

LABRANCHE & CO INC  
Form 10-Q  
November 09, 2005

## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

### FORM 10-Q

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

For the quarterly period ended September 30, 2005  
OR

o

**Transition Report Pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934**

For the transition period from            to

Commission File Number 001-15251



**LABRANCHE & CO INC.**

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(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**13-4064735**  
(I.R.S. Employer  
Identification No.)

**One Exchange Plaza, New York, New York 10006**

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(Address of principal executive offices)

**(212) 425-1144**

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(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

The number of shares of the registrant's common stock outstanding as of November 7, 2005 was 60,623,819.

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**PART I FINANCIAL INFORMATION**





**Item 1. Financial Statements.**



## LaBRANCHE &amp; CO INC. and SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

(000 s omitted except per share data)

|  | For the Three Months Ended<br>September 30, |                     | For the Nine Months Ended<br>September 30, |                     |
|--|---|---------------------|--|---------------------|
|  | 2005<br>(unaudited)                         | 2004<br>(unaudited) | 2005<br>(unaudited)                        | 2004<br>(unaudited) |
| <b>REVENUES:</b>   |   |                     |  |                     |
| Net gain on principal transactions   | \$ 47,212                                   | \$ 38,997           | \$ 135,124                                 | \$ 131,740          |
| Commissions  | 20,123                                      | 22,064              | 64,876                                     | 71,311              |
| Net gain on non-marketable investments   | 1,059                                       | 178                 | 1,381                                      | 24,527              |
| Interest   | 14,515                                      | 2,712               | 27,752                                     | 6,497               |
| Other  | 822   | 709                 | (354)                                      | 1,200               |
| Total revenues   | 83,731                                      | 64,660              | 228,779                                    | 235,275             |
| <b>EXPENSES:</b>   |   |                     |  |                     |
| Employee compensation and related benefits   | 25,747                                      | 21,985              | 72,527                                     | 72,421              |
| Interest   | 23,285                                      | 16,006              | 58,649                                     | 47,700              |
| Exchange, clearing and brokerage fees  | 10,559                                      | 10,101              | 30,445                                     | 28,684              |
| Lease of exchange memberships  | 1,008                                       | 3,804               | 3,003                                      | 11,902              |
| Depreciation and amortization of intangibles                                       | 3,008                                       | 3,057               | 9,100                                      | 9,162               |
| Goodwill impairment  | —   | 37,600              | —  | 37,600              |
| Exchange memberships impairment  | —   | —                   | —  | 18,327              |
| Debt repurchase premium  | —   | —                   | —  | 49,028              |
| Other  | 9,374                                       | 9,941               | 30,579                                     | 29,927              |
| Total expenses   | 72,981                                      | 102,494             | 204,303                                    | 304,751             |
| Income (loss) before minority interest and<br>provision (benefit) for income taxes | 10,750                                      | (37,834)            | 24,476                                     | (69,476)            |
| MINORITY INTEREST  | —   | 161                 | —  | 530                 |
| Income (loss) before provision (benefit) for<br>income taxes                       | 10,750                                      | (37,995)            | 24,476                                     | (70,006)            |
| PROVISION (BENEFIT) FOR INCOME<br>TAXES  | 1,592                                       | (1,533)             | 4,330                                      | (16,958)            |
| Net income (loss)  | 9,158                                       | (36,462)            | 20,146                                     | (53,048)            |
| Preferred dividends and discount accretion   | —   | 142                 | —  | 2,254               |
| Net income (loss) applicable to common<br>stockholders                             | \$ 9,158                                    | \$ (36,604)         | \$ 20,146                                  | \$ (55,302)         |
| <b>Weighted-average common shares outstanding:</b>                                 |   |                     |  |                     |
| Basic  | 60,624                                      | 59,926              | 60,615                                     | 59,852              |
| Diluted  | 60,964                                      | 59,926              | 60,947                                     | 59,852              |
| <b>Earnings (loss) per share:</b>  |   |                     |  |                     |
| Basic  | \$ 0.15                                     | \$ (0.61)           | \$ 0.33                                    | \$ (0.92)           |
| Diluted  | \$ 0.15                                     | \$ (0.61)           | \$ 0.33                                    | \$ (0.92)           |

