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KNIGHT TRADING GROUP INC

Form 10-Q

May 14, 2001

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SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2001

001-14223  
COMMISSION FILE NUMBER

Knight Trading 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)

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

At May 14, 2001 the number of shares outstanding of the registrant's Class A common stock was 123,718,730 and there were no shares outstanding of the registrant's Class B common stock.

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KNIGHT TRADING GROUP, INC.  
FORM 10-Q QUARTERLY REPORT  
For the Quarter Ended March 31, 2001

TABLE OF CONTENTS

Edgar Filing: KNIGHT TRADING GROUP INC - Form 10-Q

	Page
	----
PART I FINANCIAL INFORMATION:	
Item 1. Financial Statements.....	3
Consolidated Statements of Income.....	3
Consolidated Statements of Financial Condition.....	4
Consolidated Statements of Cash Flows.....	5
Notes to Consolidated Financial Statements.....	6
Management's Discussion and Analysis of Financial Condition and	
Item 2. Results of Operations.....	11
Item 3. Quantitative and Qualitative Disclosures About Market Risk.....	17
PART II OTHER INFORMATION:	
Item 1. Legal Proceedings.....	18
Item 2. Changes in Securities and Use of Proceeds.....	18
Item 3. Defaults Upon Senior Securities.....	18
Item 4. Submission of Matters to a Vote of Security Holders.....	19
Item 5. Other Information.....	19
Item 6. Exhibits and Reports on Form 8-K.....	19
Signatures.....	19

2

KNIGHT TRADING GROUP, INC.

Consolidated Statements of Income  
(Unaudited)

	For the three months ended March 31,	
	2001	2000
	-----	-----
Revenues		
Net trading revenue.....	\$187,454,445	\$486,778,104
Commissions and fees.....	14,512,201	7,027,629
Asset management fees.....	12,720,036	9,773,589
Interest and dividends, net of interest expense..	5,309,313	3,507,417
Investment income and other.....	5,651,129	3,512,299
	-----	-----
Total revenues.....	225,647,124	510,599,038
	-----	-----
Expenses		
Employee compensation and benefits.....	79,695,673	175,198,790
Payments for order flow.....	29,718,426	59,317,560
Execution and clearance fees.....	30,049,055	30,222,288
Communications and data processing.....	12,831,389	7,125,993
Depreciation and amortization.....	10,222,579	4,214,963
Professional fees.....	5,654,011	4,532,062
Occupancy and equipment rentals.....	5,010,858	3,093,186
Business development.....	3,369,758	5,238,693
Other.....	5,942,719	4,605,761
	-----	-----
Total expenses.....	182,494,468	293,549,296

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Income before income taxes and minority interest...	43,152,656	217,049,742
Income tax expense.....	17,982,130	80,454,361
Income before minority interest.....	25,170,526	136,595,381
Minority interest in consolidated subsidiaries.....	1,746,937	--
Net income.....	\$ 26,917,463	\$136,595,381
Basic earnings per share.....	\$ 0.22	\$ 1.12
Diluted earnings per share.....	\$ 0.21	\$ 1.08
Pro forma adjustments		
Income before income taxes.....		\$217,049,742
Adjustment for pro forma employee compensation and benefits.....		(267,109)
Pro forma income before income taxes.....		216,782,633
Pro forma income tax expense.....		81,050,811
Pro forma net income.....		135,731,822
Pro forma basic earnings per share.....		\$ 1.11
Pro forma diluted earnings per share.....		\$ 1.07
Shares used in basic earnings per share calculations (see Note 8).....	123,517,121	122,146,982
Shares used in diluted earnings per share calculations (see Note 8).....	126,179,906	126,981,962

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

3

KNIGHT TRADING GROUP, INC.

Consolidated Statements of Financial Condition  
(Unaudited)

	March 31, 2001	December 31, 2000
	-----	-----
<b>Assets</b>		
Cash and cash equivalents.....	\$ 374,848,966	\$ 364,057,534
Securities owned, held at clearing broker, at market value.....	1,517,954,276	1,799,966,679
Receivable from brokers and dealers.....	658,361,210	114,047,275
Fixed assets and leasehold improvements at cost, less accumulated depreciation and amortization.....	86,819,156	79,014,393
Goodwill, less accumulated amortization.....	43,194,198	45,239,177
Investments.....	83,253,424	64,917,975

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Other assets.....	54,824,311	54,166,139
	-----	-----
Total assets.....	\$2,819,255,541	\$2,521,409,172
	=====	=====
Liabilities and Stockholders' Equity		
Liabilities		
Securities sold, not yet purchased, at market value.....	\$1,745,436,253	\$1,427,214,323
Payable to brokers and dealers.....	134,333,130	184,269,478
Accrued compensation expense.....	41,693,199	62,444,645
Accrued execution and clearance fees.....	5,040,626	6,092,754
Accrued payments for order flow.....	5,981,101	11,635,069
Accounts payable, accrued expenses and other liabilities.....	22,827,010	30,576,814
Income taxes payable.....	17,563,405	4,813,771
	-----	-----
Total liabilities.....	1,972,874,724	1,727,046,854
	-----	-----
Minority interest in consolidated subsidiaries.....	27,094,662	20,175,872
	-----	-----
Stockholders' equity		
Class A Common Stock.....	1,236,505	1,232,908
Additional paid-in capital.....	331,163,026	309,611,248
Retained earnings.....	492,864,757	465,947,294
Accumulated other comprehensive income (loss)--foreign currency translation adjustments, net of tax.....	(5,978,133)	(2,605,004)
	-----	-----
Total stockholders' equity.....	819,286,155	774,186,446
	-----	-----
Total liabilities and stockholders' equity.....	\$2,819,255,541	\$2,521,409,172
	=====	=====

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

4

KNIGHT TRADING GROUP, INC.

