

NATIONAL HOLDINGS CORP  
Form 10-Q/A  
May 10, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q/A

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

For the Quarter Ended March 31, 2007

Commission File Number 001-12629

NATIONAL HOLDINGS CORPORATION  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

36-4128138  
(I.R.S. Employer  
Identification No.)

120 Broadway, 27th Floor, New York, NY 10271  
(Address including zip code of principal executive offices)  
Registrant's telephone number, including area code: (212) 417-8000

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 or a non-accelerated filer (see definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (check one)). Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

As of May 9, 2007 there were 5,410,038 shares of the registrant's common stock outstanding.

**EXPLANATORY NOTE**

This Quarterly Report on Form 10-Q/A (the “Report”) is being filed by National Holdings Corporation (the “Company”) to amend the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2007 that was initially filed with the Securities and Exchange Commission (the “SEC”) on May 8, 2007. This Report is being filed to correct formatting errors that occurred during the EDGAR process. No other changes have been made to the previously reported financial information and disclosures.

## NATIONAL HOLDINGS CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

## ASSETS

|   | March 31,<br>2007<br>(unaudited) | September 30,<br>2006<br>(see note below) |
|---|----------------------------------|---|
| CASH  | \$ 1,536,000                     | \$ 1,441,000                              |
| DEPOSITS WITH CLEARING ORGANIZATIONS  | 301,000                          | 300,000                                   |
| RECEIVABLES FROM BROKER-DEALERS<br>AND CLEARING ORGANIZATIONS   | 4,478,000                        | 3,548,000                                 |
| OTHER RECEIVABLES, net of allowance for<br>uncollectible accounts of \$467,000<br>at March 31, 2007 and September 30, 2006,<br>respectively | 664,000                          | 380,000                                   |
| ADVANCES TO REGISTERED<br>REPRESENTATIVES   | 2,318,000                        | 1,556,000                                 |
| SECURITIES OWNED  |                                  |   |
| Marketable, at market value   | 890,000                          | 475,000                                   |
| Non-marketable, at fair value   | -                                | 402,000                                   |
| FIXED ASSETS, net   | 289,000                          | 305,000                                   |
| SECURED DEMAND NOTE   | 1,000,000                        | 1,000,000                                 |
| OTHER ASSETS  | 446,000                          | 300,000                                   |
| <b>TOTAL ASSETS</b>   | <b>\$ 11,922,000</b>             | <b>\$ 9,707,000</b>                       |

## LIABILITIES AND STOCKHOLDERS' EQUITY

|   |                  |                  |
|---|------------------|------------------|
| PAYABLE TO BROKER-DEALERS AND<br>CLEARING ORGANIZATIONS   | \$ 714,000       | \$ 113,000       |
| SECURITIES SOLD, BUT NOT YET<br>PURCHASED, at market  | 176,000          | 162,000          |
| ACCOUNTS PAYABLE, ACCRUED EXPENSES<br>AND OTHER LIABILITIES   | 4,707,000        | 3,943,000        |
| CONVERTIBLE NOTES PAYABLE, net of debt<br>discounts of \$140,000 and \$159,000<br>at March 31, 2007 and September 30, 2006,<br>respectively | 860,000          | 841,000          |
| NOTES PAYABLE, net of debt discounts of<br>\$187,000 and \$45,000<br>at March 31, 2007 and September 30, 2006,<br>respectively              | 813,000          | 805,000          |
| <b>TOTAL LIABILITIES</b>  | <b>7,270,000</b> | <b>5,864,000</b> |
| SUBORDINATED BORROWINGS   | 1,000,000        | 1,000,000        |
| COMMITMENTS AND CONTINGENCIES   |                  |                  |

**STOCKHOLDERS' EQUITY**

|  |                      |                     |
|--|----------------------|---------------------|
| Preferred stock, \$.01 par value, 200,000 shares authorized; 50,000 shares designated as Series A and 20,000 shares designated as Series B   | -                    | -                   |
| Series A 9% cumulative convertible preferred stock, \$.01 par value, 50,000 shares authorized; 37,550 shares issued and outstanding (liquidation preference: \$3,755,000) at March 31, 2007 and 35,316 shares issued and outstanding (liquidation preference: \$3,531,600) at September 30, 2006 | -                    | -                   |
| Series B 10% cumulative convertible preferred stock, \$.01 par value, 20,000 shares authorized; 10,000 shares issued and outstanding (liquidation preference: \$1,000,000) at March 31, 2007 and September 30, 2006, respectively  | -                    | -                   |
| Common stock, \$.02 par value, 30,000,000 shares authorized; 5,402,851 and 5,223,968 shares issued and outstanding, at March 31, 2007 and September 30, 2006, respectively   | 108,000              | 104,000             |
| Additional paid-in capital   | 17,639,000           | 16,956,000          |
| Accumulated deficit  | (14,095,000)         | (14,217,000)        |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>  | <b>3,652,000</b>     | <b>2,843,000</b>    |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>  | <b>\$ 11,922,000</b> | <b>\$ 9,707,000</b> |

Note: The balance sheet at September 30, 2006 has been derived from the audited consolidated financial statements at that date.

See notes to condensed consolidated financial statements.

**NATIONAL HOLDINGS CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

|  | Three Months Ended |                   | Six Months Ended  |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | March 31,<br>2007  | March 31,<br>2006 | March 31,<br>2007 | March 31,<br>2006 |
| <b>REVENUES:</b>                               |                    |                   |                   |                   |
| Commissions                                    | \$ 8,522,000       | \$ 10,714,000     | \$ 16,944,000     | \$ 17,871,000     |
| Net dealer inventory gains                     | 3,760,000          | 2,191,000         | 7,059,000         | 4,052,000         |
| Investment banking                             | 3,112,000          | 4,042,000         | 3,667,000         | 7,093,000         |
| Total commission and fee revenues              | 15,394,000         | 16,947,000        | 27,670,000        | 29,016,000        |
| Interest and dividends                         | 796,000            | 696,000           | 1,361,000         | 1,382,000         |
| Transfer fees and clearing services            | 1,005,000          | 969,000           | 2,015,000         | 1,730,000         |
| Other  | 420,000            | 175,000           | 853,000           | 347,000           |
| <b>TOTAL REVENUES</b>                          | <b>17,615,000</b>  | <b>18,787,000</b> | <b>31,899,000</b> | <b>32,475,000</b> |
| <b>EXPENSES:</b>                               |                    |                   |                   |                   |
| Commissions                                    | 12,392,000         | 14,043,000        | 22,176,000        | 23,731,000        |
| Employee compensation and related expenses     | 1,749,000          | 1,592,000         | 3,262,000         | 2,884,000         |
| Clearing fees                                  | 343,000            | 436,000           | 718,000           | 800,000           |
| Communications                                 | 426,000            | 546,000           | 828,000           | 1,033,000         |
| Occupancy and equipment costs                  | 741,000            | 633,000           | 1,476,000         | 1,308,000         |
| Professional fees                              | 559,000            | 246,000           | 1,517,000         | 584,000           |
| Interest                                       | 105,000            | 176,000           | 209,000           | 285,000           |
| Taxes, licenses, registration                  | 164,000            | 169,000           | 342,000           | 314,000           |
| Other administrative expenses                  | 560,000            | 522,000           | 880,000           | 854,000           |
| <b>TOTAL EXPENSES</b>                          | <b>17,039,000</b>  | <b>18,363,000</b> | <b>31,408,000</b> | <b>31,793,000</b> |
| <b>NET INCOME</b>                              | <b>576,000</b>     | <b>424,000</b>    | <b>491,000</b>    | <b>682,000</b>    |
| Preferred stock dividends                      | (103,000)          | (95,000)          | (208,000)         | (171,000)         |
| Net income attributable to common stockholders | \$ 473,000         | \$ 329,000        | \$ 283,000        | \$ 511,000        |
| <b>NET INCOME PER COMMON SHARE</b>             |                    |                   |                   |                   |
| Basic:   | \$ 0.09            | \$ 0.06           | \$ 0.05           | \$ 0.10           |

Net income attributable to  
common stockholders

Diluted:

|   |    |      |    |      |    |      |    |      |
|---|----|------|----|------|----|------|----|------|
| Net income attributable to<br>common stockholders | \$ | 0.05 | \$ | 0.04 | \$ | 0.05 | \$ | 0.07 |
|---|----|------|----|------|----|------|----|------|

Weighted average number of  
shares outstanding

|         |            |            |            |            |
|---------|------------|------------|------------|------------|
| Basic   | 5,370,917  | 5,089,625  | 5,310,762  | 5,068,451  |
| Diluted | 11,193,816 | 10,383,571 | 10,909,161 | 10,283,235 |

See notes to condensed consolidated financial statements.