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



## LaBRANCHE &amp; CO INC. and SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(UNAUDITED)

(000 s omitted except per share data)

|   | September 30,<br>2005<br>(unaudited) | As of | December 31,<br>2004<br>(audited) |
|---|--------------------------------------|-------|-----------------------------------|
| <b>ASSETS</b>   |                                      |       |                                   |
| Cash and cash equivalents   | \$ 489,105                           | \$    | 444,446                           |
| Cash and securities segregated under federal regulations  | 6,036                                |       | 13,511                            |
| Securities purchased under agreements to resell   | 121,000                              |       | 87,000                            |
| Receivable from brokers, dealers and clearing organizations   | 637,477                              |       | 158,421                           |
| Receivable from customers   | 2,420                                |       | 10,555                            |
| Securities owned, at market value:  |                                      |       |                                   |
| Corporate equities  | 822,092                              |       | 319,378                           |
| Options   | 358,538                              |       | 110,705                           |
| Exchange-traded funds   | 560,676                              |       | 128,214                           |
| U.S. Government obligations   | 8                                    |       | 8                                 |
| Commissions receivable  | 4,623                                |       | 5,428                             |
| Exchange memberships contributed for use, at market value   | 22,880                               |       | 9,450                             |
| Exchange memberships owned, at adjusted cost (market value of \$113,395 and \$41,696, respectively)   | 59,657                               |       | 59,332                            |
| Office equipment and leasehold improvements, at cost, less accumulated depreciation and amortization of \$11,970 and \$10,655, respectively | 2,814                                |       | 3,459                             |
| Intangible assets, net of accumulated amortization:   |                                      |       |                                   |
| Specialist stock lists  | 353,422                              |       | 361,204                           |
| Trade name  | 25,011                               |       | 25,011                            |
| Goodwill  | 250,569                              |       | 250,569                           |
| Other assets  | 43,992                               |       | 68,406                            |
| Total assets  | \$ 3,760,320                         | \$    | 2,055,097                         |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                                      |       |                                   |
| Liabilities:  |                                      |       |                                   |
| Payable to brokers and dealers  | \$ 162,403                           | \$    | 120,434                           |
| Payable to customers  | 6,727                                |       | 3,830                             |
| Securities sold, but not yet purchased, at market value:  |                                      |       |                                   |
| Corporate equities  | 1,276,098                            |       | 265,078                           |
| Options   | 343,670                              |       | 92,580                            |
| Exchange-traded funds   | 419,346                              |       | 142,735                           |
| U.S. Government obligations   | 92,925                               |       | —                                 |
| Accrued compensation  | 25,411                               |       | 38,195                            |
| Accounts payable and other accrued expenses   | 31,564                               |       | 18,245                            |
| Other liabilities   | 11,911                               |       | 12,510                            |
| Income taxes payable  | 6,809                                |       | 1,671                             |
| Deferred tax liabilities  | 151,305                              |       | 156,294                           |
| Short term debt   | —                                    |       | 2,000                             |
| Long term debt  | 481,414                              |       | 481,448                           |
| Subordinated liabilities:   |                                      |       |                                   |
| Exchange memberships contributed for use, at market value   | 22,880                               |       | 9,450                             |

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|   |              |              |
|---|--------------|--------------|
| Other subordinated indebtedness   | 12,395       | 17,285       |
| Total liabilities   | 3,044,858    | 1,361,755    |
| Minority interest   | —            | 356          |
| Commitments and contingencies   |              |              |
| Common stock, \$.01 par value, 200,000,000 shares authorized; 60,623,819 and 60,532,080 shares issued and outstanding at September 30, 2005 and December 31, 2004, respectively | 606          | 605          |
| Additional paid-in capital  | 689,369      | 687,040      |
| Retained earnings   | 25,487       | 5,341        |
| Total stockholders' equity  | 715,462      | 692,986      |
| Total liabilities and stockholders' equity  | \$ 3,760,320 | \$ 2,055,097 |

