KNIGHT CAPITAL GROUP, INC.
Form 10-Q
November 09, 2010
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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 SEPTEMBER 30, 2010**

OR

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

001-14223

Commission File Number

KNIGHT CAPITAL GROUP, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or organization)

22-3689303

(I.R.S. Employer Identification Number)

545 Washington Boulevard, Jersey City, NJ 07310

(Address of principal executive offices and zip code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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 definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x 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 x

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

As of November 5, 2010 the number of shares outstanding of the Registrant s Class A Common Stock was 98,129,871 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 September 30, 2010

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	For the three months ended September 30, 2010	For the three months ended September 30, 2009	For the nine months ended September 30, 2010	For the nine months ended September 30, 2009
	(In thousands, except per share amounts)			
Revenues				
Commissions and fees	$ 157,121	$ 177,025	$ 494,626	$ 503,532
Net trading revenue	79,847	119,595	392,775	354,459
Interest, net	92	(1,050)	853	(2,687)
Investment income and other, net	2,449	4,360	1,768	3,847
Total revenues	239,509	299,930	890,022	859,151
Expenses				
Employee compensation and benefits	115,730	139,334	412,775	384,135
Execution and clearance fees	44,167	50,430	134,150	121,953
Communications and data processing	17,180	15,781	50,309	43,850
Depreciation and amortization	11,269	8,777	30,338	25,223
Interest	7,501	713	17,112	2,669
Occupancy and equipment rentals	6,630	5,930	19,332	17,180
Payments for order flow	6,598	17,737	28,712	57,813
Business development	4,451	4,058	14,991	13,497
Professional fees	3,976	3,410	12,762	9,410
Restructuring	16,731	-	16,731	-
Writedown of assets and lease loss accrual (benefit), net	-	-	1,032	(9,996)
Other	5,163	4,003	14,579	11,739
Total expenses	239,396	250,173	752,823	677,473
Income from continuing operations before income taxes	113	49,757	137,199	181,678
Income tax expense	45	19,278	54,578	73,360
Income from continuing operations, net of tax	68	30,479	82,621	108,318
Income (loss) from discontinued operations, net of tax	135	(1,253)	(215)	(34,228)
Net income	$ 203	$ 29,226	$ 82,406	$ 74,090
Basic earnings per share from continuing operations	$ 0.00	$ 0.34	$ 0.92	$ 1.22
Diluted earnings per share from continuing operations	$ 0.00	$ 0.32	$ 0.88	$ 1.16

Basic earnings per share from discontinued operations	$	0.00	$	(0.01)	$	0.00	$	(0.38)
Diluted earnings per share from discontinued operations	$	0.00	$	(0.01)	$	0.00	$	(0.37)
Basic earnings per share	$	0.00	$	0.33	$	0.92	$	0.83
Diluted earnings per share	$	0.00	$	0.31	$	0.88	$	0.79
Shares used in computation of basic earnings per share		90,405		89,278		89,809		88,919
Shares used in computation of diluted earnings per share		93,278		93,958		94,054		93,532

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

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KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Unaudited)

	September 30, 2010	December 31, 2009
	(In thousands)	
ASSETS		
Cash and cash equivalents	$ 480,871	$ 427,106
Financial instruments owned, at fair value	1,358,406	926,589
Collateralized agreements:		
Securities borrowed	1,639,694	394,417
Receivable from brokers, dealers and clearing organizations	527,614	500,143
Fixed assets and leasehold improvements, at cost, less accumulated depreciation and amortization	114,176	98,696
Investments	86,456	118,619
Goodwill	317,650	265,530
Intangible assets, less accumulated amortization	91,497	93,332
Other assets	191,564	189,592
Total assets	$ 4,807,928	$ 3,014,024
LIABILITIES & EQUITY		
Liabilities		
Financial instruments sold, not yet purchased, at fair value	$ 1,161,283	$ 639,259
Collateralized financings:		
Securities loaned	1,030,730	550,226
Financial instruments sold under agreements to repurchase	230,000	-
Other secured financings	41,405	-
Payable to brokers, dealers and clearing organizations	405,048	155,148
Accrued compensation expense	161,312	205,282
Accrued expenses and other liabilities	123,359	109,987
Credit facility	-	140,000
Long-term debt	307,952	-
Total liabilities	3,461,089	1,799,902
Equity		
Knight Capital Group, Inc. stockholders equity		
Class A common stock	1,622	1,586
Shares authorized: 500,000 at September 30, 2010 and at December 31, 2009; Shares issued: 162,183 at September 30, 2010 and 158,641 at December 31, 2009;		
Shares outstanding: 97,607 at September 30, 2010 and 92,791 at December 31, 2009		
Additional paid-in capital	794,626	746,778
Retained earnings	1,308,230	1,229,112
Treasury stock, at cost; 64,576 shares at September 30, 2010 and 65,850 shares at December 31, 2009	(758,057)	(763,974)
Accumulated other comprehensive loss	(204)	-
Total Knight Capital Group, Inc. stockholders equity	1,346,217	1,213,502
Noncontrolling interests	622	620

Total equity	1,346,839	1,214,122
Total liabilities and equity	$ 4,807,928	$ 3,014,024

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

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KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the nine months ended September 30, 2010	2009
	(In thousands)	
Cash flows from operating activities		
Net income	$ 82,406	$ 74,090
Loss from discontinued operations, net of tax	(215)	(34,228)
Income from continuing operations, net of tax	82,621	108,318
Adjustments to reconcile income from continuing operations, net of tax to net cash used in operating activities		
Stock-based compensation	39,662	35,975
Depreciation and amortization	30,338	25,223
Debt discount accretion and other debt related expenses	7,919	-
Deferred rent	3,381	1,101
Writedown of assets and lease loss accrual (benefit), net	1,032	(9,996)
Unrealized loss (gain) on investments	2,558	(1,952)
Operating activities from discontinued operations	(477)	(6,157)
(Increase) decrease in operating assets		
Financial instruments owned, at fair value	(406,446)	(521,058)
Securities borrowed	(1,245,277)	(133,964)
Receivable from brokers, dealers and clearing organizations	(27,471)	(228,907)
Other assets	5,369	(4,024)
Increase (decrease) in operating liabilities		
Financial instruments sold, not yet purchased, at fair value	492,265	352,142
Securities loaned	480,504	81,063
Financial instruments sold under agreements to repurchase	230,000	-
Other secured financings	41,405	-
Payable to brokers and dealers	249,899	300,192
Accrued compensation expense	(41,410)	2,594
Accrued expenses and other liabilities	11,046	(27,060)
Net cash used in operating activities	(43,082)	(26,510)
Cash flows from investing activities		
Distributions from investments	37,485	58,738
Purchases of investments	(7,887)	(8,913)
Purchases of fixed assets and leasehold improvements	(36,807)	(32,446)
Purchase of noncontrolling interest	(1,000)	-
Purchase of customer list	(1,000)	-
Purchase of business, net of cash acquired	(14,835)	-
Net cash (used in) provided by investing activities	(24,044)	17,379
Cash flows from financing activities		
Repayment of credit facility	(140,000)	-
Proceeds from issuance of cash convertible notes	363,808	-
Purchase of call options	(73,750)	-
Proceeds from issuance of warrants	15,000	-
Stock options exercised	1,304	10,288
Income tax benefit on stock awards exercised	205	3,518