Consolidated Statements of Cash Flows  
(Unaudited)

	For the three months ended March 31,	
	2001	2000
	-----	-----
Cash flows from operating activities		
Net income.....	\$ 26,917,463	\$ 136,595,381
Adjustments to reconcile net income to net cash provided by operating activities		
Income tax credit from stock options		

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exercised.....	1,976,947	--
Depreciation and amortization.....	10,222,579	4,214,963
Minority interest in earnings of consolidated subsidiaries.....	(1,746,937)	--
(Increase) decrease in operating assets		
Securities owned.....	282,012,403	(169,320,546)
Receivable from clearing brokers.....	(544,313,935)	(20,372,710)
Other assets.....	(658,172)	(5,163,400)
Increase (decrease) in operating liabilities		
Securities sold, not yet purchased.....	318,221,930	171,345,782
Securities sold under agreements to repurchase.....	--	(131,639)
Payable to clearing broker.....	(49,936,348)	(33,819,013)
Accrued compensation expense.....	(20,751,446)	42,455,742
Accounts payable, accrued expenses and other liabilities.....	(11,122,932)	(32,406,614)
Accrued execution and clearance fees.....	(1,052,128)	(1,157,790)
Accrued payments for order flow.....	(5,653,968)	4,295,298
Income taxes payable.....	12,749,634	63,551,880
	-----	-----
Net cash provided by operating activities...	16,865,090	160,087,334
	-----	-----
Cash flows from investing activities		
Purchases of fixed assets and leasehold improvements.....	(15,987,043)	(14,086,080)
Investments and acquisitions.....	(18,335,449)	2,832,705
Payment of contingent consideration.....	--	(3,764,257)
	-----	-----
Net cash used in investing activities.....	(34,322,492)	(15,017,632)
	-----	-----
Cash flows from financing activities		
Stock options exercised.....	2,495,450	255,997
Minority interest in consolidated subsidiaries..	25,753,384	--
	-----	-----
Net cash provided by financing activities...	28,248,834	255,997
	-----	-----
Increase in cash and cash equivalents.....	10,791,432	145,325,699
Cash and cash equivalents at beginning of period.....	364,057,534	304,053,554
	-----	-----
Cash and cash equivalents at end of period.....	\$ 374,848,966	\$ 449,379,253
	=====	=====
Supplemental disclosure of cash flow information:		
Cash paid for interest.....	\$ 8,057,835	\$ 5,122,211
	=====	=====
Cash paid for income taxes.....	\$ 5,232,496	\$ 18,101,279
	=====	=====

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

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### 1. Organization and Description of the Business

Knight Trading Group, Inc. (the "Company") and its subsidiaries operate in securities market-making and asset management business lines. Knight Securities ("KS") operates as a market maker in over-the-counter equity securities ("OTC securities"), primarily those traded in the Nasdaq stock market and on the OTC Bulletin Board. Knight Capital Markets ("KCM," formerly known as Trimark Securities) operates as a market maker in the over-the-counter market for New York Stock Exchange (NYSE)-and American Stock Exchange (AMEX)-listed securities. Knight Financial Products ("KFP") makes markets in options on individual equities, equity indices and fixed income instruments in the U.S. and in Europe. The Company also maintains an asset management business for institutional investors and high net worth individuals through its Deephaven Capital Management ("Deephaven") subsidiary. The Company also operates a professional execution services business through Knight Execution Partners ("KEP"). KS, KCM, KFP and KEP are registered as broker-dealers with the Securities and Exchange Commission ("SEC" or the "Commission"). Additionally, KS and KCM are members of the National Association of Securities Dealers, Inc. ("NASD").

In the first quarter of 2001, the Company began its Knight Roundtable Europe venture with 19 broker-dealers and banks from Europe and the United States that own an approximate 15% minority interest in the venture. The venture owns and operates Knight Securities International, Ltd. ("KSIL"), which provides best execution solutions for European investors in European and U.S. equities. In the third quarter of 2000 the Company established a joint venture operation, called Knight Securities Japan ("KSJ"), with Nikko Securities Co., Ltd. to provide wholesale market-making services in Japanese equity securities.

### 2. Significant Accounting Policies

#### Basis of consolidation and form of presentation

The accompanying consolidated financial statements include the accounts of the Company and its majority and wholly-owned subsidiaries and, in the opinion of management, reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim period. All significant intercompany transactions and balances have been eliminated. Certain footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to SEC rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. The nature of the Company's business is such that the results of an interim period are not necessarily indicative of the results for the full year. These consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000 as filed with the SEC.

#### Cash equivalents

Cash equivalents represent money market accounts, which are payable on demand, or short-term investments with an original maturity of less than 30 days. The carrying amount of such cash equivalents approximates their fair value due to the short-term nature of these instruments.

#### Investments

Investments on the Consolidated Statements of Financial Condition comprise ownership interests of less than 20% in publicly and non-publicly traded companies which are accounted for under the equity method or

the cost basis of accounting. Investments also include the Company's investments in private investment funds for which the Company is the investment manager and sponsor.