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

**LaBRANCHE & CO INC. and SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

**(000 s omitted)**



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|  | Nine Months Ended September 30, |             |
|--|---------------------------------|-------------|
|  | 2005                            | 2004        |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                                 |             |
| Net income (loss)  | \$ 20,146                       | \$ (53,048) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: |                                 |             |
| Depreciation and amortization of intangibles   | 9,100                           | 9,162       |
| Amortization of debt issuance costs and bond discount                                | 1,295                           | 6,977       |
| Minority interest in consolidated subsidiary   | —                               | 530         |
| Compensation expense related to stock-based compensation                             | 2,330                           | 3,161       |
| Deferred taxes, net  | 17,221                          | 12,840      |
| Goodwill impairment  | —                               | 37,600      |
| Exchange memberships impairment  | —                               | 18,327      |
| Acceleration of preferred stock discount accretion                                   |                                 | 496         |
| Changes in operating assets and liabilities:   |                                 |             |
| Cash and securities segregated under federal regulations                             | 7,475                           | (646)       |
| Securities purchased under agreements to resell                                      | (34,000)                        | (59,000)    |
| Receivable from brokers, dealers and clearing organizations                          | (479,056)                       | (5,172)     |
| Receivable from customers  | 8,135                           | (3,134)     |
| Securities owned, at market value:   |                                 |             |
| Corporate equities   | (502,714)                       | (226,092)   |
| Options  | (247,833)                       | (35,447)    |
| Exchange-traded funds  | (432,462)                       | (70,363)    |
| U.S. Government obligations  | —                               | (250)       |
| Commissions receivable   | 805                             | (290)       |
| Income taxes receivable  | —                               | (17,047)    |
| Other assets   | 938                             | (320)       |
| Payable to brokers and dealers   | 41,969                          | 32,590      |
| Payable to customers   | 2,897                           | (4,383)     |
| Securities sold, but not yet purchased, at market value:                             |                                 |             |
| Corporate equities   | 1,011,020                       | 127,091     |
| Options  | 251,090                         | 17,499      |
| Exchange-traded funds  | 276,611                         | 146,702     |
| U.S. Government obligations  | 92,925                          | 22,450      |
| Accrued compensation   | (12,784)                        | (15,712)    |
| Accounts payable and other accrued expenses  | 13,319                          | (2,877)     |
| Other liabilities  | (599)                           | (64,167)    |
| Income taxes payable   | 5,138                           | (8,588)     |
| Net cash provided by (used in) operating activities                                  | 52,966                          | (131,111)   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                                 |             |
| Payments for purchases of office equipment and leasehold improvements                | (673)                           | (470)       |
| Payments for purchases of exchange memberships                                       | (325)                           | (340)       |
| Net cash (used in) investing activities  | (998)                           | (810)       |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                                 |             |
| Payment to minority interest holder  | (356)                           | (322)       |
| Payment for preferred stock dividends  | —                               | (3,448)     |
| Payment for preferred stock buyback  | —                               | (39,186)    |
| Principal payments of subordinated debt  | (4,890)                         | (3,000)     |
| Proceeds from issuance of long term debt   | —                               | 460,000     |
| Repayment of short term and long term debt   | (2,063)                         | (336,358)   |
| Net cash (used in) provided by financing activities                                  | (7,309)                         | 77,686      |
| Increase (Decrease) in cash and cash equivalents                                     | 44,659                          | (54,235)    |
| CASH AND CASH EQUIVALENTS, beginning of period                                       | 444,446                         | 491,885     |
| CASH AND CASH EQUIVALENTS, end of period   | \$ 489,105                      | \$ 437,650  |

**SUPPLEMENTAL DISCLOSURE OF CASH PAID DURING THE PERIOD FOR:**

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|              |    |        |    |        |
|--------------|----|--------|----|--------|
| Interest     | \$ | 27,193 | \$ | 31,306 |
| Income taxes | \$ | 362    | \$ | 393    |

**SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING  
ACTIVITIES:**

|  |    |       |    |       |
|--|----|-------|----|-------|
| Net increase in additional paid-in capital related to stock-based awards | \$ | 2,329 | \$ | 3,134 |
|--|----|-------|----|-------|

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

**LaBRANCHE & CO INC. and SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**



**1. ORGANIZATION AND DESCRIPTION OF BUSINESS**





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The condensed consolidated financial statements include the accounts of LaBranche & Co Inc., a Delaware corporation (the Holding Company), and its subsidiaries, LaBranche & Co. LLC, a New York limited liability company, LaBranche Financial Services, Inc., a New York corporation (LFSI), LaBranche Structured Holdings, Inc., a Delaware corporation (LSHI), LABDR Services, Inc., a Delaware corporation (LABDR), and LaBranche & Co. B.V., a Netherlands private limited liability company (BV). The Holding Company is the sole member of LaBranche & Co. LLC, the 100% stockholder of LFSI, LSHI and LABDR and the sole owner of BV. LSHI is a holding company that is the sole member of LaBranche Structured Products, LLC, a New York limited liability company (LSP), LaBranche Structured Products Specialists LLC, a New York limited liability company (LSPS), LaBranche Structured Products Europe Limited, a United Kingdom single member private company (LSPE) and LaBranche Structured Products Hong Kong Limited, a Hong Kong single member private company (LSPH), and collectively with the Holding Company, LaBranche & Co. LLC, LFSI, LSHI, LABDR, LSP, LSPS and LSPE the Company). LaBranche & Co. LLC is a registered broker-dealer that operates primarily as a specialist in equity securities and rights listed on the New York Stock Exchange (NYSE) and in equity securities on the American Stock Exchange (AMEX). LFSI is a registered broker-dealer and a member of the NYSE and other exchanges and provides securities execution, securities clearing and other related services to its own customers and customers of introducing brokers. LFSI also provides direct-access floor brokerage services to institutional customers. LSP is a registered broker-dealer that operates as a specialist in options, futures and Exchange-Traded Funds (ETFs) on several exchanges, and as a market-maker in options, ETFs and futures on several exchanges. LSPS is a registered broker-dealer that operates as a specialist in ETFs traded on the NYSE. LSPE was organized to operate as a market-maker for ETFs in Europe, and is in the process of registering as a broker-dealer with the United Kingdom's Financial Securities Authority. LSPH was organized to operate as a market-maker for ETFs and engage in hedging transactions in Asia, and is in the process of registering as a broker-dealer with Hong Kong's Securities and Futures Commission. LABDR provides disaster recovery services and back-up facilities to other Holding Company subsidiaries. BV represents LaBranche & Co. LLC in European markets and provides client services to LaBranche & Co. LLC's European listed companies.

