on our Consolidated Financial Statements.

In February 2007, the FASB issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* ( SFAS 159 ), which provides an option for entities to choose to measure many financial instruments and certain other items at fair value. On January 1, 2008, we elected not to take the option available under SFAS 159 for the purposes of valuing certain financial instruments at fair value.

*Strategic Investments* Strategic investments include non-controlling equity ownership interests held by the Company or its non-broker-dealer subsidiaries, primarily in financial services-related businesses. The equity method of accounting is used when we are considered to exert significant influence on the investee. Investments are held at amortized cost when we are not considered to exert significant influence on the investee. Investments in liquid investment funds, including deferred compensation investments in mutual funds, are accounted for at fair value pursuant to SFAS 157.

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

*Market-Making Activities* Securities owned and securities sold, not yet purchased, which primarily consist of listed and OTC equities, are carried at fair value and are recorded on a trade date basis. Net trading revenue (trading gains, net of trading losses) and commissions (which includes

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commission equivalents earned on institutional client orders) and related expenses are also recorded on a trade date basis. Our clearing agreements call for payment or receipt of interest income, net of transaction-related interest charged by clearing brokers for facilitating the settlement and financing of securities transactions.

Dividend income relating to securities owned and dividend expense relating to securities sold, not yet purchased, derived from our market making activities are included as a component of Net trading revenue on our Consolidated Statements of Operations.

*Asset Management Fees* Deephaven earns asset management fees for managing the Deephaven Funds. Management fees, which are received monthly, are recorded as earned and are calculated as a percentage of each Deephaven Fund's monthly net assets.

Incentive allocation fees are earned based upon the performance of the Deephaven Funds and are calculated based upon a percentage of a new high net asset value, as defined in the applicable private placement offering memorandum, for the six month performance period ended June 30 or December 31, for some funds and for the twelve month performance period ended December 31 for other funds. A new high net asset value is defined as the amount by which the net asset value of an investor's account in a particular Deephaven fund exceeds the greater of either the investor's highest previous net asset value in that Deephaven fund or the net asset value at the time the investor made a purchase.

We record incentive allocation fees in accordance with Method 2 of EITF Topic D-96. Under this methodology, the Company recognizes incentive allocation fee income for each interim period based upon the amount that would be due if the investment advisory relationship with the Deephaven Funds were terminated at the end of such period.

Incentive allocation fees may increase or decrease during the year based on the performance of the Deephaven Funds. As such, the incentive allocation fees, in certain circumstances, may be negative for certain periods, but not lower than zero for any six-month performance period ended June 30 or December 31, for some funds, or the twelve month performance period ended December 31 for other funds. Incentive allocation fees are paid upon the close of each six month performance period, or twelve month performance period, as the case may be, and are not subject to repayment (i.e., clawback) once such performance period has closed. If a fund which has a six month performance period incurs losses in the performance period ended December 31, we may make the determination, at our sole discretion, to return all or a portion of incentive allocation fees collected for the prior six month performance period ending June 30 of that year.

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

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

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

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We estimate and accrue for potential losses that may arise out of litigation, regulatory proceedings and tax audits to the extent that such losses are probable and can be estimated in accordance with SFAS No. 5 *Accounting for Contingencies*. Significant judgment is required in making these estimates and our final liabilities may ultimately be materially different. Our total liability accrued with respect to litigation and regulatory proceedings is determined on a case-by-case basis and represents an estimate of probable losses based on, among other factors, the progress of each case, our experience with and industry experience with similar cases and the opinions and views of internal and external legal counsel. Given the inherent difficulty of predicting the outcome of our litigation and regulatory matters, particularly in cases or proceedings in which substantial or indeterminate damages or fines are sought, or where cases or proceedings are in the early stages, we cannot estimate losses or ranges of losses for cases or proceedings where there is only a reasonable possibility that a loss may be incurred. For more information on our legal and regulatory matters, see *Legal Proceedings* in Part I, Item 3 of the Company's Annual Report on Form 10-K for the year ended December 31, 2007, Part II, Item 1 included in this Form 10-Q, and other reports or documents the Company files with, or furnishes, to the SEC from time to time.