#### Market-making activities

Securities owned and securities sold, not yet purchased, which primarily consist of listed and OTC stocks, listed options contracts and futures contracts, are carried at market value and are recorded on a trade date basis. Net trading revenue (trading gains, net of trading losses) and commissions and related expenses, including compensation and benefits, execution and clearance fees and payments for order flow, are also recorded on a trade date basis. Payments for order flow represent payments to other broker-dealers for directing their order executions to the Company. The Company records interest income net of transaction-related interest charged by clearing brokers for facilitating the settlement and financing of securities transactions. Interest expense for the three months ended March 31, 2001 and 2000 was \$7,777,226 and \$5,162,123, respectively.

#### Asset management fees

The Company earns asset management fees for sponsoring and managing the investments of certain private investment funds. Such fees are recorded when earned and are calculated as a percentage of the fund's quarterly net assets, plus a percentage of a new high net asset value, as defined, for any six-month period ended June 30th or December 31st. A new high net asset value is generally defined as the amount by which the net asset value of the fund exceeds the greater of either the highest previous net asset value in the fund, or the net asset value at the time each investor made their purchase.

#### Securities borrowed/loaned

Securities borrowed and securities loaned, which are included in receivable from and payable to clearing brokers, are recorded at the amount of cash collateral advanced or received. Securities borrowed transactions require the Company to deposit cash or similar collateral with the lender. With respect to securities loaned, the Company receives collateral in the form of cash in an amount generally in excess of the market value of securities loaned. Interest income and interest expense are recorded on an accrual basis. The Company monitors the market value of securities borrowed and loaned on a daily basis. Substantially all of the Company's securities borrowed and securities loaned transactions are conducted with banks and other securities firms.

#### Foreign currencies

The functional currency of the Company's consolidated foreign subsidiaries are the U.S. dollar, the British Pound and the Japanese Yen. Assets and liabilities in foreign currencies are translated into U.S. dollars using current exchange rates at the date of the Consolidated Statements of Financial Condition. Revenues and expenses are translated at average rates during the periods. The foreign exchange gains and losses resulting from these translations are included as a separate component of stockholders' equity in the Consolidated Statements of Financial Condition.

#### Depreciation, amortization and occupancy

Fixed assets are being depreciated on a straight-line basis over their estimated useful lives of three to seven years. Leasehold improvements are

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being amortized on a straight-line basis over the life of the related office lease. The Company records rent expense on a straight-line basis over the life of the lease. The Company capitalizes certain costs associated with the acquisition or development of internal-use software in accordance with Statement of Position No. 98-1 and amortizes the software over its estimated useful life of three years.

7

### Income taxes

Income tax expense in the Consolidated Statements of Income represents actual income taxes incurred through March 31, 2001. Before the Company's merger with KFP ("the Merger"), which was completed on January 12, 2000, KFP was a limited liability company which was treated as a partnership for tax purposes and its federal and state income taxes were borne by KFP's individual partners. As such, KFP's historical financial statements only include a provision for non U.S. income taxes. Subsequent to the Merger, KFP's income is subject to federal and state income taxes. Pro forma income tax expense reflects income taxes as if the Company was subject to federal and state income taxes on KFP's income prior to the Merger.

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 are measured using the enacted tax rates and laws that will be in effect when such differences are expected to reverse.

### Estimated fair value of financial instruments

The Company's securities owned and securities sold, not yet purchased are carried at market value. Management estimates that the fair values of other financial instruments recognized on the Consolidated Statements of Financial Condition (including receivables, payables and accrued expenses) approximate their carrying values, as such financial instruments are short-term in nature, bear interest at current market rates or are subject to frequent repricing.

### Minority interest

Minority interest represents minority owners' share of net income and equity in two of the Company's consolidated subsidiaries, KSIL and KSJ.

### Accounting for derivatives

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. This statement established accounting and reporting standards for derivative instruments, including certain derivative instruments imbedded in other contracts, and for hedging activities. In June 1999, the FASB issued SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities--Deferral of the Effective Date of FASB Statement No. 133--an amendment of FASB Statement No. 133. In June 2000, the FASB issued SFAS No. 138 Accounting for Certain Derivative Instruments and Certain Hedging Activities, which is an amendment to SFAS No. 133 and is effective concurrently with SFAS No. 137. The Company adopted the provisions of SFAS No. 133, 137 and 138 as of January 1, 2001. The Company's derivative financial instruments are all held for trading purposes and historically have been carried at fair value. As such the adoption of these statements did not have a material impact on the Company's financial statements.

### Other



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The preparation of financial statements in conformity with generally accepted accounting principles 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 could differ from those estimates.

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

8

### 3. Securities Owned and Securities Sold, Not Yet Purchased

Securities owned and securities sold, not yet purchased consist of the following:

	March 31, 2001	December 31, 2000
	-----	-----
Securities owned:		
Equities.....	\$ 426,864,278	\$ 661,327,729
Options.....	1,078,764,887	1,126,483,498
U.S. government obligations.....	12,325,111	12,155,452
	-----	-----
	\$1,517,954,276	\$1,799,966,679
	=====	=====
Securities sold, not yet purchased:		
Equities.....	\$ 507,660,726	\$ 170,167,713
Options.....	1,237,775,527	1,257,046,610
	-----	-----
	\$1,745,436,253	\$1,427,214,323
	=====	=====

### 4. Receivable from/Payable to Brokers and Dealers

Amounts receivable from and payable to brokers and dealers consist of the following:

	March 31, 2001	December 31, 2000
	-----	-----
Receivable:		
Clearing brokers.....	\$ 622,198,654	\$ 86,156,298
Securities failed to deliver.....	21,369,812	19,815,796
Securities borrowed.....	14,792,744	8,075,181
	-----	-----
	\$ 658,361,210	\$ 114,047,275
	=====	=====
Payable:		
Clearing brokers.....	\$ 123,973,583	\$ 175,552,245
Securities failed to receive.....	9,770,033	8,574,981
Securities loaned.....	589,514	142,252
	-----	-----
	\$ 134,333,130	\$ 184,269,478

=====

The Company has received and pledged collateral approximately equal to the amounts borrowed and loaned, respectively.