## 2. INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND FINANCIAL INFORMATION



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The unaudited interim condensed consolidated financial information as of September 30, 2005 and for the three and nine months ended September 30, 2005 and 2004 is presented in the accompanying condensed consolidated financial statements. The unaudited interim condensed consolidated financial statements have been prepared in accordance with U.S.

generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial information. The unaudited interim condensed consolidated financial information reflects all adjustments which are, in the opinion of management, necessary for a fair presentation of the results for such periods. The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates and assumptions. The unaudited interim condensed consolidated financial information as of September 30, 2005 should be read in conjunction with the audited consolidated financial statements and notes thereto as of December 31, 2004 included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 filed with the Securities and Exchange Commission (SEC) on March 16, 2005, as amended on April 15, 2005 (the 2004 10-K). Results of the third quarter 2005 interim period are not necessarily indicative of results to be obtained for the full fiscal year.

### 3. INCOME TAXES

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes, which requires the recognition of tax benefits or expenses based on the estimated future tax effects of temporary differences between the financial statement and tax bases of its assets and liabilities. Deferred tax assets and liabilities primarily relate to tax basis differences on stock-based compensation, other compensation accruals, net operating loss carryforwards, amortization periods of certain intangible assets and differences between the financial statement and tax bases of assets acquired.

In the third quarter of 2005, the Company maintained its income tax accrual rate at 43.5%. During the quarter ended September 30, 2005, the Company recognized \$1.7 million in tax benefits resulting from a tax rate change in the first half of 2005, and \$1.3 million from the reduction of tax liabilities due to the close of a prior Federal tax year, for a total of \$3.0 million for the 2005 third quarter. The Company expects to recognize approximately \$2.2 million of additional tax benefits throughout the remainder of 2005, for a total benefit from changes in tax estimates of \$7.4 million for the 2005 fiscal year. The Company expects that its effective tax rate will be in the range of 16.0%-18.0% for the year ending December 31, 2005.

The components of the provision (benefit) for income taxes reflected on the condensed consolidated statements of operations are set forth below (000's omitted):

|  | Three Months Ended September 30, |            | Nine Months Ended September 30, |             |
|--|----------------------------------|------------|---------------------------------|-------------|
|  | 2005                             | 2004       | 2005                            | 2004        |
| Current federal, state and local taxes     | \$ 2,391                         | \$ 14,073  | \$ (12,891)                     | \$ (29,798) |
| Deferred tax provision (benefit)           | (799)                            | (15,606)   | 17,221                          | 12,840      |
| Total provision (benefit) for income taxes | \$ 1,592                         | \$ (1,533) | \$ 4,330                        | \$ (16,958) |

4. CAPITAL AND NET LIQUID ASSET REQUIREMENTS



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LaBranche & Co. LLC, as a specialist and member of the NYSE and AMEX, is subject to the provisions of SEC Rule 15c3-1, as adopted and administered by the SEC, NYSE and AMEX. LaBranche & Co. LLC is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined.

As of September 30, 2005 and December 31, 2004, LaBranche & Co. LLC's net capital, as defined under SEC Rule 15c3-1, was \$463.2 million and \$455.1 million, respectively, which exceeded the minimum requirements by \$461.9 million and \$453.2 million, respectively. LaBranche & Co. LLC's aggregate indebtedness to net capital ratio on those dates was .04 to 1 and .06 to 1, respectively.

The NYSE generally requires its specialist firms to maintain a minimum dollar regulatory capital amount in order to establish that they can meet, with their own net liquid assets, their position requirement. As of September 30, 2005 and December 31, 2004, LaBranche & Co. LLC's and LSPS' NYSE minimum required combined dollar amount of net liquid assets, as defined, was \$447.0 million. LaBranche & Co. LLC's actual net liquid assets, as defined, were \$459.0 million and \$458.7 million as of September 30, 2005 and December 31, 2004, respectively. As of September 30, 2005 and December 31, 2004, LaBranche & Co. LLC's actual net liquid assets exceeded the combined net liquid assets requirement of LaBranche & Co. LLC and LSPS. Both LaBranche & Co. LLC and LSPS thus satisfied their respective net liquid asset requirements as of those dates.

The AMEX generally requires its equity specialist firms to maintain a cash or liquid asset position of the greater of (a) \$1.0 million or (b) an amount sufficient to assume a position of sixty trading units of each security in which the equity specialist is registered. As of September 30, 2005 and December 31, 2004, LaBranche & Co. LLC satisfied the AMEX equity specialist liquid asset requirements.

As a registered broker-dealer and member firm of the NYSE, LFSI is also subject to SEC Rule 15c3-1, as adopted and administered by the SEC and the NYSE. Under the alternative method permitted by this rule, the minimum required net capital is equal to the greater of \$1.5 million or 2.0% of aggregate debit items, as defined. As of September 30, 2005 and December 31, 2004, LFSI's net capital, as defined, was \$8.2 million and \$12.5 million, respectively, which exceeded minimum requirements by \$6.7 million and \$11.0 million, respectively.