**Recently Issued Accounting Standards**

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS 141(R) ). SFAS 141(R) requires the acquiring entity in a business combination to recognize the acquisition date fair value for all identifiable assets acquired, and liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141(R) changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development and requires the expensing of acquisition-related and restructuring costs as incurred. SFAS 141(R) is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008. We are currently evaluating the potential impact, if any, of the adoption of SFAS 141(R) on our Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* ( SFAS 160 ). SFAS 160 states that accounting and reporting for minority interests will be recharacterized as noncontrolling interests and classified as a component of equity. SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. This statement is effective as of the beginning of an entity's first fiscal year beginning after December 15, 2008. We are currently evaluating the potential impact, if any, of the adoption of SFAS 160 on our Consolidated Financial Statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133* ( SFAS 161 ). SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2008, with early adoption encouraged. We are currently evaluating the potential impact, if any, of the adoption of SFAS 161 on our Consolidated Financial Statements.

In April 2008, the FASB issued FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP FAS 142-3 ). FSP FAS 142-3 removes the requirement of SFAS No. 142, *Goodwill and Other Intangible Assets* for an entity to consider, when determining the useful life of an acquired intangible asset, whether the intangible asset can be renewed without substantial cost or material

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modifications to the existing terms and conditions associated with the intangible asset. FSP FAS 142-3 replaces the previous useful-life assessment criteria with a requirement that an entity consider its own experience in renewing similar arrangements. If the entity has no relevant experience, it would consider market participant assumptions regarding renewal. FSP FAS 142-3 is effective for the Company on December 1, 2009. We are currently evaluating the potential impact, if any, of the adoption of FSP FAS 142-3 on our Consolidated Financial Statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS 162 ). SFAS 162 identifies a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for nongovernmental entities (the Hierarchy ). The Hierarchy within SFAS 162 is consistent with that previously defined in the AICPA Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* ( SAS 69 ). SFAS 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The adoption of SFAS 162 will not have a material effect on our Consolidated Financial Statements because we have utilized the guidance within SAS 69.

In June 2008, the FASB issued FASB Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and therefore need to be included in calculating earnings per share under the two-class method described in SFAS No. 128, *Earnings per Share*. Additionally, FSP EITF 03-6-1 requires companies to treat unvested share-based payment awards that have non-forfeitable rights to dividend or dividend equivalents as a separate class of securities in calculating earnings per share and is effective for financial statements issued for fiscal years beginning after December 15, 2008; early adoption is not permitted. We do not expect FSP EITF 03-6-1 to affect our results of operations or earnings per share.

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

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

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

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

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In the normal course of business, we maintain inventories of exchange-listed and OTC equity securities. The fair value of these securities at June 30, 2008 and 2007 was \$606.1 million and \$434.0 million, respectively, in long positions and \$407.4 million and \$416.6 million, respectively, in short positions. The potential change in fair value, using a hypothetical 10% decline in prices, is estimated to be a loss of \$19.9 million and \$1.7 million as of June 30, 2008 and 2007, respectively, due to the offset of gains in short positions with the losses in long positions.

As of June 30, 2008, we had a \$76.5 million corporate investment as a limited partner or non-managing member in the Deephaven Funds, \$37.0 million of which was invested in the Global Multi-Strategy Fund (formerly known as Market Neutral Fund). As of June 30, 2008, approximately 60% of the Deephaven Funds' assets under management were in the Global Multi-Strategy Fund. The investment philosophy for the Global Multi-Strategy Fund is to seek to produce returns for its investors using various investment strategies focusing on delivering attractive risk-adjusted rates of return. The performance of the Global Multi-Strategy Fund is intended to be substantially non-correlated with the general debt and equity markets, as well as with a number of other non-traditional investment strategies. Within the Global Multi-Strategy Fund, Deephaven generally employs a variety of investment strategies, including volatility-driven, fundamental equity, event-driven, credit-driven and global relative value macro/fixed income strategies among others. There is no material limitation on the types of investment strategies that may be employed by the Global Multi-Strategy Fund. There will be unhedged asset factor risks (i.e., equity, interest rate, foreign exchange) in the Global Multi-Strategy Fund.

Deephaven also manages single-strategy funds that pursue investment strategies which involve substantial risks based on the fact that they are less diversified strategies and could be more vulnerable to structural economic and regulatory changes, or general market conditions. The less diversified nature of these strategies may cause their performance to be more volatile and result in the incurrence of greater losses during unprofitable periods as compared to a more diversified approach.

Separately, Deephaven's business also involves specific categories of trading and operational risk. For example, although Deephaven may attempt to hedge positions as part of its trading strategies, there is no assurance that adequate hedging opportunities will exist. Moreover, Deephaven relies to a material degree on its prime brokers to provide leverage, custody, execution and other services, but there is no assurance that the prime brokers will continue to provide the amount of leverage which they have in the past, or on the same terms, or provide any of the other services they currently provide, on a cost-effective basis. Deephaven also faces significant risk from the fact that any of its trading counterparties could fail, which would likely have the effect of greatly diminishing the value of the assets which are the subject of trades with that counterparty. Finally, if Deephaven does not appropriately structure its use of leverage, the losses the funds incur could be materially exacerbated.