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**NATIONAL HOLDINGS CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

|  | Six Months Ended |                  |
|--|------------------|------------------|
|  | March 31, 2007   | March 31, 2006   |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                  |                  |
| Net income   | \$ 491,000       | \$ 682,000       |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities |                  |                  |
| Depreciation and amortization  | 74,000           | 68,000           |
| Amortization of deferred financing costs   | 4,000            | 1,000            |
| Amortization of note discount  | 61,000           | 130,000          |
| Compensatory element of common stock issuance  | -                | 12,000           |
| Compensatory element of common stock option issuances                                      | 29,000           | 5,000            |
| Changes in assets and liabilities  |                  |                  |
| Deposits with clearing organizations   | (1,000)          | -                |
| Receivables from broker-dealers, clearing organizations and others                         | (1,976,000)      | (1,198,000)      |
| Securities owned: marketable, at market value  | (415,000)        | (300,000)        |
| Securities owned: non-marketable, at fair value  | 402,000          | -                |
| Other assets   | (146,000)        | (96,000)         |
| Payables   | 1,392,000        | 1,678,000        |
| Securities sold, but not yet purchased, at market  | 14,000           | 29,000           |
| Net cash (used in) provided by operating activities  | (71,000)         | 1,011,000        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |                  |                  |
| Purchase of fixed assets   | (58,000)         | (117,000)        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |                  |                  |
| Net proceeds from issuance of common stock   | -                | 175,000          |
| Net proceeds from issuance of preferred stock  | -                | 972,000          |
| Net proceeds from issuance of convertible notes payable                                    | -                | 1,000,000        |
| Net proceeds from issuance of notes payable  | 1,000,000        | -                |
| Cash payment of deferred financing costs   | (22,000)         | (28,000)         |
| Payment of notes payable   | (850,000)        | (1,175,000)      |
| Dividends paid   | (50,000)         | -                |
| Exercise of stock options and warrants   | 146,000          | -                |
| Net cash provided by financing activities  | 224,000          | 944,000          |
| <b>NET INCREASE IN CASH</b>  | <b>95,000</b>    | <b>1,838,000</b> |
| <b>CASH BALANCE</b>  |                  |                  |
| Beginning of the period  | 1,441,000        | 398,000          |
| End of the period  | \$ 1,536,000     | \$ 2,236,000     |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>                                   |                  |                  |
| Cash paid during the period for:   |                  |                  |

|                                    |    |         |    |         |
|------------------------------------|----|---------|----|---------|
| Interest                           | \$ | 163,000 | \$ | 165,000 |
| Series B preferred stock dividends | \$ | 50,000  | \$ | -       |

SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING  
AND  
FINANCING ACTIVITIES

|   |    |         |    |         |
|---|----|---------|----|---------|
| Warrants issued in connection with debt | \$ | 195,000 | \$ | 187,000 |
| Preferred stock dividends               | \$ | 317,000 | \$ | 300,000 |

See notes to condensed consolidated financial statements.



**NATIONAL HOLDINGS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2007**

**(UNAUDITED)**

**NOTE 1. BASIS OF PRESENTATION**

The accompanying condensed consolidated financial statements of National Holdings Corporation (“National Holdings” or the “Company”) have been prepared in accordance with generally accepted accounting principles for interim financial statements and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and disclosures required for annual financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The condensed consolidated financial statements as of March 31, 2007 and for the periods ended March 31, 2007 and March 31, 2006 are unaudited. The results of operations for the interim periods are not necessarily indicative of the results of operations for the fiscal year. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related footnotes included thereto in the Company’s Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

**NOTE 2. RECENT ACCOUNTING PRONOUNCEMENTS**

In July 2006, the FASB released Interpretation No. 48, "Accounting for Uncertainty in Income Taxes--an interpretation of FASB Statement No. 109" ("FIN 48"), which clarifies the accounting and reporting for uncertainty in income tax law. FIN 48 prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The provisions of FIN 48 are effective after December 15, 2006. Earlier adoption is permitted as of the beginning of an enterprise's fiscal year, provided the enterprise has not yet issued financial statements, including financial statements for any interim period for that fiscal year. The cumulative effects, if any, of applying FIN 48 will be recorded as an adjustment to accumulated deficit as of the beginning of the period of adoption. The Company is evaluating the impact that the adoption of this pronouncement will have on the consolidated financial position, results of operations, or cash flows of the Company.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"). SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS 159 is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. The FASB has indicated it believes that SFAS 159 helps to mitigate this type of accounting-induced volatility by enabling companies to report related assets and liabilities at fair value, which would likely reduce the need for companies to comply with detailed rules for hedge accounting. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities.

SFAS 159 does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in SFAS 157 and SFAS No. 107, "Disclosures about Fair Value of Financial Instruments." SFAS 159 is effective for the Company as of the beginning of fiscal year 2009. The adoption of this pronouncement is not expected to have an impact on the Company's consolidated financial position, results of operations or cash flows.

In December 2006, the FASB approved FASB Staff Position (FSP) No. EITF 00-19-2, "Accounting for Registration Payment Arrangements" ("FSP EITF 00-19-2"), which specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with SFAS No. 5, "Accounting for Contingencies". FSP EITF 00-19-2 also requires additional disclosure regarding the nature of any registration payment arrangements, alternative settlement methods, the maximum potential amount of consideration and the current carrying amount of the liability, if any. The guidance in FSP EITF 00-19-2 amends FASB Statements No. 133, "Accounting for Derivative Instruments and Hedging Activities", and No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity", and FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", to include scope exceptions for registration payment arrangements.

FSP EITF 00-19-2 is effective immediately for registration payment arrangements and the financial instruments subject to those arrangements that are entered into or modified subsequent to the issuance date of this FSP, or for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years, for registration payment arrangements entered into prior to the issuance date of this FSP. The adoption of this pronouncement is not expected to have an impact on the Company's consolidated financial position, results of operations or cash flows.

### **NOTE 3. STOCK BASED COMPENSATION**

Effective October 1, 2005, the Company adopted FASB Statement of Financial Accounting Standard ("SFAS") No. 123R "Share Based Payment". This statement is a revision of SFAS Statement No. 123, and supersedes APB Opinion No. 25, and its related implementation guidance. SFAS 123R addresses all forms of share based payment ("SBP") awards including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. Under SFAS 123R, SBP awards will result in a charge to operations that will be measured at fair value on the awards grant date, based on the estimated number of awards expected to vest over the service period. During the three and six months ended March 31, 2006, the Company granted 70,000 and 170,000 stock options, respectively, with a fair value of approximately \$55,000 and \$88,000, respectively. A charge of approximately \$4,000 was recorded in the three and six months ended March 31, 2006, relating to the amortization of the fair value associated with these grants. During the three and six months ended March 31, 2007, the Company granted 570,000 and 720,000 stock options, respectively, with a fair value of approximately \$478,000 and \$574,000, respectively. A charge of approximately \$22,000 and \$29,000 was recorded in the three and six months ended March 31, 2007, respectively, relating to the amortization of the fair value associated with stock option grants.