Cost of common stock repurchased	(45,472)	(12,748)
Financing activities from discontinued operations	-	(6,178)
Net cash provided by (used in) financing activities	121,095	(5,120)
Effect of exchange rate changes on cash and cash equivalents	(204)	-
Increase (decrease) in cash and cash equivalents	53,765	(14,251)
Cash and cash equivalents at beginning of period	427,106	416,957
Cash and cash equivalents at end of period	$ 480,871	$ 402,706
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 16,565	$ 2,623
Cash paid for income taxes	$ 57,284	$ 82,171

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 three operating segments, (i) Equities, (ii) Fixed Income, Currencies and Commodities (FICC) and (iii) Corporate. As of September 30, 2010, the Company s operating segments comprised the following:

Equities

Knight Equity Markets, L.P. (KEM) primarily operates as a market maker in equity securities quoted and traded on the Nasdaq Stock Market and quoted on the OTC Bulletin Board and Pink OTC Markets. KEM also operates the Company s primary domestic institutional equity sales business.

Knight Capital Markets LLC (KCM) primarily operates as a market maker in the over-the-counter market for NYSE, NYSE Amex Equities and NYSE Arca listed securities. KCM also provides capital markets services to corporate issuers and private companies.

Knight Capital Europe Limited (KCEL) is a U.K. registered broker-dealer that provides trade execution services for institutional and broker-dealer clients in U.S., European and Asian equities. KCEL also provides trade execution services for institutional clients in U.S., European and Asian fixed income and foreign exchange products.

Knight Capital Asia Limited LLC (KCAL) provides trade execution services in Asian, U.S. and European equities and fixed income to institutional clients worldwide.

Knight Direct LLC (Knight Direct) provides institutions with direct market access trading through Knight Direct™, an advanced electronic platform. Knight Direct offers a suite of algorithms that allow 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. Knight Direct s European business is operated through KCEL.

Knight Clearing Services LLC (KCS) operates as a self clearing broker-dealer that provides equity settlement and clearance services for the Company s broker-dealer subsidiaries. KCS is a member of The Depository Trust Company and the National Securities Clearing Corporation. KCS is a registered clearing member of NYSE, Nasdaq, ISE, NSX, Chicago Stock Exchange, CBOE Stock Exchange, Nasdaq OMX, Nasdaq OMX BX, Nasdaq OMX PHLX, NYSE Arca and BATS.

FICC

Knight Libertas Holdings LLC and its affiliates (collectively, Knight Fixed Income) provide research, sales and trading across a broad range of fixed income securities, including high-yield and high-grade corporate bonds, distressed debt, asset- and mortgage-backed securities, federal agency securities, convertible bonds, hybrid securities, syndicated bank loans and emerging markets. Knight Fixed Income also provides capital markets services to corporate issuers and private companies. Knight Fixed Income s European business is operated through KCEL.

KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

Hotspot Holdings FX, Inc. and its subsidiaries (Hotspot) provide institutions and dealers with spot foreign exchange, gold and silver executions through an advanced, fully electronic platform. Hotspot s European business is operated through KCEL.

Knight BondPoint, Inc. (Knight BondPoint) provides electronic access and trade execution services for the retail fixed income market.

Urban Financial Group, Inc. (Urban), acquired on July 1, 2010, is an originator of direct and brokered residential mortgage loans and an originator of home equity conversion mortgages, or reverse mortgages, insured by the Federal Housing Administration.

Knight s domestic broker-dealers are registered with the SEC, and are members of one or more self-regulatory organizations, including the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB), and the National Futures Association (NFA). Collectively, Knight s domestic broker-dealers are members of all major U.S. stock, options and futures exchanges and marketplaces. Urban is regulated by the U.S. Department of Housing and Urban Development (HUD). KCEL is authorized and regulated by the U.K. Financial Services Authority (FSA) and is a member of most European Regulated Markets and Multilateral Trading Facilities. KCAL is a broker-dealer registered as an exchange participant with the Hong Kong Stock Exchange and is regulated by the Hong Kong Securities and Futures Commission (SFC).

Corporate

The Corporate segment invests in strategic financial services-oriented opportunities, allocates, deploys and monitors all capital, and maintains all corporate overhead expenses and all other expenses that are not attributable to the Equities and FICC segments. Corporate overhead expenses consist of compensation for senior executives and other employees of the corporate holding company, expenses from legal and other professional services relating to corporate matters as well as directors fees and directors and officers insurance.

Discontinued Operations

Deephaven Capital Management LLC and its subsidiaries (collectively, Deephaven) was the former registered investment adviser to, and sponsor of, the Deephaven investment funds (the Deephaven Funds). During the first quarter of 2009, Deephaven completed the sale of substantially all of its assets to Stark & Roth, Inc. (together with its affiliates, Stark) with Stark agreeing to assume certain limited liabilities of Deephaven. At that time, Deephaven was replaced by Stark as the investment manager, managing member and general partner for the Deephaven Funds and the Company exited the Deephaven business. As a result of this sale, Deephaven was classified as a discontinued operation.

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), should be read in conjunction with the audited Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. These unaudited Consolidated Financial

KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

Statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. All such adjustments are of a normal recurring nature. 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. All significant intercompany transactions and balances have been eliminated. Interim period operating results may not be indicative of the operating results for a full year.

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

The Company consolidates all of its wholly-owned subsidiaries as well as any investment in which it is considered to be the primary beneficiary of a variable interest entity (VIE). The Company performs a qualitative assessment to determine if a VIE should be consolidated. The primary attributes the Company assesses include the entity s capital structure and voting power. The Company will consolidate a VIE if it has both i) the power to direct the activities of a VIE that most significantly impact the entity s economic performance and ii) the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE.

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, trading and sales activities

Financial instruments owned and Financial instruments sold, not yet purchased, which primarily consist of listed and OTC equity securities, 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 institutional client orders) and related expenses are also recorded on a trade date basis. The Company s third party 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 income and interest expense which has been netted on the Consolidated Statements of Operations, is presented in the following table (in millions).