As a clearing broker-dealer, LFSI is subject to SEC Rule 15c3-3, as adopted and administered by the SEC. As of October 4, 2005, to comply with its September 30, 2005 requirement, cash and U.S. Treasury Bills in the amount of \$2.0 million were segregated in a special reserve account for the exclusive benefit of customers exceeding the actual requirements by \$2.0 million. As of January 4, 2005, to comply with its December 31, 2004 requirement, cash and U.S. Treasury Bills in the amount of \$0.1 million were segregated in a special reserve account for the exclusive benefit of customers, thus exceeding actual requirements by \$0.1 million. In addition, the Proprietary Accounts of Introducing Brokers

( PAIB ) Calculation is computed in order for correspondent firms to classify their assets held by LFSI as allowable assets in the correspondents net capital calculation. As of October 4, 2005, to comply with LFSI s September 30, 2005 requirement, cash and U.S. Treasury Bills in the amount of \$5.2 million were segregated in a special reserve account for the exclusive benefit of customers, thus exceeding actual requirements by \$1.2 million. As of January 4, 2005, to comply with LFSI s December 31, 2004 requirement, cash and U.S. Treasury Bills in the amount of \$4.4 million were segregated in a special reserve account for the exclusive benefit of customers, thus exceeding actual requirements by \$3.4 million.

As a registered broker-dealer and AMEX member firm, LSP is subject to SEC Rule 15c3-1, as adopted and administered by the SEC and the AMEX. LSP is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $1/15$  of aggregate indebtedness, as defined. As of September 30, 2005 and December 31, 2004, LSP s net capital, as defined, was \$45.9 million and \$23.8 million, respectively, which exceeded minimum requirements by \$45.4 million and \$23.2 million, respectively.

LSPS, as a specialist and member of the NYSE, is subject to the provisions of SEC Rule 15c3-1, as adopted and administered by the SEC and NYSE. LSPS is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $1/15$  of aggregate indebtedness, as defined. As of September 30, 2005 and December 31, 2004, LSPS net capital, as defined, was \$3.9 million and \$4.4 million, respectively, which exceeded the minimum requirements by \$3.7 million and \$4.3 million, respectively. LSPS aggregate indebtedness to net capital ratio on those dates was .53 to 1 and .13 to 1, respectively.

## 5. EARNINGS (LOSS) PER SHARE

Earnings (loss) per share are computed in accordance with SFAS No. 128, Earnings Per Share. Basic earnings (loss) per share is calculated by dividing net income (loss) applicable to common stockholders by the weighted-average number of common shares outstanding. Diluted earnings (loss) per share includes the determinants of basic earnings (loss) per share and, in addition, gives effect to dilutive potential common shares for periods in which there is net income available to common stockholders.

The computations of basic and diluted earnings (loss) per share are set forth below (000 s omitted, except per share data):

|   | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30, |             |
|---|-------------------------------------|-------------|------------------------------------|-------------|
|   | 2005                                | 2004        | 2005                               | 2004        |
| Net income (loss)   | \$ 9,158                            | \$ (36,462) | \$ 20,146                          | \$ (53,048) |
| Less: preferred dividends and discount accretion  | —                                   | 142         | —                                  | 2,254       |
| Numerator for basic and diluted earnings (loss) per share net income (loss) applicable to common stockholders | \$ 9,158                            | \$ (36,604) | \$ 20,146                          | \$ (55,302) |
| Denominator for basic earnings (loss) per share weighted-average number of common shares outstanding          | 60,624                              | 59,926      | 60,615                             | 59,852      |
| Dilutive shares:  |                                     |             |                                    |             |
| Restricted stock units  | 340                                 | —           | 332                                | —           |
| Denominator for diluted earnings (loss) per share weighted-average number of common                           | 60,964                              | 59,926      | 60,947                             | 59,852      |



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shares outstanding

Earnings (loss) per share:

|         |    |      |    |        |    |      |    |        |
|---------|----|------|----|--------|----|------|----|--------|
| Basic   | \$ | 0.15 | \$ | (0.61) | \$ | 0.33 | \$ | (0.92) |
| Diluted | \$ | 0.15 | \$ | (0.61) | \$ | 0.33 | \$ | (0.92) |

Options to purchase an aggregate of 1,709,778 and 2,724,223 shares of common stock were outstanding during the three and nine months ended September 30, 2005 and 2004, respectively, but were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the Company's common stock. In addition, potential common shares relating to restricted stock and restricted stock units for the three months ended September 30, 2005 and 2004 totaling 728,706 and 552,960 shares, respectively, and nine months ended September 30, 2005 and 2004 totaling 736,829 and 484,094 shares, respectively, were antidilutive. The calculation of diluted earnings per share does not include the antidilutive effect of these stock-based awards.