As stock-based compensation expense recognized in the condensed consolidated statements of operations is based on awards that are ultimately expected to vest, it has been reduced for expected forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. If factors change and the Company employs different assumptions in the application of SFAS No. 123(R) in future periods, the compensation expense that the Company records under SFAS No. 123(R) may differ significantly from what has been recorded in the current period.



The Black-Scholes option valuation model is used to estimate the fair value of the options granted. The model includes subjective input assumptions that can materially affect the fair value estimates. The model was developed for use in estimating the fair value of traded options that have no vesting restrictions and that are fully transferable. For example, the expected volatility is estimated based on the most recent historical period of time equal to the weighted average life of the options granted. Options issued under the Company's option plans have characteristics that differ from traded options. In management's opinion, this valuation model does not necessarily provide a reliable single measure of the fair value of its employee stock options. Principal assumptions used in applying the Black-Scholes model along with the results from the model were as follows:

|                         | 2007  | 2006  |
|-------------------------|-------|-------|
| <b>Assumptions:</b>     |       |       |
| Risk-free interest rate | 4.40% | 4.40% |
| Expected life, in years | 3.0   | 3.0   |
| Expected volatility     | 83%   | 88%   |

A summary of the stock option activity as of March 31, 2007, and changes during the six month period then ended is presented below:

|                                   | Shares    | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|-----------------------------------|-----------|--|---|---------------------------------|
| Outstanding at September 30, 2006 | 932,000   | \$ 1.30                                  | 3.31  |                                 |
| Granted                           | 720,000   | \$ 1.60                                  | 4.91  |                                 |
| Exercised                         | (20,000)  | \$ 0.72                                  |   |                                 |
| Expired                           | (25,000)  | \$ 2.00                                  |   |                                 |
| Outstanding at March 31, 2007     | 1,607,000 | \$ 1.43                                  | 3.83  | \$ 425,000                      |
| Exercisable at March 31, 2007     | 962,000   | \$ 1.33                                  | 3.17  | \$ 333,000                      |

As of March 31, 2007, there was \$613,000 of total deferred compensation costs related to share-based compensation arrangements.

A summary of the status of the Company's nonvested shares as of March 31, 2007, and changes during the six month period then ended is presented below:

| Nonvested Shares                   | Shares   | Weighted<br>Average<br>Grant Date<br>Fair Value |
|------------------------------------|----------|---|
| Nonvested at September 30,<br>2006 | 75,000   | \$ 0.33   |
| Granted                            | 595,000  | \$ 0.81   |
| Vested                             | (25,000) | \$ 0.33   |
| Expired                            | -        |   |
| Nonvested at March 31, 2007        | 645,000  | \$ 0.78   |

#### NOTE 4. SECURITIES OWNED AND SECURITIES SOLD, BUT NOT YET PURCHASED

The following table shows the quoted market values of the Company's marketable securities owned and securities sold, but not yet purchased as of March 31, 2007:

|                        | Securities held<br>for resale | Securities sold,<br>but<br>not yet<br>purchased |
|------------------------|-------------------------------|---|
| Corporate stocks       | \$ 868,000                    | \$ 176,000                                      |
| Corporate bonds        | 6,000                         | -   |
| Government obligations | 16,000                        | -   |
|                        | \$ 890,000                    | \$ 176,000                                      |

#### NOTE 5. CLEARING AGREEMENTS

In April 2005, the Company's wholly-owned subsidiary, National Securities Corporation ("National Securities") entered into a clearing agreement with National Financial Services LLC ("NFS") that became effective in June 2005. In the first quarter of fiscal year 2007, NFS paid National Securities a \$750,000 business credit, that is being amortized over an eight year period, the net amount of which has been included in "Accounts Payable, Accrued Expenses and Other Liabilities" in the accompanying consolidated statements of financial condition as of March 31, 2007. In the second quarter of fiscal year 2007, NFS agreed to provide National Securities a \$250,000 clearing fee waiver that is being amortized over a two year period, the net amount of which has been included in "Accounts Payable, Accrued Expenses and Other Liabilities" in the accompanying consolidated statements of financial condition as of March 31, 2007. The clearing agreement includes a termination fee if National Securities terminates the agreement without cause. Additionally, in June 2005, National Securities entered into a clearing agreement with Penson Financial Services, Inc. ("Penson") for the purpose of providing clearing services that are not provided by NFS. The Company believes that the overall effect of these clearing relationships is beneficial to the Company's cost structure, liquidity and capital resources.

#### NOTE 6. CONTINGENCIES

In September 2006, the former chairman and chief executive officer of the Company, Steven A. Rothstein, commenced an arbitration against the current chairman and chief executive officer of the Company, Mark Goldwasser, in the matter *Rothstein et al. vs. Goldwasser*, NASD No. 06-04000. Rothstein is alleging fraud and

inequitable conduct relating to his attempts to sell his investment in the Company in calendar year 2001, and is seeking approximately \$5,750,000 in damages. The Company is indemnifying Mr. Goldwasser in this action. The Company and Mr. Goldwasser believe this action is without merit, and intend to vigorously defend this action.

The Company is a defendant in various other arbitrations and administrative proceedings, lawsuits and claims seeking in the aggregate damages of approximately \$1,200,000. The Company believes such claims are substantially without merit, and estimates that its liability, primarily for defense costs, will approximate \$200,000 (exclusive of unspecified punitive damages related to certain claims and inclusive of expected insurance coverage). These matters arise in the normal course of business. The Company intends to vigorously defend itself in these actions, and believes that the eventual outcome of these matters will not have a material adverse effect on the Company. However, the ultimate outcome of these matters cannot be determined at this time. The amounts related to such matters that are reasonably estimable and which have been accrued at March 31, 2007 and 2006, is \$331,000 and \$228,000, respectively, and have been included in "Accounts Payable, Accrued Expenses and Other Liabilities" in the accompanying consolidated statements of financial condition. The Company has included in "Professional fees" litigation and NASD related expenses of \$344,000 and \$155,000 for the second quarter of fiscal year 2007 and 2006, respectively, and \$1,133,000 and \$400,000 for the first six months of fiscal year 2007 and 2006, respectively.

#### **NOTE 7. DIVIDENDS ON CONVERTIBLE PREFERRED STOCK**

The holders of the Company's Series A convertible preferred stock, that are convertible into the Company's common stock at \$1.25 per share, are entitled to receive dividends on a quarterly basis at a rate of 9% per annum, per share. Such dividends are cumulative and accrue whether or not declared by the Company's Board of Directors, but are payable only when, as and if declared by the Company's Board of Directors. In March 2007, the Company's Board of Directors declared an in-kind dividend in the aggregate of 2,537 shares of Series A preferred stock, in payment of approximately \$317,000 of dividends accrued through March 31, 2007. Such shares were issued on April 30, 2007. At March 31, 2007, the accumulated dividend on the Company's 37,550 issued and outstanding shares of Series A preferred stock was \$0.

The holders of the Company's Series B convertible preferred stock, convertible into the Company's common stock at \$.75 per share, are entitled to receive dividends on a quarterly basis at a rate of 10% per annum per share. Such dividends are cumulative and are payable only when declared by the Company's Board of Directors. In March 2007, the Company's Board of Directors declared a cash dividend of \$25,000 payable to the holders of the Series B preferred stock that was paid in April 2007.