	For the three months ended September 30, 2010	For the three months ended September 30, 2009	For the nine months ended September 30, 2010	For the nine months ended September 30, 2009
Interest income	$ 3.9	$ 0.7	$ 9.2	$ 2.1
Interest expense	(3.8)	(1.7)	(8.3)	(4.8)
Interest, net	$ 0.1	$ (1.1)	$ 0.9	$ (2.7)

Totals may not add due to rounding.

KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

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 and expense presented in the following table (in millions).

	For the three months ended September 30,		For the nine months ended September 30,	
	2010	2009	2010	2009
Dividend income	$ 5.3	$ 7.2	$ 16.4	$ 16.7
Dividend expense	$ (3.5)	$ (7.1)	$ (11.1)	$ (15.0)

Payments for order flow primarily represent payments to broker-dealer clients, in the normal course of business, for directing their order flow in U.S. equities to the Company.

Collateralized agreements and financings

Collateralized agreements consist of securities borrowed. Collateralized financings consist of securities loaned, financial instruments sold under agreements to repurchase, and other secured financings.

Securities borrowed and securities loaned transactions are accounted for as collateralized financing transactions and are recorded at the amount of cash collateral advanced or received, which approximates fair value. Securities borrowed transactions facilitate the settlement process and require the Company to deposit cash or other collateral with the lender. Securities loaned transactions help finance the Company s securities inventory whereby the Company lends stock in exchange for the receipt of cash or other collateral from the borrower. In these transactions, the Company receives or lends cash or other collateral in an amount generally in excess of the market value of the applicable securities borrowed or loaned. The Company monitors the market value of securities borrowed or loaned on a daily basis, with additional collateral obtained or refunded as necessary.

Financial instruments sold under agreements to repurchase are used to finance securities inventory and are recorded at their contractual amount, which approximates fair value. The Company has entered into tri-party repurchase agreements which bear interest at negotiated rates. The Company receives cash and makes delivery of financial instruments to a custodian who monitors the market value of these securities on a daily basis. The market value of the securities delivered must be equal to or in excess of the principal amount loaned under the tri-party repurchase agreements plus the agreed upon margin requirement. The custodian may request additional collateral, if appropriate.

Other secured financings are additional contractual agreements used to finance securities inventory or loans and are recorded at their contractual amount, which approximates fair value. These agreements are short-term with durations of typically less than a month and bear interest at negotiated rates. The Company receives cash and pledges financial instruments or other assets to banks as collateral for these secured financing arrangements. The market value of the collateral delivered must be in excess of the principal amount loaned plus the agreed upon margin requirement under the secured financings. The banks may request additional collateral, if appropriate.

KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

The Company s collateralized agreements and financings are recorded at amounts that approximate fair value. These items are not materially sensitive to shifts in interest rates because they are short-term in nature and are fully collateralized.

Estimated fair value of financial instruments

The Company values its financial instruments using a hierarchy of fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value.

The fair value hierarchy can be summarized 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 financial instruments owned and financial instruments 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 observable inputs such as quoted market prices or alternative pricing sources with reasonable levels of price transparency, are generally classified within Level 2 of the fair value hierarchy.

As discussed in Footnote 8 Long-Term Debt, the Company entered into purchased call options and recorded an embedded conversion derivative concurrent with its issuance of long-term debt. The fair value of these options and derivative are determined using an option pricing model based on observable inputs such as implied volatility of the Company s common stock, risk-free interest rate, and other factors and, as such, are classified within Level 2 of the fair value hierarchy.

As of September 30, 2010, the Company s loans inventory, foreign currency forward contracts, investment in the Deephaven Funds and deferred compensation investments are also classified within 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

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

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. As of September 30, 2010 and December 31, 2009, the Company did not hold any financial instruments that met the definition of Level 3.

The Company has elected to account for its loan inventory associated with the Urban business at fair value, as these assets are generally not held to maturity and the Company believes that fair value better reflects the economics of these loan transactions.

There were no transfers of financial instruments between levels of the fair value hierarchy for any periods presented.

Investments

Investments comprise strategic investments, deferred compensation investments and investment in the Deephaven Funds. Strategic investments include noncontrolling equity ownership interests and debt instruments held by the Company within its non-broker-dealer subsidiaries, primarily in financial services-related businesses. Strategic investments are accounted for under the equity method, at cost or at fair value. The equity method of accounting is used where the Company is considered to exert significant influence on the investee. Strategic investments are held at cost, less impairment if any, when the Company is not considered to exert significant influence on the investee. The equity method of accounting is generally used for investments in limited partnerships and limited liability companies that are held by the Company or any of its non-broker-dealer subsidiaries while strategic investments in corporations by such non-broker-dealers are generally held at adjusted cost. Deferred compensation investments in mutual funds and the investment in the Deephaven Funds are accounted for at fair value.

Strategic investments are reviewed on an ongoing basis to ensure that the carrying values of the investments have not been impaired. If the Company determines 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 net realizable value.

The Company has several deferred compensation plan investments related to certain employees and directors. These plans provide a return to the participants based upon the performance of various investments. In order to hedge its liability under these plans, the Company generally acquires the underlying investments and holds such investments until the deferred compensation liabilities are satisfied. Changes in value of such investments are recorded in Investment income and other, net, with a corresponding charge or credit to Employee compensation and benefits on the Consolidated Statements of Operations.

Goodwill and intangible assets

The Company tests goodwill and intangible assets with an indefinite useful life for impairment annually or when an event occurs or circumstances change that signify the existence of impairment. The Company amortizes other intangible assets on a straight line basis over their useful lives and tests for recoverability whenever events indicate that the carrying amounts may not be recoverable.

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

Treasury stock

The Company records its purchases of treasury stock at cost as a separate component of stockholders equity. The Company obtains treasury stock through purchases in the open market or through privately negotiated transactions. The Company may re-issue treasury stock, at average cost, related to the acquisition of new businesses or, in certain instances, as inducement grants to new hires.

Foreign currency translation and foreign currency forward contracts

As a result of changes in the currencies in which the Company s foreign subsidiaries earn the majority of their revenues, the Company changed the functional currency of KCEL to the Pound Sterling from the U.S. dollar and KCAL to the Hong Kong dollar from the U.S. dollar, effective January 1, 2010. These changes were reflected prospectively and resulted in recording a $2.4 million cumulative translation adjustment gain which is included in Accumulated other comprehensive loss, a $0.9 million reduction in Fixed assets and leasehold improvements and a $3.3 million reduction in Retained earnings on the Consolidated Statements of Financial Condition. For all other entities, the Company s functional currency is the U.S. dollar.