## 6. EMPLOYEE INCENTIVE PLANS

Effective January 1, 2003, the Company began to account for stock-based employee compensation in accordance with the prospective method prescribed by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, an Amendment of FASB Statement No. 123. Under this method, compensation expense is recognized over the period that an employee provides service in exchange for the award, based on the grant date fair value of stock options and restricted stock units granted to employees on or after January 1, 2003.

Compensation expense resulting from stock-based awards granted for the year ended December 31, 2002 and prior years is accounted for under the intrinsic value-based method prescribed by APB No. 25, Accounting for Stock Issued to Employees, as permitted by SFAS No. 123, Accounting for Stock-Based Compensation. In accordance with APB No. 25, no compensation expense is recognized for stock options issued for years prior to fiscal 2003 that had no intrinsic value on the date of grant. In addition, compensation expense was not recognized for those stock options issued in connection with the Company's acquisition of ROBB PECK McCOOEY Financial Services, Inc. (RPM) in March 2001. Such options were treated as part of the purchase price of RPM in accordance with the rules of purchase accounting.

Had the Company recognized compensation expense over the relevant service period under the fair value-based method of SFAS No. 123 with respect to stock options granted for the year ended December 31, 2002 and prior years, net income (loss) applicable to common stockholders would have been reduced, resulting in pro forma net income (loss) applicable to common stockholders and earnings per share as presented below:

| (000 \$ omitted, except per share data)  | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30, |             |
|--|-------------------------------------|-------------|------------------------------------|-------------|
|  | 2005                                | 2004        | 2005                               | 2004        |
| Net income (loss) applicable to common stockholders, as reported                                 | \$ 9,158                            | \$ (36,604) | \$ 20,146                          | \$ (55,302) |
| Add: Stock-based compensation expense included in reported net income (loss) (net of tax effect) | 188                                 | 420         | 1,192                              | 1,584       |
| Less: Stock-based compensation expense under SFAS 123 (net of tax effect)                        | (188)                               | (1,672)     | (1,386)                            | (5,704)     |
| Pro forma net income (loss) applicable to common stockholders                                    | \$ 9,158                            | \$ (37,856) | \$ 19,952                          | \$ (59,422) |
| Diluted earnings (loss) per share, as reported   | \$ 0.15                             | \$ (0.61)   | \$ 0.33                            | \$ (0.92)   |
| Pro forma diluted earnings (loss) per share  | \$ 0.15                             | \$ (0.63)   | \$ 0.33                            | \$ (0.99)   |

The effect of applying SFAS No. 123 in the pro forma disclosure above may not be representative of the potential effect stock-based compensation could have on net income in future periods.

## 7. BUSINESS SEGMENTS

Segment information is presented in accordance with SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information. The Company's business segments are based on the nature of the financial services provided, their revenue source and the Company's management organization.

The Company's Specialist segment operates as a specialist in equities, rights and ETFs listed on the NYSE, as a specialist in equities, options, ETFs and futures on several exchanges, and as a market-maker in ETFs, futures and options on several exchanges. This segment also provides support services for the NYSE specialist activities. The Specialist segment currently includes the operations of LaBranche & Co. LLC, LSHI and its direct subsidiaries, LABDR and BV.

The Company's Execution and Clearing segment provides securities execution, securities clearing and other related services to its own customers and customers of introducing brokers. This segment also provides direct-access floor brokerage services to institutional customers. The Execution and Clearing segment currently includes the operations of LFSI.

Revenues and expenses directly associated with each segment are included in determining its operating results. Other expenses, including corporate overhead, which are not directly attributable to a particular segment, generally are allocated to each segment based on its resource usage levels or other appropriate measures. Interest with respect to the Company's \$473.4 million aggregate principal amount of senior notes and senior subordinated notes outstanding, certain administrative expenses, corporate overhead expenses and other sources of revenues are not specifically allocated by management when reviewing the Company's segments' performance, and appear in the Other section. Selected financial information for each segment is set forth below (000 \$ omitted):