#### **NOTE 8. INCOME PER COMMON SHARE**

Basic income per share is computed on the basis of the weighted average number of common shares outstanding. Diluted income per share is computed on the basis of the weighted average number of common shares outstanding plus the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted.

The following table sets forth the components used in the computation of basic and diluted income per common share:

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|  | Three Months Ended |                | Six Months Ended |                |
|--|--------------------|----------------|------------------|----------------|
|  | March 31, 2007     | March 31, 2006 | March 31, 2007   | March 31, 2006 |
| <b>Numerator:</b>  |                    |                |                  |                |
| Net income   | \$ 576,000         | \$ 424,000     | \$ 491,000       | \$ 682,000     |
| Preferred stock dividends  | (103,000)          | (95,000)       | (208,000)        | (171,000)      |
| Numerator for basic earnings per share   |                    |                |                  |                |
| -- net income attributable to common stockholders - as reported                                      | 473,000            | 329,000        | 283,000          | 511,000        |
| <b>Effect of dilutive securities:</b>  |                    |                |                  |                |
| Interest on convertible notes  | 27,000             | 24,000         | 54,000           | 24,000         |
| Preferred stock dividends  | 103,000            | 95,000         | 208,000          | 171,000        |
| Numerator for basic earnings per share   |                    |                |                  |                |
| -- net income attributable to common stockholders - as adjusted                                      | \$ 603,000         | \$ 448,000     | \$ 545,000       | \$ 706,000     |
| <b>Denominator:</b>  |                    |                |                  |                |
| Denominator for basic earnings per share--weighted average shares                                    |                    |                |                  |                |
|  | 5,370,917          | 5,089,625      | 5,310,762        | 5,068,451      |
| <b>Effect of dilutive securities:</b>  |                    |                |                  |                |
| Stock options  | 207,934            | 37,372         | 104,786          | 17,905         |
| Warrants   | 277,632            | 97,961         | 156,280          | 38,266         |
| <b>Assumed conversion of:</b>  |                    |                |                  |                |
| Series A Preferred Stock   | 3,004,000          | 2,825,280      | 3,004,000        | 2,825,280      |
| Series B Preferred Stock   | 1,333,333          | 1,333,333      | 1,333,333        | 1,333,333      |
| Notes  | 1,000,000          | 1,000,000      | 1,000,000        | 1,000,000      |
| Dilutive potential common shares   | 5,822,899          | 5,293,946      | 5,598,399        | 5,214,784      |
| Denominator for diluted earnings per share--adjusted weighted-average shares and assumed conversions |                    |                |                  |                |
|  | 11,193,816         | 10,383,571     | 10,909,161       | 10,283,235     |
| Net income available to common stockholders  |                    |                |                  |                |
| Basic:   | \$ 0.09            | \$ 0.06        | \$ 0.05          | \$ 0.10        |
| Diluted:   | \$ 0.05            | \$ 0.04        | \$ 0.05          | \$ 0.07        |

**NOTE 9. ACCOUNTS PAYABLE, ACCRUED EXPENSES AND OTHER LIABILITIES**

Accounts payable, accrued expenses and other liabilities as of March 31, 2007 and September 30, 2006, respectively, consist of the following:

|                     | March 31, 2007 | September 30, 2006 |
|---------------------|----------------|--------------------|
| Commissions payable | \$ 1,975,000   | \$ 1,993,000       |
| Legal payable       | 348,000        | 325,000            |
| Other               | 2,384,000      | 1,625,000          |
| Total               | \$ 4,707,000   | \$ 3,943,000       |





#### **NOTE 10. NOTES PAYABLE**

In February 2007, the Company used \$850,000 of the proceeds from the private placement of 10% promissory notes (See Note 11) to pay in full promissory notes that had maturity dates in February 2007.

In February 2007, National Securities and the holder of a \$1.0 million secured demand note that was scheduled to mature on March 1, 2007, extended the term of the secured demand note to March 1, 2008.

#### **NOTE 11. PRIVATE PLACEMENT OF 10% PROMISSORY NOTES**

In February 2007, the Company completed a financing transaction under which certain investors made an investment in the Company by purchasing 10% promissory notes in the principal amount of \$1.0 million, with warrants to purchase an aggregate of 250,000 shares of common stock at an exercise price of \$1.40 per share. The promissory notes mature in February 2009, and have a stated interest rate of 10% per annum. The fair value of the warrants was calculated using the Black-Scholes Option Valuation Model. The Company recorded a debt discount of approximately \$195,000 that will be charged to interest expense over the life of the debt.

The Company and the investors entered into a registration rights agreement, wherein the investors received unlimited piggyback registration rights and one demand registration right for the shares of common stock issuable upon exercise of the warrants. The investors can make such demand one year after the date of issuance of the warrants, and the Company has agreed to file the registration statement within 90 days of such demand. The Company has agreed to use commercially reasonable efforts to have the registration statement declared effective. There are no penalties for failure to have the registration statement declared effective.

The investment included \$500,000 by Christopher C. Dewey and \$250,000 by St. Cloud Capital Partners, L.P. ("St. Cloud"). Mr. Dewey, and Marshall S. Geller, the Co-Founder and Senior Managing Partner of St. Cloud, are each members of the Company's board of directors. The Company incurred legal fees and other costs related to this capital transaction in the amount of \$22,000 that were capitalized and will be amortized to interest expense over the life of the promissory notes.

#### **NOTE 12. STOCKHOLDERS' EQUITY**

In the three and six months ended March 31, 2007 the Company received proceeds of approximately \$14,000 and \$146,000, respectively, from the exercise of 20,000 and 154,643, respectively, outstanding warrants and stock options. In the second quarter ended March 31, 2007, a holder of Series A preferred stock converted 303 shares of Series A preferred stock into 24,240 share of the Company's common stock. In April 2007, the Company received proceeds of approximately \$5,700 from the exercise of outstanding warrants to purchase 7,187 shares of the Company's common stock.

#### **NOTE 13. NEW SUBSIDIARIES**

In the third quarter of fiscal year 2006, the Company formed National Insurance Corporation ("National Insurance") that provides fixed insurance products to its clients, including life insurance, disability insurance, long term care insurance and fixed annuities. National Insurance has finalized certain of the requisite state registrations, and commenced business operations during the second quarter of fiscal year 2007, that were diminimus.

In the first quarter of fiscal year 2007, the Company formed a new wholly owned subsidiary, National Holdings Mortgage Corporation ("National Holdings Mortgage") that will operate a mortgage broker business. National Mortgage is in the process of completing the requisite state registrations, and has not yet commenced business operations.



## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. This Quarterly Report may contain certain statements of a forward-looking nature relating to future events or future business performance. Any such statements that refer to the Company's estimated or anticipated future results or other non-historical facts are forward-looking and reflect the Company's current perspective of existing trends and information. These statements involve risks and uncertainties that cannot be predicted or quantified and, consequently, actual results may differ materially from those expressed or implied by such forward-looking statements. Such risks and uncertainties include, among others, risks and uncertainties detailed in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission on December 7, 2006. Any forward-looking statements contained in or incorporated into this Quarterly Report speak only as of the date of this Quarterly Report. The Company undertakes no obligation to update publicly any forward-looking statement, whether as a result of new information, future events or otherwise.*

### RESULTS OF OPERATIONS

#### Three Months Ended March 31, 2007 Compared to Three Months Ended March 31, 2006

The Company's second quarter of fiscal year 2007 resulted in a decrease in revenues, and a comparatively greater decrease in expenses compared to the same period last year. As a result, the Company reported net income of \$576,000 compared with net income of \$424,000 for the second quarter of fiscal years 2007 and 2006, respectively. This represents an improvement of \$152,000 from the prior period.

|                                      | Three Months Ended |               | Increase (Decrease) |         |
|--------------------------------------|--------------------|---------------|---------------------|---------|
|                                      | 2007               | 2006          | Amount              | Percent |
| Commissions                          | \$ 8,522,000       | \$ 10,714,000 | \$ (2,192,000)      | (20%)   |
| Proprietary trading                  | 3,498,000          | 2,062,000     | 1,436,000           | 70%     |
| Market making                        | 168,000            | 76,000        | 92,000              | 121%    |
| Mark-ups and mark-downs              | 94,000             | 53,000        | 41,000              | 77%     |
| Net dealer inventory gains           | 3,760,000          | 2,191,000     | 1,569,000           | 72%     |
| Investment banking                   | 3,112,000          | 4,042,000     | (930,000)           | (23%)   |
| Interest and dividends               | 796,000            | 696,000       | 100,000             | 14%     |
| Transfer fees and clearance services | 1,005,000          | 969,000       | 36,000              | 4%      |
| Other                                | 420,000            | 175,000       | 245,000             | 140%    |
|                                      | \$ 17,615,000      | \$ 18,787,000 | \$ (1,172,000)      | (6%)    |

Total revenues decreased \$1,172,000, or 6%, in the second quarter of fiscal year 2007 to \$17,615,000 from \$18,787,000 in the second quarter of fiscal year 2006. This decrease is due to a decline in commissions and the completion of fewer and relatively smaller investment banking transactions, partially offset by an increase in net dealer inventory gains. During the second quarter of fiscal year 2007, total trading volume decreased 8%, compared to the second quarter of fiscal year 2006. The greater decrease in trading volume compared to revenues reflects an increase in the average revenue per trade, partially offset by the Company's re-entry into market making activities. Trading volume in this period related to retail brokerage decreased 15%. Commission revenue decreased \$2,192,000, or 20%, to \$8,522,000 from \$10,714,000 during the second quarter of fiscal year 2007 compared with the same period in fiscal year 2006. Net dealer inventory gains, which includes profits on proprietary trading, market making activities and customer mark-ups and mark-downs, increased \$1,569,000, or 72%, to \$3,760,000 from \$2,191,000 during the second quarter of fiscal year 2007 compared with the same period in fiscal year 2006. The increase is primarily due to an increase in proprietary trading in the bond market, and reflects the Company's re-entry into market making activities. During the second quarter of fiscal year 2007, revenues from proprietary trading increased \$1,436,000, or

70%, to \$3,498,000 from \$2,062,000 in the same period of fiscal year 2006, revenues from market making activities increased \$92,000, or 121%, to \$168,000 from \$76,000 in the second quarter of fiscal year 2006, and revenues from customer mark-ups and mark-downs increased \$41,000, or 77%, to \$94,000 from \$53,000 in the second quarter of fiscal year 2006.

Investment banking revenue decreased \$930,000, or 23%, to \$3,112,000 from \$4,042,000 in the second quarter of fiscal year 2007 compared with the second quarter of fiscal year 2006. The decrease in investment banking revenues is attributable to the Company having completed fewer and relatively smaller investment banking transactions in the second quarter of fiscal year 2007. Interest and dividend income increased \$100,000, or 14%, to \$796,000 from \$696,000 in the second quarter of fiscal year 2007 compared with the same period last year. The increase in interest income is attributable to an increase in the amount of debit balances in National Securities' customer accounts from the same period last year. Transfer fees increased \$36,000, or 4%, to \$1,005,000 in the second quarter of fiscal year 2007 from \$969,000 in the second quarter of fiscal year 2006. The increase reflects higher transfer fees for trades generated from the retail brokerage business of brokers recently associated with the Company.

Other revenue, consisting of asset management fees, and miscellaneous transaction fees and trading fees, increased \$245,000, or 140%, to \$420,000 from \$175,000 during the second quarter of fiscal year 2007 compared to the second quarter of fiscal year 2006. The increase is due to an increase in fee based assets under management.

|                                       | Three Months Ended<br>March 31, |               | Increase (Decrease) |         |
|---------------------------------------|---------------------------------|---------------|---------------------|---------|
|                                       | 2007                            | 2006          | Amount              | Percent |
| <b>Commission expense related to:</b> |                                 |               |                     |         |
| Commission revenue                    | \$ 7,629,000                    | \$ 9,449,000  | \$ (1,820,000)      | (19%)   |
| Net dealer inventory gains            | 2,927,000                       | 1,644,000     | 1,283,000           | 78%     |
| Investment banking                    | 1,836,000                       | 2,950,000     | (1,114,000)         | 38%     |
| Commissions                           | 12,392,000                      | 14,043,000    | (1,651,000)         | (12%)   |
| Employee compensation                 | 1,749,000                       | 1,592,000     | 157,000             | 10%     |
| Clearing fees                         | 343,000                         | 436,000       | (93,000)            | (21%)   |
| Communications                        | 426,000                         | 546,000       | (120,000)           | (22%)   |
| Occupancy and equipment costs         | 741,000                         | 633,000       | 108,000             | 17%     |
| Professional fees                     | 559,000                         | 246,000       | 313,000             | 127%    |
| Interest                              | 105,000                         | 176,000       | (71,000)            | (40%)   |
| Taxes, licenses and registration      | 164,000                         | 169,000       | (5,000)             | (3%)    |
| Other administrative expenses         | 560,000                         | 522,000       | 38,000              | 7%      |
|                                       | \$ 17,039,000                   | \$ 18,363,000 | \$ (1,324,000)      | (7%)    |

In comparison with the 6% decrease in total revenues, total expenses decreased 7%, or \$1,324,000, to \$17,039,000 for the second quarter of fiscal year 2007 compared to \$18,363,000 in the second quarter of fiscal year 2006. The decrease in total expenses is primarily the result of lower commission expenses directly associated with commission revenues.

Commission expense, which includes expenses related to commission revenue, net dealer inventory gains and investment banking, decreased \$1,651,000, or 12%, to \$12,392,000 in the second quarter of fiscal year 2007 from \$14,043,000 in the second quarter of fiscal year 2006. Commission expense related to commission revenue decreased \$1,820,000, or 19%, to \$7,629,000 in the second quarter of fiscal year 2007 from \$9,449,000 in the second quarter of fiscal year 2006; commission expense related to net dealer inventory gains increased \$1,283,000, or 78%, to \$2,927,000 in the second quarter of fiscal year 2007 from \$1,644,000 in the second quarter of fiscal year 2006; and commission expense related to investment banking decreased \$1,114,000, or 38%, to \$1,836,000 in the second quarter of fiscal year 2007 from \$2,950,000 in the second quarter of fiscal year 2006. Commission expense as a percentage of commission revenues increased to 90% in the second quarter of fiscal year 2007 from 88% in the second quarter of fiscal year 2006. This increase is attributable to changes in the production of particular brokers, not all of who are paid at the same commission rate and an increase in the amortization of advances to registered representatives. Commission expense as a percentage of net dealer inventory gains increased to 78% in the second quarter of fiscal year 2007 from 75% in the second quarter of fiscal year 2006. This increase is attributable to changes in the production of particular brokers and traders, not all of who are paid at the same commission rate. Commission expense as a percentage of investment banking revenues decreased to 59% in the second quarter of fiscal year 2007 from 73% in the second quarter of fiscal year 2006. This decrease is attributable to the type and size of the particular investment banking transactions completed in the current year's quarter. Commission expense includes the amortization of advances to registered representatives of \$346,000 and \$305,000 for the second quarter of fiscal years 2007 and 2006, respectively. These amounts fluctuate based upon the amounts of advances outstanding and the time period for which the registered representatives have agreed to be affiliated with National Securities.