Assets and liabilities of foreign subsidiaries having non-U.S. dollar functional currencies are translated at exchange rates at the end of a period. Revenues and expenses are translated at average exchange rates during the period. Gains and losses resulting from translating foreign currency financial statements into U.S. dollars are included in other comprehensive income (loss) (see Footnote 9 Comprehensive Income). Gains or losses resulting from foreign currency transactions are included in Investment income and other, net on the Company s Consolidated Statements of Operations. For the three and nine months ended September 30, 2010, losses of $0.1 million and $0.5 million, respectively, were recorded in Investment income and other, net on the Consolidated Statements of Operations.

The Company seeks to reduce the impact of fluctuations in foreign exchange rates on its net investment in certain non-U.S. operations through the use of foreign currency forward contracts. For foreign currency forward contracts designated as hedges, the Company assesses the risk management objectives and strategy, including identification of the hedging instrument, the hedged item and the risk exposure and how effectiveness is to be assessed prospectively and retrospectively. The ineffectiveness of the hedge is assessed based on the overall changes in the fair value of the forward contracts. For qualifying net investment hedges, the gains or losses, to the extent effective, are included in Accumulated other comprehensive loss on the Consolidated Statements of Financial Condition and the ineffective portion, if any, is recorded in Investment income and other, net on the Consolidated Statements of Operations.

Soft dollar and commission recapture expense

Under a commission management program, the Company allows institutional clients to allocate a portion of their gross commissions to pay for research and other services provided by third parties. As the Company acts as an agent in these transactions, it records such expenses on a net basis within Commissions and fees on the Consolidated Statements of Operations.

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

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 cost over the software s estimated useful life of three years, commencing at the time the software is placed in service.

The Company recognizes rent expense under operating leases with fixed rent escalations, lease incentives and free rent periods on a straight-line basis over the lease term beginning on the date the Company takes possession of or controls the use of the space, including during free rent periods.

Lease loss

The Company s policy is to identify excess real estate capacity and where applicable, accrue for related future costs, net of estimated sublease income. In determining the accrual, a nominal cash flow analysis is performed for lease losses initiated prior to December 31, 2002 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, such accrual is adjusted to the extent the actual terms of subleased property differ from the assumptions used in the calculation of the accrual. In the event that the Company concludes that previously determined excess real estate is needed for the Company s use, such lease loss accrual will be adjusted accordingly. Any such adjustments to previous lease loss accruals are recorded in Writedown of assets and lease loss accrual (benefit), net on the Consolidated Statements of Operations.

Income taxes

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

Discontinued operations

Revenues and expenses associated with a separate segment or reporting unit that has been disposed of through closure or sale are included in Income (loss) from discontinued operations, net of tax on the Consolidated Statements of Operations. Assets and liabilities of discontinued operations are included in Other assets and Accrued expenses and other liabilities, respectively, on the Consolidated Statements of Financial Condition. Cash flows from discontinued operations are presented on the Consolidated Statements of Cash Flows within operating, investing and financing activities, as applicable, for all periods.

KNIGHT CAPITAL GROUP, INC.

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Stock-based compensation

Stock-based compensation is measured based on the grant date fair value of the awards. These costs are amortized over the requisite service period, which is typically the vesting period.

Expected forfeitures are 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. The benefit recorded did not have a material impact on the results of operations in any of the periods presented.

The Company applies a non-substantive vesting period approach for stock-based awards 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.

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.

Accounting Standards Updates

Effective January 1, 2010, the Company adopted two Accounting Standards Updates (ASU), which were issued by the Financial Accounting Standards Board (FASB). The first ASU requires a reporting entity to disclose separately the amounts of transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers. This ASU also clarifies existing disclosure requirements related to how assets and liabilities should be grouped by class and valuation techniques used for recurring and nonrecurring fair value measurements. Certain disclosure requirements of this ASU were effective for the Company beginning in the first quarter of 2010, while other disclosure requirements of this ASU are effective for financial statements issued for reporting periods beginning after December 15, 2010. Since these amended principles require only additional disclosures concerning fair value measurements, adoption did not and will not affect the Company s Consolidated Financial Statements.

The second ASU relates to the accounting for VIEs. This ASU significantly changed the criteria by which an enterprise determines whether or not it must consolidate a VIE. Under the new guidance, consolidation of a VIE requires both the power to direct the activities that most significantly impact the VIE s economic performance and the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits of the VIE that could potentially be significant to the VIE. The adoption of this ASU had no impact on the Company s Consolidated Financial Statements.

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3. Fair Value Instruments

The Company s financial instruments recorded at fair value have been categorized based upon a fair value hierarchy, 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 (in millions):

	Assets and Liabilities Measured at Fair Value on a Recurring Basis			
September 30, 2010	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets				
Financial instruments owned, at fair value:				
Equities[1]	$ 1,227.7	$ -	$ -	$ 1,227.7
U.S. government obligations	3.3	-	-	3.3
Corporate debt	30.6	-	-	30.6
Listed equity options	13.5	-	-	13.5
Loans inventory	-	53.6	-	53.6
Purchased call options	-	29.8	-	29.8
Total Financial instruments owned, at fair value	1,275.0	83.4	-	1,358.4
Deferred compensation investments[2]	-	16.1	-	16.1
Investment in Deephaven Funds[2]	-	3.9	-	3.9
Total fair value of financial instrument assets	$ 1,275.0	$ 103.4	$ -	$ 1,378.4
Liabilities				
Financial instruments sold, not yet purchased, at fair value:				
Equities[1]	$ 1,069.1	$ -	$ -	$ 1,069.1
U.S. government obligations	37.3	-	-	37.3
Listed equity options	11.4	-	-	11.4
Corporate debt	0.4	-	-	0.4
Embedded conversion derivative	-	29.8	-	29.8
Total return swap	-	11.0	-	11.0
Foreign currency forward contracts	-	2.3	-	2.3
Total fair value of financial instrument liabilities	$ 1,118.2	$ 43.1	$ -	$ 1,161.3

(1) Equities of $257.9 million have been netted by their respective long and short positions by CUSIP number.

(2) Deferred compensation investments and investment in the Deephaven Funds are included within Investments on the Consolidated Statements of Financial Condition. Excluded from deferred compensation investments is $3.0 million of Level 2 assets which relate to discontinued operations and are included within Other assets on the Consolidated Statements of Financial Condition.

Totals may not add due to rounding.

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(Unaudited)

December 31, 2009	Assets and Liabilities Measured at Fair Value on a Recurring Basis Level 1	Level 2	Level 3	Total
Assets				
Financial instruments owned, at fair value:				
Equities[1]	$ 921.1	$ -	$ -	$ 921.1
U.S. government obligations	3.5	-	-	3.5
Listed equity options	2.0	-	-	2.0
Total Financial instruments owned, at fair value	926.6	-	-	926.6
Deferred compensation investments[2]	-	45.0	-	45.0
Investment in Deephaven Funds[2]	-	8.5	-	8.5
Total fair value of financial instrument assets	$ 926.6	$ 53.5	$ -	$ 980.0
Liabilites				
Financial instruments sold, not yet purchased, at fair value:				
Equities[1]	$ 638.1	$ -	$ -	$ 638.1
Listed equity options	1.2	-	-	1.2
Total fair value of financial instrument liabilities	$ 639.3	$ -	$ -	$ 639.3

(1) Equities of $191.1 million have been netted by their respective long and short positions by CUSIP number.