5. Investments

The Company's wholly-owned subsidiary, Deephaven, is the investment manager and sponsor of private investment funds that engage in various trading strategies involving equities, debt instruments and derivatives. The Company owns interests in these private investment funds. Such investments amounted to approximately \$33.1 million at March 31, 2001. Certain officers of the Company also own interests in these private investment funds. Additionally, the Company has made strategic investments in the National Association of Securities Dealers, Inc., Nasdaq Europe (formerly known as Easdaq), Netfolio, Inc. and other public and private companies.

9

6. Significant Customers

The Company considers significant customers to be customers who provide the Company with 10% or more of its order flow, as measured in share volume, during the period. For the three months ended March 31, 2001, the Company had no significant customers.

7. 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:

	Three months ended March 31,	
	2001	2000
	-----	-----
Net income/pro forma net income.....	\$ 26,917,463	\$ 135,731,822
Foreign currency translation adjustment, net of tax...	(3,373,129)	(63,374)
	-----	-----
Total comprehensive income, net of tax.....	\$ 23,544,334	\$ 135,668,448
	=====	=====

8. Earnings per Share

Basic and diluted earnings per common share have been calculated by dividing net income by the sum of the weighted average shares of Class A Common Stock outstanding during each respective period.

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the three months ended March 31, 2001 and 2000:

For the three months ended March 31,

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	2001		2000	
	Numerator/ net income	Denominator/ shares	Numerator/ pro forma net income	Denominator/ pro forma shares
Income and shares used in basic calculations.....	\$26,917,463	123,517,121	\$135,731,822	122,146,982
Effect of dilutive stock options.....	--	2,662,785	--	4,834,980
Income and shares used in diluted calculations.....	\$26,917,463	126,179,906	\$135,731,822	126,981,962
Basic earnings per share.....		\$ 0.22		\$ 1.11
Diluted earnings per share.....		\$ 0.21		\$ 1.07

9. Net Capital Requirements

As registered broker-dealers, KS, KCM, KFP and KEP are subject to the SEC's Uniform Net Capital Rule (the "Rule") which requires the maintenance of minimum net capital. KS, KCM and KEP have elected to use the basic method, permitted by the Rule, which requires that they each maintain net capital equal to the greater of \$1.0 million (\$100,000 for KEP) or 6 2/3% of aggregate indebtedness, as defined. KFP has elected to use the alternative method, permitted by the Rule, which requires that it maintains net capital equal to the greater of \$250,000 or 2% of aggregate debit items, as defined.

At March 31, 2001, KS had net capital of \$277,218,655 which was \$274,732,205 in excess of its required net capital of \$2,486,450, KCM had net capital of \$45,892,193 which was \$44,861,771 in excess of its required net capital of \$1,030,422, KFP had net capital of \$35,097,162 which was \$34,847,162 in excess of its required net capital of \$250,000, and KEP had net capital of \$7,566,636 which was \$7,422,745 in excess of its required net capital of \$143,891.

10

Additionally, KSIL and KSJ are subject to regulatory requirements in the countries in which they operate, including the requirements of the Securities and Futures Authority Limited in the United Kingdom and the Financial Supervisory Agency in Japan. As of March 31, 2001, the Company was in compliance with these capital adequacy requirements.

10. Business Segments

The Company has two reportable business segments: securities market-making and asset management. Securities market-making primarily represents market-making in equity securities listed on Nasdaq, on the OTCBB of the NASD, in the over-the-counter market for NYSE- and AMEX-listed securities and in options on individual equities, equity indices, fixed income instruments and certain commodities. The asset management segment consists of investment management and sponsorship for a series of private investment funds.

The Company's net revenues, income before income taxes and minority interest

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and assets by segment are summarized below:

	Securities Market Making	Asset Management	Total
For the three months ended March 31, 2001:			
Revenues.....	\$ 211,014,792	\$14,632,332	\$ 225,647,124
Income before income taxes and minority interest.....	34,267,125	8,885,531	43,152,656
Total Assets.....	2,770,211,058	49,044,483	2,819,255,541
For the three months ended March 31, 2000:			
Revenues.....	499,279,490	11,319,548	510,599,038
Pro forma income before income taxes.....	207,875,207	8,907,426	216,782,633
Total Assets.....	1,862,915,235	28,355,590	1,891,270,825

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

The following discussion of our results of operations should be read in conjunction with our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2000. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth elsewhere in this document.

We have experienced and expect to continue to experience, significant fluctuations in quarterly operating results due to a variety of factors, including the value of our securities positions and our ability to manage the risks attendant thereto, the volume of our market-making activities, volatility in the securities markets, our ability to manage personnel and expenses, the amount of revenue derived from limit orders as a percentage of net trading revenues, changes in payments for order flow or clearing costs, the addition or loss of sales and trading professionals, regulatory changes, the amount and timing of capital expenditures, the incurrence of costs associated with acquisitions and general market conditions. If demand for our market-making services and asset management declines and we are unable to adjust our cost structure on a timely basis, our operating results could be materially and adversely affected. We have experienced, and may experience in the future, significant seasonality in our business.