Employee compensation expense increased \$157,000, or 10%, to \$1,749,000 in the second quarter of fiscal year 2007 from \$1,592,000 in the second quarter of fiscal year 2006. The increase is attributable to new employees hired during fiscal years 2007 and 2006. Overall, combined commission and employee compensation expense, as a percentage of revenue decreased to 80% from 83% in the second quarter of fiscal years 2007 and 2006, respectively. The decrease is attributable to an overall lower payout percentage related to commission revenues.

Clearing fees decreased \$93,000, or 21%, to \$343,000 in the second quarter of fiscal year 2007 from \$436,000 in the second quarter of fiscal year 2006. The decrease in clearing fees is attributable to the reduction in commission revenues in the second quarter of fiscal year 2007 compared to the second quarter of fiscal year 2006, and the amortization of credits received from one of the Company's clearing firms.

Communications expense decreased \$120,000, or 22%, to \$426,000 from \$546,000 in the second quarter of fiscal year 2007 compared to the second quarter of fiscal year 2006. The decrease is primarily due to the Company's ability to acquire certain of these services at a lower price. Occupancy costs increased \$108,000, or 17%, to \$741,000 from \$633,000 in the second quarter of fiscal year 2007 compared to the second quarter of fiscal year 2006. The increase in occupancy expense is due to costs incurred to transfer certain of the Company's paper files to a digital system, and annual rent increases contained in the Company's office leases. Professional fees increased \$313,000, or 127%, to \$559,000 from \$246,000 in the second quarter of fiscal year 2007 compared to the second quarter of fiscal year 2006. The increase in professional fees is primarily a result of legal fees and costs incurred to settle certain arbitrations.

Interest expense decreased \$71,000, or 40%, to \$105,000 from \$176,000 in the second quarter of fiscal year 2007 compared to the second quarter of fiscal year 2006. The decrease in interest expense is primarily attributable to the acceleration of amortization on notes that were paid prior to maturity in the second quarter of fiscal year 2006. Included in interest expense is the amortization of \$34,000 and \$99,000 for the second quarter of fiscal years 2007 and 2006, respectively. Taxes, licenses and registration decreased \$5,000, or 3%, to \$164,000 from \$169,000 in the second quarter of fiscal year 2007 compared to the second quarter of fiscal year 2006. Other administrative expenses increased \$38,000, or 7%, to \$560,000 from \$522,000 in the second quarter of fiscal year 2007 compared to the second quarter of fiscal year 2006. The increase in other administrative expenses is attributable to incentives provided to new registered representatives.





The Company reported net income of \$576,000 in the second quarter of fiscal year 2007 compared to net income of \$424,000 in the second quarter of fiscal year 2006. Overall, the diluted earnings attributable to common stockholders in the second quarter of fiscal year 2007 was \$473,000, or \$.05 per common share, as compared to the diluted earnings attributable to common stockholders of \$329,000, or \$.04 per common share in the second quarter of fiscal year 2006. The net income attributable to common stockholders reflects \$103,000 and \$95,000 of cumulative preferred stock dividends on the Company's preferred stock for the second quarter of fiscal years 2007 and 2006, respectively.

#### Six Months Ended March 31, 2007 Compared to Six Months Ended March 31, 2006

The Company's first six months of fiscal year 2007 resulted in a decrease in revenues, and a relatively similar decrease in expenses compared to the same period last year. As a result, the Company reported net income of \$491,000 compared with net income of \$682,000 for the first six months of fiscal years 2007 and 2006, respectively. This represents a decline of \$191,000 from the prior period.

|                                      | Six Months Ended<br>March 31, |               | Increase (Decrease) |         |
|--------------------------------------|-------------------------------|---------------|---------------------|---------|
|                                      | 2007                          | 2006          | Amount              | Percent |
| Commissions                          | \$ 16,944,000                 | \$ 17,871,000 | \$ (927,000)        | (5%)    |
| Proprietary trading                  | 6,299,000                     | 3,895,000     | 2,404,000           | 62%     |
| Market making                        | 615,000                       | 84,000        | 531,000             | 632%    |
| Mark-ups and mark-downs              | 145,000                       | 73,000        | 72,000              | 99%     |
| Net dealer inventory gains           | 7,059,000                     | 4,052,000     | 3,007,000           | 74%     |
| Investment banking                   | 3,667,000                     | 7,093,000     | (3,426,000)         | (48%)   |
| Interest and dividends               | 1,361,000                     | 1,382,000     | (21,000)            | (2%)    |
| Transfer fees and clearance services | 2,015,000                     | 1,730,000     | 285,000             | 16%     |
| Other                                | 853,000                       | 347,000       | 506,000             | 146%    |
|                                      | \$ 31,899,000                 | \$ 32,475,000 | \$ (576,000)        | (2%)    |

Total revenues decreased \$576,000, or 2%, in the first six months of fiscal year 2007 to \$31,899,000 from \$32,475,000 in the first six months of fiscal year 2006. This decrease is due to a decline in commissions and the completion of fewer and relatively smaller investment banking transactions, partially offset by an increase in net dealer inventory gains. During the first six months of fiscal year 2007, total trading volume increased less than 1%, compared to the first six months of fiscal year 2006. This slight increase reflects an increase in the average revenue per trade. Trading volume in this period related to retail brokerage decreased 10%. Commission revenue decreased \$927,000, or 5%, to \$16,944,000 from \$17,871,000 during the first six months of fiscal year 2007 compared with the same period in fiscal year 2006. Net dealer inventory gains, which includes profits on proprietary trading, market making activities and customer mark-ups and mark-downs, increased \$3,007,000, or 74%, to \$7,059,000 from \$4,052,000 during the first six months of fiscal year 2007 compared with the same period in fiscal year 2006. The increase is primarily due to an increase in proprietary trading in the bond market, and reflects the Company's re-entry into market making activities. During the first six months of fiscal year 2007, revenues from proprietary trading increased \$2,404,000, or 62%, to \$6,299,000 from \$3,895,000 in the same period of fiscal year 2006, revenues from market making activities increased \$531,000, or 632%, to \$615,000 from \$84,000 in the first six months of fiscal year 2007, and revenues from customer mark-ups and mark-downs increased \$72,000, or 99%, to \$145,000 from \$73,000 in the first six months of fiscal year 2006.

Investment banking revenue decreased \$3,426,000, or 48%, to \$3,667,000 from \$7,093,000 in the first six months of fiscal year 2007 compared with the first six months of fiscal year 2006. The decrease in investment banking revenues is attributable to the Company having completed fewer and relatively smaller investment banking transactions in the first six months of fiscal year 2007. Interest and dividend income decreased \$21,000, or 2%, to \$1,361,000 from

\$1,382,000 in the first six months of fiscal year 2007 compared with the same period last year. The decrease in interest income is attributable to lower margin debit balances in the first quarter of fiscal year 2007 resulting from a stricter margin policy imposed by our clearing firms. Transfer fees increased \$285,000, or 16%, to \$2,015,000 in the first six months of fiscal year 2007 from \$1,730,000 in the first six months of fiscal year 2006. The increase reflects higher transfer fees for trades generated from the retail brokerage business of brokers recently associated with the Company.