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

**Operational Risk**

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

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### **Risk.**

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

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

### **Legal Risk**

Legal risk includes the risk of non-compliance with applicable legal and regulatory requirements and standards. Legal risk also includes contractual and commercial risk such as the risk that counterparty's performance obligations will be unenforceable. We are generally subject to extensive regulation in the different jurisdictions in which we conduct our business (see Government Regulation and Market Structure in Part I, Item 1 of our Annual Report on Form 10-K for the year ended December 31, 2007). We have established procedures based on legal and regulatory requirements that are designed to foster compliance with applicable statutory and regulatory requirements. We have also established procedures that are designed to require that our policies relating to conduct, ethics and business practices are followed.

### **Item 4. Controls and Procedures**

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

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

***Legal***

***Short Selling Litigation***

In the second quarter of 2008, the following development occurred in the *Eagletech Communications Inc. et al. v. Citigroup, Inc. et al.* action described in the Company's Form 10-K for the year ended December 31, 2007:

Pursuant to an Order, dated June 25, 2008, the Court dismissed with prejudice four of plaintiffs' federal claims against Knight and remanded plaintiffs' remaining claims to the Clerk of the Circuit Court of the Seventeenth Judicial Circuit in and for Broward County, Florida. On or about July 25, 2008, plaintiffs filed a Notice of Appeal.

***Regulatory***

We own subsidiaries including regulated entities that are subject to extensive oversight under federal, state and applicable international laws as well as SRO rules. Changes in market structure and the need to remain competitive require constant changes to our systems and order handling procedures. We make these changes while continuously endeavoring to comply with many complex laws and rules. Compliance, surveillance or trading issues, common in the securities industry, and which are monitored or reported to the SEC, CFTC or SROs, are reviewed in the ordinary course of business by our primary regulators, the SEC, FINRA, FSA, CFTC, MSRB and NFA. As a major order flow execution destination, we are named from time to time in, or are asked to respond to a number of regulatory matters brought by U.S. regulators, foreign regulators and SROs that arise from our trading activity. The Company is currently the subject of various regulatory reviews and investigations. In some instances, these matters may rise to a SEC, CFTC, FSA or SRO disciplinary action and/or civil or administrative action.

As disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006, in March 2005, NASD (now known as FINRA) announced that it had charged Kenneth Pasternak, former CEO of KSLP, and John Leighton, former head of KSLP's institutional sales desk, in an administrative complaint alleging supervisory violations in connection with fraudulent sales to institutional customers in 1999 and 2000. Pursuant to a decision dated April 11, 2007, the majority of a NASD Hearing Panel found that Pasternak and Leighton failed to supervise KSLP's Institutional Sales Department reasonably during the period of January 1999 to September 2000 in violation of NASD rules. Pasternak and Leighton were each fined \$100,000. Pasternak was suspended in all supervisory capacities for two years and Leighton was barred in all supervisory capacities. On or about May 3, 2007, Pasternak and Leighton each filed a Notice of Appeal from the NASD Hearing Panel's decision. In May 2007, the NASD filed a Notice of Cross-Appeal from the NASD Hearing Panel's decision. This matter was heard on July 28, 2008 by a sub-committee of FINRA's National Adjudicatory Council (the NAC), and we

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expect the NAC will issue its decision before the end of 2008. In August 2005, the SEC announced that it had filed a civil fraud action in the United States District Court for the District of New Jersey against Kenneth Pasternak and John Leighton. Pursuant to an Order filed on June 24, 2008, the Court ordered that judgment be entered in favor of Pasternak and Leighton and against the SEC. The SEC's time to appeal from this ruling has not yet expired.

For further information on Legal Proceedings, see the section entitled "Legal Proceedings", in Part I, Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2007, and other reports or documents the Company files with, or furnishes to the SEC from time to time.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A.

"Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2007, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K, are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

The following table contains information about our purchases of our Class A Common Stock during the second quarter of 2008 (in thousands, except per share amounts):

| Period                                | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>(1)</sup> | Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs |
|---------------------------------------|----------------------------------|------------------------------|---|--|
| <b>April 1, 2008 - April 30, 2008</b> |                                  |                              |   |  |
| Common stock repurchases              | -                                |                              | -   | \$ 351,001   |
| Employee transactions <sup>(2)</sup>  | 9                                |                              | -   |  |
| Total                                 | 9                                | \$ 16.91                     | -   |  |
| <b>May 1, 2008 - May 31, 2008</b>     |                                  |                              |   |  |
| Common stock repurchases              | 312                              |                              | 312   | \$ 345,512   |
| Employee transactions <sup>(2)</sup>  | 1                                |                              | -   |  |
| Total                                 | 314                              | \$ 17.57                     | 312   |  |
| <b>June 1, 2008 - June 30, 2008</b>   |                                  |                              |   |  |
| Common stock repurchases              | 89                               |                              | 89  | \$ 343,923   |
| Employee transactions <sup>(2)</sup>  | 5                                |                              | -   |  |
| Total                                 | 94                               | \$ 17.98                     | 89  |  |
| <b>Total</b>                          |                                  |                              |   |  |
| Common stock repurchases              | 401                              |                              | 401   |  |
| Employee transactions <sup>(2)</sup>  | 16                               |                              | -   |  |
| Total                                 | 417                              | \$ 17.65                     | 401   |  |

Totals may not add due to rounding.

- (1) On April 4, 2002, our Board of Directors announced the authorization of a stock repurchase program, which allowed for the purchase of Class A Common Stock up to a total amount of \$35 million. This repurchase program was increased by an aggregate of \$965 million to a total of \$1 billion by resolutions of our Board of Directors adopted on July 16, 2002, May 12, 2003, April 20, 2004, August 8, 2004, April 19, 2005, October 18, 2005, April 18, 2006 and

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July 17, 2007. We may repurchase shares from time to time in open market transactions, accelerated stock buyback programs, tender offers, privately negotiated transactions or by other means. Repurchases may also be made under a Rule 10b5-1 plan. The timing and amount of repurchase transactions will be determined by our management based on their evaluation of market conditions, share price, legal requirements and other factors. The program may be suspended, modified or discontinued at any time without prior notice. We caution that there are no assurances that any further repurchases may actually occur. The repurchase program has no set expiration or termination date.

(2) Represents shares of common stock withheld in satisfaction of tax withholding obligations upon vesting of restricted stock.

**Item 3. Defaults Upon Senior Securities**

None.

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

The Company held its Annual Meeting of Stockholders on May 14, 2008 for the purpose of: (i) electing its Board of Directors; and (ii) ratifying the appointment of its independent auditor.

The Company's Board of Directors consists of a total of seven people who are elected by the holders of the Company's Class A Common Stock. The seven people were nominated by the Board of Directors to serve as directors for a term of one year.

The following sets forth the results of the election of directors. Under applicable Delaware law, abstentions and broker non-votes are disregarded and have no effect on the outcome of the vote:

**Table of Contents****DIRECTORS**

| <b>NAME OF NOMINEE</b> | <b>FOR</b> | <b>%</b> | <b>AGAINST</b> | <b>%</b> |
|------------------------|------------|----------|----------------|----------|
| William L. Bolster     | 81,657,964 | 97.35%   | 2,226,839      | 2.65%    |
| Gary R. Griffith       | 83,040,536 | 99.11%   | 744,795        | 0.89%    |
| Thomas M. Joyce        | 82,701,794 | 98.70%   | 1,087,953      | 1.30%    |
| Robert M. Lazarowitz   | 83,043,916 | 99.11%   | 746,294        | 0.89%    |
| Thomas C. Lockburner   | 83,036,493 | 99.10%   | 754,255        | 0.90%    |
| James T. Milde         | 81,660,722 | 97.46%   | 2,127,999      | 2.54%    |
| Laurie M. Shahon       | 81,666,228 | 97.46%   | 2,124,247      | 2.54%    |

No proxies were solicited from the holders of Class B Common Stock since no such shares are outstanding. There was no solicitation in opposition to the nominees proposed to be elected by the holders of the Class A Common Stock in the Proxy Statement.

The ratification of the appointment of PricewaterhouseCoopers LLP as independent auditor for the Company for the fiscal year ending December 31, 2008 was approved by the stockholders with 83,310,103 votes FOR (99.31%), 533,457 votes AGAINST (0.64%), and 41,243 (0.05%) votes ABSTAINED. Under applicable Delaware law, abstentions are counted as votes against this proposal and broker non-votes are disregarded and have no effect on the outcome of the vote.

Further information regarding these matters is contained in the Company's Proxy Statement dated April 3, 2008.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

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

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Jersey City, State of New Jersey, on this 11th day of August, 2008

KNIGHT CAPITAL GROUP, INC.

By: /s/ THOMAS M. JOYCE

Chairman of the Board and Chief Executive Officer  
(Principal Executive Officer)

By: /s/ STEVEN BISGAY

Chief Financial Officer  
(Principal Financial and Accounting Officer)