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

#### Overview

We are the leading market maker in equity securities listed on Nasdaq, the

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OTCBB of the NASD, and the over-the-counter market for New York Stock Exchange (NYSE) and American Stock Exchange (AMEX)--listed securities. Additionally, we make markets in equity securities in Europe and Japan. We are also a leading market maker in options on individual equities, equity indices and fixed income instruments in the U.S. and Europe. The firm also maintains an asset management business for institutional investors and high net worth individuals through our Deephaven subsidiary.

KS's share volume totaled 21.4 billion and 37.9 billion, or 81% and 86% of our total equity market-making share volume, for the three months ended March 31, 2001 and 2000, respectively. KCM's share volume totaled 6.0 billion and 5.1 billion, or 19% and 14% of our total equity market-making share volume for the three months ended March 31, 2001 and 2000, respectively. KFP's U.S. option contract volume amounted to 8.5 million and 3.5 million contracts for the three months ended March 31, 2001 and 2000, respectively.

### Revenues

Our revenues consist principally of net trading revenue from U.S. securities market-making activities. Net trading revenue, which represents trading gains net of trading losses, is primarily affected by changes in equity trade and share volumes and option contract volumes, our revenue capture per share and option contract, our ability to derive trading gains by taking proprietary positions, changes in our execution standards, volatility in the marketplace, our mix of broker-dealer and institutional customers and by regulatory changes and evolving industry customs and practices. Our net trading revenue per trade for OTC securities has historically exceeded the net trading revenue per trade for listed securities.

We continue to focus on increasing our institutional business. OTC securities transactions with institutional customers are executed as principal, and all related profits and losses are included within net trading revenue. Listed securities transactions with institutional customers are executed on an agency basis, for which we earn commissions on a per share basis. We also receive fees for providing certain information to market data providers and for directing trades to certain destinations for execution. Commissions and fees are primarily affected by changes in our trade and share volumes in listed securities.

Asset management fees represent fees earned for sponsoring and managing the investments of private investment funds. Asset management fees are primarily affected by the rates of return earned on the funds we manage and changes in the amounts of assets under management.

We earn interest income from our cash held at banks and cash held in trading accounts at clearing brokers, net of transaction-related interest charged by clearing brokers for facilitating the settlement and financing of securities transactions. Net interest is primarily affected by the changes in cash balances held at banks and clearing brokers and our level of securities positions.

### Expenses

Our operating expenses largely consist of employee compensation and benefits, payments for order flow and execution and clearance fees. A substantial portion of these expenses vary in proportion to our trading revenue. Employee compensation and benefits expense, which is largely profitability based, fluctuates, for the most part, based on changes in net trading revenue, our profitability and our number of employees. Payments for order flow fluctuate based on equity share and options volume, the mix of market orders and limit orders and the mix of orders received from broker-dealers who accept payments for order flow. Execution and clearance fees

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fluctuate primarily based on changes in equity trade and share volume, option contract volume, the mix of trades of OTC securities compared to listed securities, clearance fees charged by clearing brokers and electronic communications networks, commonly referred to as ECNs. Our international expansion efforts have increased our operating expenses.

12

Employee compensation and benefits expense primarily consists of salaries and wages paid to administrative and customer service personnel and profitability based compensation, which includes compensation and benefits paid to market-making and sales personnel based on their individual performance, and incentive compensation paid to all other employees based on our overall profitability. Approximately 60% of our employees are directly involved in market-making, sales or customer service activities. Compensation for employees engaged in market-making and sales activities, the largest component of employee compensation and benefits, is determined primarily based on a percentage of gross trading profits net of expenses including payments for order flow, execution and clearance costs and overhead allocations. Employee compensation and benefits will, therefore, be affected by changes in payments for order flow, execution and clearance costs and the costs we allocate to employees engaged in market-making and sales activities.

Payments for order flow represent customary payments to broker-dealers, in the normal course of business, for directing their order flow in equity securities and options to us. We only pay broker-dealers for orders that provide us with a profit opportunity. For example, we make payments on market orders, but do not pay on limit orders. Payments for order flow also change as we modify our payment formulas and as our percentage of customers whose policy is not to accept payments for order flow varies.

Execution and clearance fees primarily represent clearance fees paid to clearing brokers for OTC and listed securities and options contracts, transaction fees paid to Nasdaq, payments made to third parties for exchange seat leases and execution fees paid to third parties, primarily for executing trades in listed securities on the NYSE and AMEX and for executing orders through ECNs. Due to our significant equity share and trade volume, we have been able to negotiate favorable rates and volume discounts from clearing brokers and providers of execution services. As a result of these lower rates and discounts and the increase in equity trade volume of OTC securities as a percentage of total trade volume, execution and clearance fees per trade have decreased.

Communications and data processing expense primarily consists of costs for obtaining stock market data and telecommunications services.

Depreciation and amortization expense results from the depreciation of fixed assets purchased by us and the amortization of goodwill, which includes contingent consideration resulting from the acquisitions of the listed securities market-making businesses of KCM and Tradetech Securities, L.P., ("Tradetech"). Depreciation and amortization expense also includes the amortization of goodwill related to our purchases of various options-related businesses.

Professional fees primarily consist of fees paid to computer programming and systems consultants, as well as legal fees and other professional fees.