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|  | Three Months Ended<br>September 30, |              | Nine Months Ended<br>September 30, |              |
|--|-------------------------------------|--------------|------------------------------------|--------------|
|  | 2005                                | 2004         | 2005                               | 2004         |
| <b>Specialist Segment:</b>                       |                                     |              |                                    |              |
| Revenues   | \$ 71,877                           | \$ 53,532    | \$ 192,448                         | \$ 174,305   |
| Operating expenses                               | 44,311                              | 33,324       | 114,117                            | 98,537       |
| Goodwill impairment                              | —                                   | 37,600       | —                                  | 37,600       |
| Exchange memberships impairment                  | —                                   | —            | —                                  | 16,300       |
| Depreciation and amortization of intangibles     | 2,868                               | 2,916        | 8,675                              | 8,728        |
| Income (loss) before minority interest and taxes | 24,698                              | (20,308)     | 69,656                             | 13,140       |
| Segment goodwill                                 | 250,569                             | 251,993      | 250,569                            | 251,993      |
| Segment assets                                   | \$ 3,548,010                        | \$ 2,020,902 | \$ 3,548,010                       | \$ 2,020,902 |
| <b>Execution and Clearing Segment:</b>           |                                     |              |                                    |              |
| Revenues   | \$ 10,035                           | \$ 10,594    | \$ 33,022                          | \$ 35,405    |
| Operating expenses                               | 10,484                              | 11,892       | 34,845                             | 39,319       |
| Exchange memberships impairment                  | —                                   | —            | —                                  | 2,027        |
| Depreciation and amortization of intangibles     | 108                                 | 115          | 331                                | 359          |
| Loss before minority interest and taxes          | (557)                               | (1,413)      | (2,154)                            | (6,300)      |
| Segment assets                                   | \$ 59,058                           | \$ 53,897    | \$ 59,058                          | \$ 53,897    |
| <b>Other (1):</b>                                |                                     |              |                                    |              |
| Revenues   | \$ 1,819                            | \$ 534       | \$ 3,309                           | \$ 25,565    |
| Operating expenses                               | 15,178                              | 16,621       | 46,241                             | 52,778       |
| Debt repurchase premium                          | —                                   | —            | —                                  | 49,028       |
| Depreciation and amortization of intangibles     | 32                                  | 26           | 94                                 | 75           |
| Loss before minority interest and taxes          | (13,391)                            | (16,113)     | (43,026)                           | (76,316)     |
| Segment assets                                   | \$ 153,252                          | \$ 147,677   | \$ 153,252                         | \$ 147,677   |
| <b>Total:</b>                                    |                                     |              |                                    |              |
| Revenues   | \$ 83,731                           | \$ 64,660    | \$ 228,779                         | \$ 235,275   |
| Operating expenses                               | 69,973                              | 61,837       | 195,203                            | 190,634      |
| Goodwill impairment                              | —                                   | 37,600       | —                                  | 37,600       |
| Exchange memberships impairment                  | —                                   | —            | —                                  | 18,327       |
| Debt repurchase premium                          | —                                   | —            | —                                  | 49,028       |
| Depreciation and amortization of intangibles     | 3,008                               | 3,057        | 9,100                              | 9,162        |
| Income (loss) before minority interest and taxes | 10,750                              | (37,834)     | 24,476                             | (69,476)     |
| Goodwill   | 250,569                             | 251,993      | 250,569                            | 251,993      |
| Assets   | \$ 3,760,320                        | \$ 2,222,476 | \$ 3,760,320                       | \$ 2,222,476 |

(1) *Other* is comprised primarily of the interest on the Holding Company's indebtedness, unallocated corporate administrative expenses, including professional and legal costs, unallocated revenues (primarily interest income and net gains from non-marketable investments) and elimination entries.

## 8. CONTINGENCIES

There have been no material new developments in the Company's legal proceedings since the filing of the Company's Form 10-Q for the quarter ended June 30, 2005, filed August



9, 2005 (the Second Quarter 10-Q ), which updated the legal proceedings disclosed in the 2004 10-K and the Company's Form 10-Q for the quarter ended March 31, 2005, filed May 10, 2005 (the First Quarter 10-Q ) except as follows:

Last Atlantis/Rule/Martin. On October 4, 2005, the court in the Last Atlantis action granted the plaintiffs' motion for leave to file a second amended complaint and to join Bryan Rule and River North Investors LLC as plaintiffs. On October 5, 2005, the second amended complaint was filed.

On September 28, 2005, Bryan Rule and River North Investors LLC, who, as stated above, now are plaintiffs in the Last Atlantis action, commenced an action in the United States District Court for the Northern District of Illinois, Rule et al. v. Chicago Board Options Exchange, Inc., et al., No. 05 C 5600. The complaint in this action is substantially similar to the second amended complaint in the Last Atlantis action, making substantially the same allegations and seeking the same relief against the same defendants, including the Company and LSP, except that the complaint in this action also asserts a federal antitrust law claim (Section 1 of the Sherman Act).

On September 30, 2005, Brad Martin commenced an action in the United States District Court for the Northern District of Illinois, Martin v. Chicago Board Options Exchange, Inc., et al., No. 05 C 5671. The complaint in this action is substantially similar to the second amended complaint in the Last Atlantis action and the complaint in the Rule action, making substantially the same allegations and seeking the same relief against the same defendants, including the Company and LSP, except that the complaint in this action, like the complaint in the Rule action, also asserts a federal antitrust law claim (Section 1 of the Sherman Act). To the Company's knowledge, neither the Company nor LSP has been served with the complaint in this action.