Other revenue, consisting of asset management fees and miscellaneous transaction fees and trading fees, increased \$506,000, or 146%, to \$853,000 from \$347,000 during the first six months of fiscal year 2007 compared to the first six months of fiscal year 2006. The increase is due to an increase in fee based assets under management.

|                                       | Six Months Ended<br>March 31, |               | Increase (Decrease) |         |
|---------------------------------------|-------------------------------|---------------|---------------------|---------|
|                                       | 2007                          | 2006          | Amount              | Percent |
| <b>Commission expense related to:</b> |                               |               |                     |         |
| Commission revenue                    | \$ 14,962,000                 | \$ 15,722,000 | \$ (760,000)        | (5%)    |
| Net dealer inventory gains            | 5,368,000                     | 2,984,000     | 2,384,000           | 80%     |
| Investment banking                    | 1,846,000                     | 5,025,000     | (3,179,000)         | (63%)   |
| Commissions                           | 22,176,000                    | 23,731,000    | (1,555,000)         | (7%)    |
| Employee compensation                 | 3,262,000                     | 2,884,000     | 378,000             | 13%     |
| Clearing fees                         | 718,000                       | 800,000       | (82,000)            | (10%)   |
| Communications                        | 828,000                       | 1,033,000     | (205,000)           | (20%)   |
| Occupancy and equipment costs         | 1,476,000                     | 1,308,000     | 168,000             | 13%     |
| Professional fees                     | 1,517,000                     | 584,000       | 933,000             | 160%    |
| Interest                              | 209,000                       | 285,000       | (76,000)            | (27%)   |
| Taxes, licenses and registration      | 342,000                       | 314,000       | 28,000              | 9%      |
| Other administrative expenses         | 880,000                       | 854,000       | 26,000              | 3%      |
|                                       | \$ 31,408,000                 | \$ 31,793,000 | \$ (385,000)        | (1%)    |

In comparison with the 2% decrease in total revenues, total expenses decreased 1%, or \$385,000, to \$31,408,000 for the first six months of fiscal year 2007 compared to \$31,793,000 in the first six months of fiscal year 2006. The decrease in total expenses is the result of lower commission expenses directly associated with commission revenues.

Commission expense, which includes expenses related to commission revenue, net dealer inventory gains and investment banking, decreased \$1,555,000, or 7%, to \$22,176,000 in the first six months of fiscal year 2007 from \$23,731,000 in the first six months of fiscal year 2006. Commission expense related to commission revenue decreased \$760,000, or 5%, to \$14,962,000 in the first six months of fiscal year 2007 from \$15,722,000 in the first six months of fiscal year 2006; commission expense related to net dealer inventory gains increased \$2,384,000, or 80%, to \$5,368,000 in the first six months of fiscal year 2007 from \$2,984,000 in the first six months of fiscal year 2006; and commission expense related to investment banking decreased \$3,179,000, or 63%, to \$1,846,000 in the first six months of fiscal year 2007 from \$5,025,000 in the first six months of fiscal year 2006. Commission expense as a percentage of commission revenues remained relatively constant at 88% in the first six months of fiscal years 2007 and 2006. Commission expense as a percentage of net dealer inventory gains increased to 76% in the first six months of fiscal year 2007 from 74% in the first six months of fiscal year 2006. This increase is attributable to changes in the production of particular brokers and traders, not all of who are paid at the same commission rate. Commission expense as a percentage of investment banking revenues decreased to 50% in the second quarter of fiscal year 2007 from 71% in the second quarter of fiscal year 2006. This decrease is attributable to the type and size of the particular investment banking transactions completed in the current year's quarter. Commission expense includes the amortization of advances to registered representatives of \$576,000 and \$617,000 for the first six months of fiscal years 2007 and 2006, respectively. These amounts fluctuate based upon the amounts of advances outstanding and the time period for which the registered representatives have agreed to be affiliated with National Securities.

Employee compensation expense increased \$378,000, or 13%, to \$3,262,000 in the first six months of fiscal year 2007 from \$2,884,000 in the first six months of fiscal year 2006. The increase is attributable to new employees hired during fiscal years 2007 and 2006, and year-end bonuses that were paid to certain staff employees in the first quarter of fiscal year 2007. Overall, combined commission and employee compensation expense, as a percentage of revenue decreased to 80% from 82% in the first six months of fiscal years 2007 and 2006, respectively. The decrease is attributable to an overall lower payout percentage related to commission revenues.

Clearing fees decreased \$82,000, or 10%, to \$718,000 in the first six months of fiscal year 2007 from \$800,000 in the first six months of fiscal year 2006. The decrease in clearing fees is attributable to the reduction in commission revenues in the first six months of fiscal year 2007 compared to the first six months of fiscal year 2006, and the amortization of credits received from one of the Company's clearing firms.

Communications expense decreased \$205,000, or 20%, to \$828,000 from \$1,033,000 in the first six months of fiscal year 2007 compared to the first six months of fiscal year 2006. The decrease is primarily due to the Company's ability to acquire certain of these services at a lower price. Occupancy costs increased \$168,000, or 13%, to \$1,476,000 from \$1,308,000 in the first six months of fiscal year 2007 compared to the first six months of fiscal year 2006. The increase in occupancy expense is due to costs incurred to transfer certain of the Company's paper files to a digital system, and annual rent increases contained in the Company's office leases. Professional fees increased \$933,000, or 160%, to \$1,517,000 from \$584,000 in the first six months of fiscal year 2007 compared to the first six months of fiscal year 2006. The increase in professional fees is primarily a result of legal fees and costs incurred to settle certain arbitrations.

Interest expense decreased \$76,000, or 27%, to \$209,000 from \$285,000 in the first six months of fiscal year 2007 compared to the first six months of fiscal year 2006. The decrease in interest expense is primarily attributable to the acceleration of amortization on notes that were paid prior to maturity in the second quarter of fiscal year 2006. Included in interest expense is the amortization of \$65,000 and \$131,000 for the first six months of fiscal years 2007 and 2006, respectively. Taxes, licenses and registration increased \$28,000, or 9%, to \$342,000 from \$314,000 in the first six months of fiscal year 2007 compared to the first six months of fiscal year 2006. The increase is due to registration incentives provided to certain brokers who became affiliated with the Company in the first quarter of fiscal year 2007. Other administrative expenses increased \$26,000, or 3%, to \$880,000 from \$854,000 in the first six months of fiscal year 2007 compared to the first six months of fiscal year 2006. The increase in other administrative expenses is attributable to incentives provided to new registered representatives.

The Company reported net income of \$491,000 in the first six months of fiscal year 2007 compared to net income of \$682,000 in the first six months of fiscal year 2006. Overall, the diluted earnings attributable to common stockholders in the first six months of fiscal year 2007 was \$283,000, or \$.05 per common share, as compared to diluted earnings attributable to common stockholders of \$511,000, or \$.07 per common share in the first six months of fiscal year 2006. The net income attributable to common stockholders reflects \$208,000 and \$171,000 of cumulative preferred stock dividends on the Company's preferred stock for the first six months of fiscal years 2007 and 2006, respectively.

### **Liquidity and Capital Resources**

National Securities, as a registered broker-dealer, is subject to the SEC's Uniform Net Capital Rule 15c3-1 that requires the maintenance of minimum net capital. National Securities has elected to use the alternative standard method permitted by the rule. This requires that National Securities maintain minimum net capital equal to the greater of \$250,000 or a specified amount per security based on the bid price of each security for which National Securities is a market maker. At March 31, 2007, National Securities' net capital exceeded the requirement by \$2,174,000.

Advances, dividend payments and other equity withdrawals from the Company's broker-dealer subsidiary are restricted by the regulations of the SEC and other regulatory agencies. These regulatory restrictions may limit the amounts that a broker-dealer subsidiary may dividend or advance to the Company.

The Company extends unsecured credit in the normal course of business to its brokers. The determination of the appropriate amount of the reserve for uncollectible accounts is based upon a review of the amount of credit extended, the length of time each receivable has been outstanding, and the specific individual brokers from whom the receivables are due.