Occupancy and equipment rentals expense primarily consists of rental payments on office and equipment leases.

Business development expense primarily consists of advertising costs and

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marketing expenses, including travel and entertainment expenses and promotion costs.

Other expenses primarily consist of administrative expenses and other operating costs.

### Income Tax

Income tax expense in the Consolidated Statements of Income represents actual income taxes incurred through March 31, 2001 and 2000, respectively. Before the Merger, KFP was a limited liability company which was treated as a partnership for tax purposes and its U.S. federal and state income taxes were borne by KFP's individual partners. As such, KFP's historical financial statements only include a provision for non-U.S. income taxes. Subsequent to the Merger on January 12, 2000, KFP's income is subject to federal income taxes and

13

state income taxes. Pro forma income tax expense reflects income taxes as if the Company was subject to federal and state income taxes on KFP's income prior to the Merger.

### Results of Operations

Three Months Ended March 31, 2001 and 2000

#### Revenues

Net trading revenue from equity security market-making decreased 67.8% to \$145.9 million for the three months ended March 31, 2001, from \$453.7 million for the comparable period in 2000. This decrease was primarily due to lower equity share volume and decreased average revenue per equity share. Total equity share volume decreased 39.6% to 26.5 billion equity shares for the three months ended March 31, 2001, from 43.8 billion equity shares for the comparable period in 2000, while average revenue per equity share decreased to \$.0055 per share from \$.0104 during the same period in 2000. Net trading revenue from options market-making increased 25.8% to \$41.6 million for the three months ended March 31, 2001, from \$33.0 million for the comparable period in 2000. This increase is primarily due to higher U.S. option contract volume, offset by lower average revenue per option contract. Total U.S. option contract volume increased 139.6% to 8.5 million contracts for the three months ended March 31, 2001, from 3.5 million contracts for the comparable period in 2000, while average revenue per U.S. option contract decreased to \$4.92 per contract for the three months ended March 31, 2001, from \$9.37 per contract during the same period in 2000.

Commissions and fees increased 106.5% to \$14.5 million for the three months ended March 31, 2001, from \$7.0 million for the comparable period in 2000. This increase is primarily due to payments received by our professional execution services business, KEP, for directing order executions, as well as higher equity share volumes from institutional customers in listed securities and higher fees for providing certain information to market data providers.

Asset management fees increased 30.1% to \$12.7 million for the three months ended March 31, 2001, from \$9.8 million for the comparable period in 2000. The increase in fees was primarily due to an increase in the amount of funds under management in the Deephaven Market Neutral Master Fund, which contained the majority of our funds under management, from \$374 million at March 31, 2000 to \$899 million at March 31, 2001. The increase was partially offset by the decrease in fund return from 9.05% for the first quarter of 2000 to 5.11% for

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the first quarter of 2001.

Interest income, net of interest expense, increased 51.4% to \$5.3 million for the three months ended March 31, 2001, from \$3.5 million for the comparable period in 2000. This increase was primarily due to larger cash balances held at our clearing brokers.

Investment income and other income increased 60.9% to \$5.7 million for the three months ended March 31, 2001, from \$3.5 million for the comparable period in 2000. This increase was primarily due to an increase in income from our investments, primarily our investments in the private hedge funds that we sponsor and manage.

### Expenses

Employee compensation and benefits expense decreased 54.6% to \$79.7 million for the three months ended March 31, 2001, from \$175.5 million for the comparable pro forma period in 2000. As a percentage of total revenue, employee compensation and benefits expense increased to 35.3% for the three months ended March 31, 2001, from 34.4% for the comparable pro forma period in 2000. The decrease on a dollar basis was primarily due to decreased gross trading profits and lower margins, offset, in part, by a growth in the number of employees. The increase on a percentage basis was primarily due to a growth in our number of employees and the decrease in average net revenue per equity share. Due to decreased net trading revenue and profitability,

14

profitability based compensation decreased 68.9% to \$48.3 million for the three months ended March 31, 2001, from \$155.6 million for the comparable pro forma period in 2000, and represented 60.6% and 88.7% of total employee compensation and benefits expense for the three months ended March 31, 2001 and 2000, respectively. Our number of employees increased to 1,389 employees as of March 31, 2001, from 925 employees as of March 31, 2000.

Payments for order flow decreased 49.9% to \$29.7 million for the three months ended March 31, 2001, from \$59.3 million for the comparable period in 2000. As a percentage of total revenue, payments for order flow increased to 13.2% for the three months ended March 31, 2001 from 11.6% for the comparable period in 2000. The decrease in payments for order flow on a dollar basis was primarily due to a 39.6% decrease in equity shares traded for the three months ended March 31, 2001 to 26.5 billion shares, down from 43.8 billion for the comparable period in 2000. The increase in payments for order flow as a percentage of total revenue was primarily due to a decrease in our average revenue per equity share and the introduction of payment for order flow in the options marketplace in the third quarter of 2000.

Execution and clearance fees decreased 0.6% to \$30.0 million for the three months ended March 31, 2001, from \$30.2 million for the comparable period in 2000. As a percentage of revenue, execution and clearance fees increased to 13.3% for the three months ended March 31, 2001 from 5.9% for the comparable period in 2000. Despite the 31.5% decrease in equity trades executed to 30.2 million equity trades for the three months ended March 31, 2001 from 44.1 million equity trades for the comparable period in 2000, execution and clearance fees remained relatively constant due to an offsetting 139.6% increase in U.S. options contracts executed from 3.5 million U.S. options contracts executed for the three months ended March 31, 2000 to 8.5 million for the three months ended March 31, 2001. The increase in our execution and clearance fees as a percentage of net trading revenue was primarily due to a decrease in average revenue per equity trade and an increase in options volume.