(2) Deferred compensation investments and investment in the Deephaven Funds are included within Investments on the Consolidated Statements of Financial Condition. Excluded from deferred compensation investments is $10.5 million of Level 2 assets which relate to discontinued operations and are included within Other assets on the Consolidated Statements of Financial Condition.

Totals may not add due to rounding.

The following table summarizes the fair value of derivative instruments in the Consolidated Statements of Financial Condition and the effect of changes in fair value on the Consolidated Statements of Operations (in millions):

Asset Derivatives	Balance Sheet Location	Fair Value as of September 30, 2010	December 31, 2009
Derivative instruments not designated as hedging instruments:	Financial instruments owned, at fair value		
Purchased call options		$ 29.8	$ -
Listed equity options[1]		13.5	2.0
		$ 43.2	$ 2.0

Liability Derivatives

Derivative instruments not designated as hedging instruments:	Financial instruments sold, not yet purchased, at fair value				
Embedded conversion derivative		$	29.8	$	-
Listed equity options[(1)]			11.4		1.2
		$	41.2	$	1.2
Derivative instruments designated as hedging instruments:	Financial instruments sold, not yet purchased, at fair value				
Foreign currency forward contracts		$	2.3	$	-

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

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(1) As of September 30, 2010, the Company held 75,364 long and 79,244 short listed equity option contracts. As of December 31, 2009, the Company held 9,185 long and 5,675 short listed equity option contracts. The contracts are not subject to collateral requirements and are not netted.

Totals may not add due to rounding.

Derivative instruments not designated as hedging instruments:	Statement of Operations / Other Comprehensive Income Location	Gain (Loss) Recognized For the Three Months Ended September 30, 2010	2009
Purchased call options	Investment income and other, net	$ (21.2)	$ -
Listed equity options	Net trading revenue	1.9	(2.6)
Embedded conversion derivative	Investment income and other, net	21.2	-
		$ 1.9	$ (2.6)
Derivative instruments designated as hedging instruments:			
Foreign currency forward contracts	Cumulative Translation Adjustment	$ (2.3)	$ -

Totals may not add due to rounding.

Derivative instruments not designated as hedging instruments:	Statement of Operations / Other Comprehensive Income Location	Gain (Loss) Recognized For the Nine Months Ended September 30, 2010	2009
Purchased call options	Investment income and other, net	$ (44.0)	$ -
Listed equity options	Net trading revenue	1.7	(8.6)
Embedded conversion derivative	Investment income and other, net	44.0	-
		$ 1.7	$ (8.6)
Derivative instruments designated as hedging instruments:			
Foreign currency forward contracts	Cumulative Translation Adjustment	$ (2.3)	$ -

Totals may not add due to rounding.

At September 30, 2010, the Company had a foreign currency contract with a notional value of 55 million British pounds. The fair value of the contract was $2.3 million and is included in Financial instruments sold, not yet purchased, at fair value on the Consolidated Statements of Financial Condition.

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4. Collateralized Transactions

The Company receives financial instruments as collateral in connection with securities borrowed. Such financial instruments generally consist of equity and convertible securities but may include obligations of the U.S. government, federal agencies, sovereignties and corporations. In most cases, the Company is permitted to deliver or repledge these financial instruments in connection with securities lending and other secured financings and meeting settlement requirements. As of September 30, 2010, the fair value of financial instruments received as collateral by the Company that it was permitted to deliver or repledge was $1.41 billion, of which $1.38 billion had been delivered or repledged, of which $712.6 million could be repledged by the receiving counterparty. As of December 31, 2009, the fair value of financial instruments received as collateral by the Company that it was permitted to deliver or repledge was $349.1 million, of which $314.7 million had been delivered or repledged, all of which could be repledged by the receiving counterparty. The Company also pledges assets that it owns to counterparties who, in turn, are permitted to deliver or repledge them. Financial instruments pledged to counterparties that have the right to deliver or repledge them were $278.7 million and $212.5 million at September 30, 2010 and December 31, 2009, respectively, and are included in Financial instruments owned, at fair value on the Consolidated Statements of Financial Condition.

The Company enters into collateralized transactions in order to finance securities inventory positions. Under these transactions, the Company pledges certain financial instruments owned to collateralize repurchase agreements and other secured financings. Financial instruments owned and pledged to counterparties that did not have the right to sell or repledge such financial instruments consisted of equity securities with a fair value of $261.6 million as of September 30, 2010 and are included in Financial instruments owned, at fair value on the Consolidated Statements of Financial Condition. Repurchase agreements and other secured financings are short-term and mature within one year.

Urban has committed collateralized financing facilities to finance its loan origination activity. At September 30, 2010, Urban had $41.4 million borrowed under these committed collateralized financing facilities. None of the collateral that secures these financings can be repledged by the lenders.

5. Receivable from and Payable to brokers, dealers and clearing organizations

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

	September 30, 2010	December 31, 2009
Receivable:		
Clearing brokers and other	$ 461.1	$ 412.7
Securities failed to deliver	66.5	87.5
	$ 527.6	$ 500.1
Payable:		
Clearing brokers and other	354.9	92.8
Securities failed to receive	50.2	62.4
	$ 405.0	$ 155.1

Totals may not add due to rounding.

KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

6. Investments

Investments include strategic investments, deferred compensation investments related to employee and director deferred compensation plans and investment in Deephaven Funds. Investments consist of the following (in millions):

	September 30, 2010	December 31, 2009
Strategic Investments:		
Limited liability companies, limited partnerships and corporations accounted for under the equity method	$ 61.2	$ 57.4
Common stock of private companies representing less than 20% equity ownership held at adjusted cost	0.3	0.3
Debt instruments, held at amortized cost	5.0	7.5
Total Strategic Investments	**66.4**	**65.2**
Deferred compensation investments	16.1	45.0
Investment in Deephaven Funds	3.9	8.5
Total Investments	**$ 86.5**	**$ 118.6**

Totals may not add due to rounding.

Included in the investment in limited liability companies at September 30, 2010 and December 31, 2009 is an equity investment in Direct Edge of $45.4 million and $41.3 million, respectively.

See Footnote 2 Significant Accounting Policies for a discussion of valuation of Investments.