The objective of liquidity management is to ensure that the Company has ready access to sufficient funds to meet commitments, fund deposit withdrawals and efficiently provide for the credit needs of customers.

In April 2005, National Securities entered into a clearing agreement with NFS that became effective in June 2005. In the first quarter of fiscal year 2007, NFS paid National Securities a \$750,000 business credit, that is being amortized over an eight year period, the net amount of which has been included in "Accounts Payable, Accrued Expenses and Other Liabilities" in the accompanying consolidated statements of financial condition as of March 31, 2007. In the second quarter of fiscal year 2007, NFS agreed to provide National Securities a \$250,000 clearing fee waiver, that is being amortized over a two year period, the net amount of which has been included in "Accounts Payable, Accrued Expenses and Other Liabilities" in the accompanying consolidated statements of financial condition as of March 31, 2007. The clearing agreement includes a termination fee if National Securities terminates the agreement without cause. Additionally, in June 2005, National Securities entered into a clearing agreement with Penson for the purpose of providing clearing services that are not provided by NFS. The Company believes that the overall effect of these clearing relationships is beneficial to the Company's cost structure, liquidity and capital resources.

In February 2007, the Company completed a financing transaction under which certain investors made an investment in the Company by purchasing 10% promissory notes in the principal amount of \$1.0 million, with warrants to purchase an aggregate of 250,000 shares of common stock at an exercise price of \$1.40 per share. The promissory notes mature in February 2009, and have a stated interest rate of 10% per annum. The fair value of the warrants was calculated using the Black-Scholes Option Valuation Model. The Company recorded a debt discount of approximately \$195,000 that will be charged to interest expense over the life of the debt.

The investment included \$500,000 by Christopher C. Dewey and \$250,000 by St. Cloud. Mr. Dewey, and Marshall S. Geller, the Co-Founder and Senior Managing Partner of St. Cloud, are each members of the Company's board of directors. The Company incurred legal fees and other costs related to this capital transaction in the amount of \$22,000 that were capitalized and will be amortized to interest expense over the life of the promissory notes. The Company used \$850,000 of the proceeds to pay in full promissory notes that had maturity dates in February 2007.

In February 2007, National Securities and the holder of a \$1.0 million secured demand note that was scheduled to mature on March 1, 2007, extended the term of the secured demand note to March 1, 2008.

In the quarter and six months ended March 31, 2007 the Company received proceeds of approximately \$14,000 and \$146,000, respectively, from the exercise of outstanding warrants and stock options.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company's primary market risk arises from the fact that it engages in proprietary trading and historically made dealer markets in equity securities. Accordingly, the Company may be required to maintain certain amounts of inventories in order to facilitate customer order flow. The Company may incur losses as a result of price movements in these inventories due to changes in interest rates, foreign exchange rates, equity prices and other political factors. The Company is not subject to direct market risk due to changes in foreign exchange rates. However, the Company is subject to market risk as a result of changes in interest rates and equity prices, which are affected by global economic conditions. The Company manages its exposure to market risk by limiting its net long or short positions. Trading and inventory accounts are monitored daily by management and the Company has instituted position limits.

Credit risk represents the amount of accounting loss the Company could incur if counterparties to its proprietary transactions fail to perform and the value of any collateral proves inadequate. Although credit risk relating to various financing activities is reduced by the industry practice of obtaining and maintaining collateral, the Company maintains more stringent requirements to further reduce its exposure. The Company monitors its exposure to counterparty risk on a daily basis by using credit exposure information and monitoring collateral values. The Company maintains a credit committee, which reviews margin requirements for large or concentrated accounts and sets higher requirements or requires a reduction of either the level of margin debt or investment in high-risk securities or, in some cases, requiring the transfer of the account to another broker-dealer.

The Company monitors its market and credit risks daily through internal control procedures designed to identify and evaluate the various risks to which the Company is exposed. There can be no assurance, however, that the Company's risk management procedures and internal controls will prevent losses from occurring as a result of such risks.

The following table shows the quoted market values of the Company's marketable securities owned ("long"), securities sold, but not yet purchased ("short") and net positions as of March 31, 2007:

|                        | Long       | Short      | Net        |
|------------------------|------------|------------|------------|
| Corporate stocks       | \$ 868,000 | \$ 176,000 | \$ 692,000 |
| Corporate bonds        | 6,000      | -          | 6,000      |
| Government obligations | 16,000     | -          | 16,000     |
|                        | \$ 890,000 | \$ 176,000 | \$ 714,000 |

**ITEM 4. CONTROLS AND PROCEDURES**

Evaluation of disclosure controls and procedures. Based on the evaluation of the Company's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) required by the Exchange Act Rules 13a-15(b) or 15d-15(b), the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities, particularly during the period in which this quarterly report on Form 10-Q was being prepared.

Changes in internal controls. There were no significant changes in the Company's internal controls or in other factors that could significantly affect those controls and procedures subsequent to the date of our evaluation nor any significant deficiencies or material weaknesses in such disclosure controls and procedures requiring corrective actions.

**PART II - OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

During the quarter ended March 31, 2007, there were no significant developments in the Company's legal proceedings. For a detailed discussion of the Company's legal proceedings, please refer to Note 6 herein, and the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

**ITEM 1A. RISK FACTORS**

There are no material changes from the risk factors previously disclosed in the Company's Form 10-K for the year ended September 30, 2006.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Previously reported in the Company's Current Report on Form 8-K filed with the SEC on February 23, 2007.

**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 shareholders on March 13, 2007. Proxies were solicited by the Company pursuant to Regulation 14A under the Exchange Act of 1934, as amended. At the annual meeting, the Company's shareholders approved the following proposals:

1. The number of shares voted "for" and "withhold authority" in connection with the election of Mark Goldwasser as a Class III Director to the Board of Directors of the Company was as follows:

|           | For       | Withhold<br>Authority |
|-----------|-----------|-----------------------|
| In Person | -         | -                     |
| By Proxy  | 6,597,649 | 8,833                 |
| Total     | 6,597,649 | 8,833                 |

The number of shares voted "for" and "withhold authority" in connection with the election of Gary A. Rosenberg as a Class III Director to the Board of Directors of the Company was as follows:

|           | For       | Withhold<br>Authority |
|-----------|-----------|-----------------------|
| In Person | -         | -                     |
| By Proxy  | 6,593,274 | 13,208                |
| Total     | 6,593,274 | 13,208                |

The terms of Marshall S. Geller and Christopher C. Dewey, Class I Directors, and Robert J. Rosan and Norman J. Kurlan, Class II Directors, continued after the annual meeting.

2. The number of shares voted “for”, “against” and “abstain” in connection with the ratification of Marcum & Kliegman LLP as the Company’s independent public accountants for the fiscal year ending September 30, 2007 was as follows:

|           | For       | Against | Abstain |
|-----------|-----------|---------|---------|
| In Person | -         | -       | -       |
| By Proxy  | 6,605,182 | 1,300   | -       |
| Total     | 6,605,182 | 1,300   | -       |

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

- 31.1 Chief Executive Officer’s Certificate pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Chief Financial Officer’s Certificate pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Chief Executive Officer’s Certificate pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Chief Financial Officer’s Certificate pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



**SIGNATURES**

Pursuant to the requirements 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.

**NATIONAL HOLDINGS CORPORATION AND SUBSIDIARY**

May 10, 2007

By: /s/ Mark Goldwasser

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Mark Goldwasser  
President and Chief Executive Officer

May 10, 2007

By: /s/ Robert H. Daskal

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Robert H. Daskal  
Chief Financial Officer