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Communications and data processing expense increased 80.1% to \$12.8 million for the three months ended March 31, 2001, from \$7.1 million for the comparable period in 2000. This increase was generally attributable to an increase in our number of employees and our international expansion in Europe and Japan.

Depreciation and amortization expense increased 142.5% to \$10.2 million for the three months ended March 31, 2001, from \$4.2 million for the comparable period in 2000. This increase was primarily due to the purchase of approximately \$72.9 million of additional fixed assets and leasehold improvements between March 31, 2000 and March 31, 2001 and the amortization of goodwill related to our acquisitions of the listed securities market-making businesses of KCM and Tradetech and various options specialist businesses.

Professional fees increased 24.8% to \$5.7 million for the three months ended March 31, 2001, up from \$4.5 million for the comparable period in 2000. This increase was primarily due to increased consulting expenses related to our investments in technology, our European and Japanese expansion efforts as well as legal and other professional fees.

Occupancy and equipment rentals expense increased 62.0% to \$5.0 million for the three months ended March 31, 2001, from \$3.1 million for the comparable period in 2000. This increase was primarily attributable to additional office space and increased computer equipment lease expense. We occupied 277,812 square feet of office space at March 31, 2001, up from 161,909 square feet of office space at March 31, 2000.

Business development expense decreased to \$3.4 million for the three months ended March 31, 2001, from \$5.2 million for the comparable period in 2000. This decrease was primarily the result of decreased advertising costs in the first quarter of 2001 from the first quarter of 2000.

Other expenses increased 29.0% to \$5.9 million for the three months ended March 31, 2001, from \$4.6 million for the comparable period in 2000. This was primarily the result of increased administrative expenses and other operating costs in connection with our overall business growth.

15

Our effective and pro forma effective tax rates for the three months ended March 31, 2001 and 2000 differ from the federal statutory rate of 35% due to state income taxes, as well as nondeductible expenses, including the amortization of goodwill resulting from the acquisition of KCM and a portion of business development expenses. Our effective tax rate increased to 42% for the three months ended March 31, 2001 from 37% for the three months ended March 31, 2000 primarily due to non-deductible foreign losses and state and local income taxes.

### Recently Issued Accounting Standards

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. This statement established accounting and reporting standards for derivative instruments, including certain derivative instruments imbedded in other contracts, and for hedging activities. In June 1999, the FASB issued SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities--Deferral of the Effective Date of FASB Statement No. 133--an amendment of FASB Statement No. 133. In June 2000, the FASB issued SFAS No. 138 Accounting for Certain Derivative Instruments and Certain Hedging Activities, which is an amendment to SFAS No. 133 and is effective concurrently with SFAS No. 137. We adopted the provisions of SFAS No. 133, 137 and 138 as of January 1, 2001. The adoption of these statements did

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not have a material impact on our financial statements.

In September 2000, the FASB issued SFAS No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities--a replacement of FASB Statement No. 125. This statement resets accounting standards for differentiating between securitizations and other transfers of financial assets that are sales from transfers that are secured borrowings. We adopted certain provisions of SFAS No. 140 as of December 31, 2000 which did not have a material impact on our financial statements. We anticipate adopting the remaining provisions of SFAS No. 140 effective April 1, 2001 and do not believe that the adoption of these remaining provisions will have a material impact on our financial statements.

### Liquidity and Capital Resources

Historically, we have financed our business primarily through cash generated by operations, as well as the proceeds from our stock offerings, the private placement of preferred and common units and borrowings under subordinated notes. As of March 31, 2001, we had \$2.8 billion in assets, 90.5% of which consisted of cash or assets readily convertible into cash, principally receivables from clearing brokers and securities owned. Receivables from clearing brokers include interest bearing cash balances held with clearing brokers, including, or net of, amounts related to securities transactions that have not yet reached their contracted settlement date, which is generally within three business days of the trade date. Securities owned principally consist of equity securities that trade in Nasdaq and on the NYSE and AMEX markets and listed options contracts that trade on national exchanges.

Net income and pro forma net income plus depreciation and amortization was \$37.1 million and \$139.9 million during the three months ended March 31, 2001 and 2000, respectively. Depreciation and amortization expense, which related to fixed assets and goodwill, was \$10.2 million and \$4.2 million during the three months ended March 31, 2001 and 2000, respectively. Capital expenditures were \$16.0 million and \$14.1 million for the three months ended March 31, 2001 and 2000, respectively, primarily related to the purchase of data processing and communications equipment, as well as leasehold improvements and additional office facilities to support our growth. In acquiring fixed assets, particularly technology equipment, we make a decision about whether to lease such equipment or purchase it outright based on a number of factors including its estimated useful life, obsolescence and cost. Additionally, we made cash payments of \$3.8 million for the three months ended March 31, 2000 in connection with our acquisitions of the listed securities market-making businesses of KCM in 1995 and Tradetech in 1997. These arrangements ended during 2000. We anticipate that we will meet our 2001 capital expenditure needs out of operating cash flows.