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 2010, the Company tested for the impairment of goodwill and intangible assets with indefinite lives.

Amortizable intangibles are tested for recoverability whenever events indicate that the carrying amounts may not be recoverable. During the second quarter of 2010, the Company discontinued the use of the Libertas trade name and wrote off the remaining book value of $0.3 million. During the second quarter of 2009, the Company discontinued the use of the Donaldson trade name and wrote off the remaining book value of $2.4 million. No other events occurred during the three and nine months ended September 30, 2010 and 2009 that would indicate that the carrying amounts of the Company s goodwill or intangible assets may not be recoverable.

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The following table summarizes the Company s Goodwill and Intangible assets, net of accumulated amortization, as of September 30, 2010 and December 31, 2009 (in millions):

Goodwill	**September 30, 2010**	**December 31, 2009**
Equities		
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 EdgeTrade business	51.7	51.7
Total	114.7	114.7
FICC		
Purchase of Hotspot business	55.7	55.7
Purchase of Valubond business	14.2	14.2
Purchase of Libertas business(1)	114.3	81.0
Purchase of Urban business	17.8	-
Total	202.0	150.8
Corporate		
Other	1.0	-
Total	1.0	-
Consolidated Total	**$ 317.7**	**$ 265.5**

(1) During the third quarter of 2010, the Company recorded a $33.3 million increase in Knight Fixed Income goodwill as a result of achieving its second year performance target in accordance with the earn-out provisions in the acquisition documents. As a result, the Company issued $33.3 million in Knight unregistered common stock to the sellers.

Intangible assets primarily represent client relationships and are amortized over their remaining useful lives, the majority of which have been determined to range from four to 24 years. The weighted average remaining life of the Company s intangible assets at September 30, 2010 and December 31, 2009 is approximately 10 and 11 years, respectively.

Total Intangible assets decreased by $1.8 million during the nine months ended September 30, 2010 primarily due to amortization expense offset by the purchase of broker relationships and other intangibles associated with the acquisition of Urban in the FICC segment and a newly acquired customer list in the Equities segment.

The Company recorded amortization expense, related to its intangible assets of $3.5 million and $2.7 million, for the three months ended September 30, 2010 and 2009, respectively, and $9.0 million and $8.1 million, for the nine months ended September 30, 2010 and 2009, respectively. The estimated amortization expense relating to the intangible assets for each of the next five years approximates $3.4 million for the remainder of 2010, $13.6 million in 2011, $13.3 million in 2012, $11.1 million in 2013 and $9.3 million in 2014.

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The following table summarizes the Company s Intangible assets, net of accumulated amortization as of September 30, 2010 and December 31, 2009 (in millions):

Intangible Assets	September 30, 2010	December 31, 2009
Equities		
Customer and broker relationships	$ 18.1	$ 19.8
Trade names	3.5	3.7
Other	4.4	5.0
Total	26.0	28.6
FICC		
Customer and broker relationships	42.4	41.9
Trade names	4.7	3.7
Other	3.5	3.6
Total	50.6	49.3
Corporate		
Other	14.9	15.5
Total	14.9	15.5
Consolidated Total	**$ 91.5**	**$ 93.3**

		September 30, 2010	December 31, 2009
Customer and broker relationships(1)	Gross carrying amount	$ 90.8	$ 85.3
	Accumulated amortization	(30.2)	(23.6)
	Net carrying amount	60.5	61.7
Trade names(2)	Gross carrying amount	9.8	8.8
	Accumulated amortization	(1.6)	(1.3)
	Net carrying amount	8.2	7.5
Other(3)	Gross carrying amount	29.3	29.0

	Accumulated amortization	(6.6)	(4.8)
	Net carrying amount	22.7	24.2
Total	Gross carrying amount	129.9	123.0
	Accumulated amortization	(38.4)	(29.7)
	Net carrying amount	**$ 91.5**	**$ 93.3**

(1) - Customer and broker relationships primarily relate to the Donaldson, Direct Trading, Hotspot, EdgeTrade, Libertas and Urban acquisitions. The weighted average remaining life is approximately 10 years and 11 years as of September 30, 2010 and December 31, 2009, respectively. Lives may be reduced depending upon actual retention rates.

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(Unaudited)

(2) - Trade names relate to the acquisitions of Hotspot, EdgeTrade and Urban. The weighted average remaining life is approximately 14 and 16 years as of September 30, 2010 and December 31, 2009, respectively. During the second quarter of 2010, the Libertas trade name with an unamortized cost of $0.3 million was written off. During 2009, the Donaldson trade name with an unamortized cost of $2.4 million was written off.

(3) - Other includes trading rights, technology, non-compete agreements and domain name rights acquired by the Company. The weighted average remaining life is approximately eight and seven years as of September 30, 2010 and December 31, 2009, respectively.

Totals may not add due to rounding.

8. Long-Term Debt

In March 2010, the Company issued $375.0 million of Cash Convertible Senior Subordinated Notes (the Notes) due on March 15, 2015 in a private offering exempt from registration under the Securities Act of 1933, as amended. At the same time, the Company entered into hedge transactions effected through the purchase of options and sale of warrants designed to limit shareholder dilution up to a price of $31.50 per share.

The Notes bear interest at a rate of 3.50% per year, payable semi-annually in arrears, on March 15 and September 15 of each year, commencing on September 15, 2010 and will mature on March 15, 2015, subject to earlier repurchase or conversion. In connection with the issuance of the Notes, the Company recognized an original issue discount of $73.8 million which will be accreted to interest expense over the term of the Notes, resulting in an effective annual interest rate of the Notes of approximately 7.9%. The Notes, net of original issue discount are reported as Long-term debt in the Company s Consolidated Statements of Financial Condition. As of September 30, 2010 the net balance was $308.0 million.

Prior to December 15, 2014, the Notes will be convertible into cash only upon specified events which are based upon the price of the Company s common shares and of the Notes or upon the occurrence of specified corporate events. On or after December 15, 2014, the Notes will be convertible at any time, based on an initial conversion rate of 47.9185 shares of Knight common stock per $1,000 principal amount of Notes, which is equivalent to an initial conversion price of approximately $20.87 or a conversion premium of approximately 32.5% over the closing sale price of $15.75 per share of Knight common stock on the Nasdaq Global Select Market on March 15, 2010. The conversion rate and conversion price will be subject to adjustment in certain events, such as distributions of dividends or stock splits. Upon cash conversion, Knight will deliver an amount of cash calculated over the applicable observation period. Knight will not deliver its common stock (or any other securities) upon conversion under any circumstances. In addition, following certain corporate events that occur prior to the maturity date, the Company will pay a cash make-whole premium by increasing the conversion rate for a holder who elects to convert its Notes in connection with such a corporate event in certain circumstances. Subject to certain exceptions, holders may require the Company to repurchase, for cash, all or part of the Notes upon a fundamental change at a price equal to 100% of the principal amount of the Notes being repurchased plus any accrued and unpaid interest.

Concurrent with the sale of the Notes, the Company paid $73.7 million to enter into privately negotiated cash convertible note hedge transactions (the purchased call options) with affiliates of the initial purchasers of the Notes and another financial institution (the option counterparties) that are

KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

expected generally to reduce Knight s exposure to potential cash payments in excess of the principal amount of the Notes that may be required to be made by Knight upon the cash conversion of the Notes. The purchased call options cover, subject to adjustments, approximately 18 million shares of the Company s Class A common stock at a strike price of $20.87 and are expected to reduce the Company s economic exposure to potential cash payments in the event that the market price per share of the Company s Class A common stock is greater than the conversion price of the Notes. The purchased call options were recorded as an asset within Financial instruments owned, at fair value on the Consolidated Statements of Financial Condition and are accounted for as derivative instruments under GAAP. As of September 30, 2010, the fair value of the purchased call options was $29.8 million.

In connection with the sale of the Notes, the Company also entered into separate warrant transactions with the option counterparties whereby the Company sold to the option counterparties, for $15.0 million, warrants (the warrants) to purchase shares of the Company s Class A common stock, subject to adjustments, at a strike price of $31.50 per share, which represents a premium of approximately 100% over the closing price of Knight common stock on March 15, 2010. The warrants are net share settled, meaning that the Company will issue a number of shares per warrant having a value equal to the difference between the share price at each warrant expiration date and the strike price; however, at the discretion of the Company, Knight may elect to settle the warrants in cash. If the market price per share of the Company s Class A common stock exceeds the strike price of the warrants over the warrants exercise period and the Company elects net share settlement, the warrants would have a dilutive effect on the Company s Class A common stock. The warrants may not be exercised prior to the maturity of the Notes. The warrants have been recorded as Additional paid-in capital in the Consolidated Statements of Financial Condition. The warrants also meet the criteria of derivative instruments under GAAP; however, because the warrants are indexed to the Company s Class A common stock and are recorded within Equity in the Consolidated Statements of Financial Condition, the warrants are exempt from the scope and fair value provisions of GAAP related to accounting for derivative instruments.

The requirement that the Company settle conversions of the Notes entirely in cash gives rise to a bifurcatable derivative instrument under GAAP (the embedded conversion derivative). The initial valuation of the embedded conversion derivative was $73.8 million, and was recorded as a liability within Financial instruments sold, not yet purchased, at fair value on the Consolidated Statements of Financial Condition. As of September 30, 2010, the fair value of the embedded conversion derivative was $29.8 million.

Both the purchased call options and the embedded conversion derivative are derivative instruments and as such are marked to fair value each reporting period with any change recognized on the Consolidated Statements of Operations as Investment income and other, net. The Company expects the gain or loss associated with changes to the valuation of the purchased call options to substantially offset the gain or loss associated with changes to the valuation of the embedded conversion derivative.

In connection with the issuance of the Notes, the Company incurred issuance costs of $8.5 million. The issuance costs are recorded within Other assets in the Consolidated Statements of Financial Condition and are amortized over the term of the Notes. The Consolidated Statements of Operations for the three and nine months ended September 30, 2010 includes $0.4 million and $0.9 million, respectively, in Other expense related to the amortization of the debt issuance costs and $6.2 million and $13.7 million, respectively, in Interest expense related to the interest on the Notes.

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Concurrent with the Notes offering, the Company repaid the amounts outstanding under the $140.0 million credit agreement originally entered into on October 9, 2007. Approximately $0.9 million of interest expense relating to the credit agreement was recorded for the three months ended September 30, 2009 and $0.5 million and $1.8 million for the nine months ended September 30, 2010 and 2009, respectively.

9. Comprehensive Income

Comprehensive income includes net income and changes in equity except those resulting from investments by, or distributions to, stockholders. Comprehensive income is as follows (in millions):

	For the three months ended September 30, 2010	2009
Net Income	$ 0.2	$ 29.2
Other comprehensive income:		
Cumulative translation adjustment	2.1	-
Comprehensive income	$ 2.3	$ 29.2

	For the nine months ended Sepember 30, 2010	2009
Net Income	$ 82.4	$ 74.1
Other comprehensive income:		
Cumulative translation adjustment	(2.7)	-
Comprehensive income	$ 79.7	$ 74.1

Totals may not add due to rounding.

10. Stock-Based Compensation

The Company previously 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, the Knight Capital Group, Inc. 2006 Equity Incentive Plan (the 2006 Plan) (collectively, the Existing Stock Plans) and the Knight Capital Group, Inc. 2009 Inducement Award Plan (the Inducement Plan). At the Company s 2010 Annual Meeting of Stockholders, the Company s stockholders approved the Knight Capital Group, Inc. 2010 Equity Incentive Plan (the 2010 Plan , collectively with the Existing Stock Plans and the Inducement Plan, the Stock Plans). As a result of the establishment of the 2010 Plan, the 2010 Plan replaced the Existing Stock Plans for future equity grants and no additional grants will be made under the Existing Stock Plans (but the terms and conditions of any outstanding equity grants under the Existing Stock Plans will not be affected). Shares remaining available for grant under the Existing Stock Plans as of the approval date of the 2010 Plan were transferred to, and made available for grant under the 2010 Plan. In addition, any shares which would have become available again under the Existing Stock Plans due to cancellation or expiration of existing grants under the Existing Stock Plans will become available for grant under the 2010 Plan.

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,

KNIGHT CAPITAL GROUP, INC.

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(Unaudited)

2010 Plan and Inducement Plan only), restricted stock and restricted stock units (collectively, the awards), as defined by the Stock Plans. In addition to overall limitations on the aggregate number of awards that may be awarded under the Stock Plans, the Stock Plans (except for the Inducement Plan) 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 and 2010 Plan only) or shares of restricted stock or restricted stock units that may be awarded. As of September 30, 2010, the Company has not issued any stock appreciation rights.