16

As registered broker-dealers and market makers, KS, KCM, KFP and KEP are subject to regulatory requirements intended to ensure the general financial soundness and liquidity of broker-dealers and requiring the maintenance of minimum levels of net capital, as defined in SEC Rule 15c3-1. These regulations also prohibit a broker-dealer from repaying subordinated borrowings, paying cash dividends, making loans to its parent, affiliates or employees, or otherwise entering into transactions which would result in a reduction of its total net capital to less than 120.0% of its required minimum capital. Moreover, broker-dealers, including KS, KCM, KFP and KEP, are required to notify the SEC prior to repaying subordinated borrowings, paying dividends and making loans to their parents, affiliates or employees, or otherwise entering into transactions, which, if executed, would result in a reduction of 30.0% or more of their excess net capital (net capital less minimum requirement). The

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SEC has the ability to prohibit or restrict such transactions if the result is detrimental to the financial integrity of the broker-dealer. At March 31, 2001, KS had net capital of \$277.2 million, which was \$274.7 million in excess of its required net capital of \$2.5 million, KCM had net capital of \$45.9 million which was \$44.9 million in excess of its required net capital of \$1.0 million, KFP had net capital of \$35.1 million, which was \$34.8 million in excess of its required net capital of \$250,000 and KEP had net capital of \$7.6 million, which was \$7.4 million in excess of its required net capital of \$143,891. Additionally, KSIL and KSJ are subject to capital adequacy requirements of the Securities and Futures Authority Limited in the United Kingdom and the Financial Supervisory Agency in Japan, respectively. As of March 31, 2001, we were in compliance with the capital adequacy requirements of all of our foreign subsidiaries.

We currently anticipate that available cash resources and credit facilities will be sufficient to meet our anticipated working capital and capital expenditure requirements for at least the next 12 months.

Other

In March 2001, we finalized our first closing for a pan-European market-making venture with 19 broker-dealers and banks from Europe and the United States. Our partners in the initial closing of Knight Roundtable Europe Limited, which consist of a diverse group of leading pan-European and U.S. securities firms, banks and broker-dealers, have contributed a total of \$27.6 million. This amount has been matched by us and we have also contributed to the venture our UK broker-dealer, KSIL. Following this closing, our ownership in Knight Roundtable Europe Limited stands at approximately 85%. Additional closings may occur, and, upon completion, our partners could collectively own up to 30% of the venture. We believe Knight Roundtable Europe Limited will further establish our international presence by leveraging technology and the Company's trading methodologies to provide best execution solutions for European investors in pan-European and U.S. equities.

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

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

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

In the normal course of our equities market-making business, we maintain inventories of exchange-listed and OTC securities. The fair value of these securities at March 31, 2001 was \$115.2 million in long positions and \$85.6 million in short positions. The potential change in fair value, using a hypothetical 10.0% decline in prices, is estimated to be a \$2.9 million loss as of March 31, 2001 due to the offset of losses in long positions with gains in short positions.

In the normal course of options market making, we maintain inventories of

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options, futures and equities. Our main exposures are from equity price and volatility risk. We manage these exposures by constantly monitoring and diversifying our exposures and position sizes and establishing offsetting hedges. Our market-making staff and trading room managers continuously manage our positions and our risk exposures. Our systems incorporate trades and update our risk profile using options pricing models on a real time basis.

Our proprietary options risk management system allows us to stress test our portfolio on a real-time basis. On a daily basis, risk reports are distributed to senior management and the firm's risk managers who incorporate this information in our daily market-making decisions. These reports identify potential exposures in terms of options and futures on individual securities and index contracts, organized in different ways such as industry sectors, under extreme price and volatility movements. At March 31, 2001, 10% movements in volatility and stock prices on our entire equity options and equity index options portfolios, which contain the majority of our market risk, would have resulted in approximately the following gains (losses) in our options market-making portfolio:

	Change in Stock Prices		
	-10%	None	+10%
Change in Volatility			
+10%.....	(\$6,000)	(\$789,000)	\$3.7 million
None.....	(645,000)	--	4.4 million
-10%.....	(1.5 million)	(1.1 million)	5.5 million

This stress analysis covers positions in options and futures, underlying securities and related hedges. The 10% changes in stock prices and volatility in the charts above make the assumption of a universal 10% movement in all of our underlying positions. The analysis also includes a number of estimates that we believe to be reasonable, but cannot assure that they produce an accurate measure of future risk.

For working capital purposes, we invest in money market funds, commercial paper, government securities or maintain interest bearing balances in our trading accounts with clearing brokers, which are classified as cash equivalents and receivable from clearing brokers, respectively, in the Consolidated Statements of Financial Condition. These other amounts do not have maturity dates or present a material market risk, as the balances are short-term in nature and subject to daily repricing.

### PART II. OTHER INFORMATION

#### Item 1. Legal Proceedings

We and certain of our officers and employees have been subject to legal proceedings in the past and may be subject to legal proceedings in the future. We are not currently a party to any legal proceedings, the adverse outcome of which, individually or in the aggregate, we can predict with any reasonable certainty, could have a material adverse effect on our business, financial condition or operating results. We and certain of our past and present officers and employees are currently the subject of legal proceedings, such as those stated in our 8-K filing of November 30, 2000, that are in their preliminary stages. As such, we are unable to predict the outcome of any such proceeding and assess or quantify the potential damages, if any.

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Item 2. Changes in Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

18

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

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

None.

### 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 thereto until duly authorized.

Knight Trading Group, Inc.

/s/ Robert I. Turner

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By: Robert I. Turner

Title: Director, Executive Vice  
President, Chief Financial  
Officer and Treasurer (principal  
financial and accounting  
officer)

Date: May 14, 2001

19