Restricted Shares and Restricted Stock Units

Eligible employees and directors may receive restricted shares and/or restricted stock units (collectively restricted awards) as a portion of their total compensation. The substantial majority of restricted awards generally vest ratably over three years. During 2009, the Company established the Inducement Plan with 1.5 million authorized shares and granted 378,000 restricted shares as inducement awards to new employees pursuant to this plan. During the nine months ended September 30, 2010, the Company issued 197,000 restricted shares as inducement awards pursuant to this plan. These shares were issued out of treasury and vest ratably over three years. The fair value of the inducement awards are measured in the same manner as other restricted awards. The Company has also issued restricted awards that vest based upon the market price of Knight s common stock reaching a certain price for a specified period of time (Market Shares). The Company has the right to fully vest employees and directors in their restricted stock units 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 other than Market Shares based on the fair 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 determines compensation cost for Market Shares based upon the fair value of such awards at date of grant and projected median vesting periods, both of which are based on statistical simulation models. The principal assumptions utilized in valuing Market Shares and determining their median vesting periods 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 award; 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) maximum life based upon the maximum contractual life of the award. Based upon the results of this model, the weighted-average fair value and median vesting period of Market Shares granted in the first quarter of 2009 were $9.65 per share and 1.7 years, respectively. The principal assumptions used in valuing Market Shares issued in the first quarter of 2009 were a risk-free interest rate of 2.6%, expected volatility of 40% and maximum life of four years. There were no Market Shares granted in 2010.

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(Unaudited)

Compensation expense relating to restricted awards, primarily recorded in Employee compensation and benefits, as well as the corresponding income tax benefit, which is recorded in Income tax expense on the Consolidated Statements of Operations are presented in the following table (in millions).

	For the three months ended September 30, 2010	For the three months ended September 30, 2009	For the nine months ended September 30, 2010	For the nine months ended September 30, 2009
	(In millions)			
Restricted awards	$ 11.0	$ 10.9	$ 37.3	$ 34.2
Income tax benefit	$ 4.4	$ 4.4	$ 14.9	$ 13.7

The following table summarizes restricted awards activity during the nine months ended September 30, 2010 (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, 2010	2,186.5	$ 16.92	3,590.7	$ 15.60
Granted	397.0	15.66	3,588.1	14.34
Vested	(1,142.6)	17.12	(734.5)	16.88
Forfeited	(220.8)	15.76	(157.1)	18.29
Outstanding at September 30, 2010	1,220.1	$ 16.54	6,287.2	$ 14.66

Totals may not add due to rounding.
There is $69.6 million of unamortized compensation related to unvested restricted awards outstanding at September 30, 2010. The cost of these unvested restricted awards is expected to be recognized over a weighted average life of 1.6 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 and directors 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

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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. During the nine months ended September 30, 2010, the Company granted 1.2 million options to employees. Based on the results of the model, the weighted-average fair value of the stock options granted during the nine months ended September 30, 2010 and 2009 was $4.93 and $5.43 per option, respectively.

Compensation expense relating to stock options, all of which was recorded in Employee compensation and benefits, as well as the corresponding income tax benefit, which is recorded in Income tax expense on the Consolidated Statements of Operations are presented in the following table (in millions).

	For the three months ended September 30,		For the nine months ended September 30,	
	2010	2009	2010	2009
Options	$ 0.5	$ 0.4	$ 2.3	$ 1.8
Income tax benefit	$ 0.2	$ 0.2	$ 0.9	$ 0.7

The following table summarizes stock option activity during the nine months ended September 30, 2010 (stock options in thousands):

	Number of Stock Options	Weighted-Average Exercise Price
Outstanding at January 1, 2010	3,554.0	$ 13.29
Granted at market value	1,185.1	15.89
Exercised	(131.6)	9.99
Forfeited or expired	(383.0)	18.36
Outstanding at September 30, 2010	4,224.5	$ 13.66
Exercisable at September 30, 2010	3,042.9	$ 13.66
Available for future grants at September 30, 2010*	10,975.3	

Totals may not add due to rounding.

* Represents both options and awards available for grant

There is $3.4 million of unrecognized compensation related to unvested stock options outstanding at September 30, 2010. The cost of these unvested awards is expected to be recognized over a weighted average life of 2.1 years.

11. 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 files separate company income tax returns.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

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 September 30, 2010	2009	For the nine months ended September 30, 2010	2009
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	6.0%	4.2%	4.6%	5.4%
Nondeductible charges and other, net	-0.9%	-0.5%	0.2%	0.0%
Actual income tax rate	40.1%	38.7%	39.8%	40.4%

At September 30, 2010, the Company did not have any unrecognized tax benefits.

As of September 30, 2010, the Company is subject to U.S. Federal income tax examinations for the tax years 2007 through 2009, and to non-U.S. income tax examinations for the tax years 2006 through 2009. In addition, the Company is subject to state and local income tax examinations in various jurisdictions for the tax years 2003 through 2009. 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.

It is the Company s policy to record interest and penalties associated with tax audits as a component of Income from continuing operations, net of tax. Penalties, if any, 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.

12. Restructuring, Writedown of Assets and Lease Loss

In the third quarter of 2010, the Company recorded a Restructuring charge of $16.7 million related to a plan to reduce headcount in order to rationalize expenses. The charge, which consists of severance and related costs, affected all operating segments.

Writedown of assets and lease loss accrual (benefit), net was a charge of $1.0 million and a benefit of $10.0 million for the nine months ended September 30, 2010 and 2009, respectively. There were no writedowns or lease loss charges for the three months ended September 30, 2010 and 2009.

During the second quarter of 2010, the Company recorded a charge of $0.3 million related to the Company s decision to discontinue the use of the Libertas trade name and a lease loss accrual of $0.7 million relating to excess real estate capacity. During the second quarter of 2009, the Company recorded a benefit of $13.1 million related to a reversal of a previously recognized lease loss with respect to the Company s office space in Jersey City, N.J. The Company had previously considered a portion of these premises to be excess real estate and had therefore recorded a lease loss accrual for such excess office space. Based on expected growth and future needs, in the second quarter of 2009 management made the decision to build out and occupy the excess office space and therefore recorded a benefit related to the reversal of such previously recorded lease loss.

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Also included in the nine months ended September 30, 2009 is a charge of $2.4 million related to the Company s decision to discontinue the use of the Donaldson trade name and the writedown of $0.7 million of capitalized software resulting from the sale of Hotspot s retail customer accounts.

13. Discontinued Operations

In the first quarter of 2009, Deephaven completed the sale of substantially all of its assets to Stark & Roth, Inc. (together with its affiliates, Stark) with Stark agreeing to assume certain limited liabilities of Deephaven. At that time, Deephaven was replaced by Stark as the investment manager, managing member and general partner for the Deephaven Funds and the Company exited the Deephaven business. As a result of this sale, Deephaven was classified as a discontinued operation.

Income (loss) from the discontinued operations, net of tax are presented in the following table (in millions).

	For the three months ended September 30,		For the nine months ended September 30,	
	2010	2009	2010	2009
Pre-tax Income (loss) from discontinued operations	$ 0.2	$ (1.9)	$ 0.0	$ (51.8)
Income tax (expense) benefit	(0.1)	0.7	(0.2)	17.6
Income (loss) from discontinued operations, net of tax	$ 0.1	$ (1.3)	$ (0.2)	$