EEOC Claim. On September 27, 2005, the Equal Employment Opportunity Commission (the EEOC ) commenced an action in the United States District Court for the Southern District of New York, EEOC v. LaBranche & Co Inc., No. 05 CV 8304, on behalf of a former employee of LaBranche. The complaint in this action alleges that the Company harassed and discriminated against the employee on the basis of a disability, retaliated against him for complaining about the alleged harassment and constructively discharged him. The complaint seeks injunctive relief and monetary damages, including reinstatement, back pay and front pay.

The Company believes that the claims asserted against it by the plaintiffs in the pending proceedings described in the 2004 10-K, the First Quarter 10-Q, the Second Quarter 10-Q and above are without merit, and the Company denies all allegations of wrongdoing. There can be no assurance, however, as to the outcome or timing of the resolution of these proceedings. The Company therefore is unable to estimate the amount or potential range of any loss that may arise out of these proceedings. The range of possible resolutions could include determinations and judgments against the Company or settlements that could require substantial payments by the Company that could have a material adverse effect on the Company's financial condition, results of operations and cash flows.

**In addition to the proceedings described in the 2004 10-K, the First Quarter 10-Q, Second Quarter 10-Q, and above, the Company and its operating subsidiaries have been the target, from time to time, of various claims, lawsuits and regulatory inquiries in the ordinary course of their respective businesses. While the ultimate outcome of those claims and lawsuits which currently are pending cannot be predicted with certainty, the Company believes, based on its understanding of the facts of these proceedings, that their ultimate resolution will not, in the aggregate, have a material adverse effect on the Company's financial condition, results of operations or cash flows**

**9. SUBSEQUENT EVENTS.**

In connection with the sale of its investment in Lava Trading, Inc. as part of an acquisition of Lava in August 2004, the Company received cash of approximately \$39.0 million at the closing. Additional consideration of approximately \$9.6 million was deposited in escrow to secure the Company's indemnification obligations as a selling stockholder of Lava until November 2, 2005. This escrow fund was released on October 31, 2005 and the Company received approximately \$9.6 million at that time.



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

*Unless the context otherwise requires, the Company, we or us shall mean LaBranche & Co Inc. and subsidiaries.*

*This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended December 31, 2004 (the 2004 10-K ) and our Condensed Consolidated Financial Statements and the Notes thereto contained in this report.*

**Executive Overview**

*Our net income available to common stockholders was \$9.2 million, or \$0.15 per diluted share, for the third quarter of 2005, compared to a net loss applicable to common stockholders of \$36.6 million, or \$0.61 per diluted share, for the same period last year. Our 2005 third quarter results include a tax benefit of \$3.0 million, or \$0.05 per diluted share, relating to a reduction in our income tax rate and the reduction of tax liabilities due to the close of a prior federal tax year. The 2004 third quarter results, however, included a non-cash pre-tax goodwill impairment charge of \$37.6 million, and a \$0.5 million after-tax charge due to the acceleration of the discount accretion with respect to the remaining shares of Series B Preferred Stock that we repurchased during the third quarter 2004. Our 2005 third quarter results reflect increased principal trading revenues from higher share volumes and dollar value traded of our NYSE-listed company stocks, continued improvement of our specialist and market making trading activities and higher interest income from increases in interest rates, our trading activity and our cash balances.*

*Our net income available to common stockholders for the nine months ended September 30, 2005 was \$20.1 million, or \$0.33 per diluted share, which includes an aggregate tax benefit for the period of \$6.4 million, or \$0.11 per diluted share, relating to the income tax rate change and the close of a prior tax year described above. Our net loss applicable to common stockholders for the nine months ended September 30, 2004 of \$55.3 million, or \$0.92 per diluted share, include the above-mentioned goodwill impairment and preferred stock discount charges, as well as a \$55.9 million charge in connection with the May 2004 refinancing of our indebtedness, a non-cash charge of \$18.3 million in connection with the impairment of our exchange memberships, and a \$24.9 million appreciation in the fair value of an investment. Our results for the first nine months of 2005, as compared to the same period of 2004, reflect an increase in our net gain on principal transactions, primarily from our specialist and market maker trading activity.*

*Notwithstanding the announcement of the planned merger between the NYSE and Archipelago Holdings, Inc. (currently expected to be consummated in the first half of 2006), SEC approval of Regulation NMS and the NYSE's hybrid model initiatives, there have still been no substantive changes to NYSE market structure or the role of the specialist. Currently, there is only speculation as to how the NYSE specialists will interact with the general marketplace while trading in their listed company stocks on the floor of the NYSE after the planned merger is consummated, but we expect that the specialist will continue to be an*

*integral part of the NYSE market structure. It is also our understanding that the NYSE will continue to operate as a separate operating company following the merger. The NYSE and its senior executives also have confirmed that the specialists will continue to be an integral part of the market model of the separate NYSE operating company.*

*We continue to expand our product offerings in our specialist segment by not only increasing our participation as a specialist in U.S. listed ETFs, but by seeking to expand our operations outside the United States. We believe that these efforts will further diversify our product offerings and revenue streams, while maintaining our business focus and strategy on the activities we do best being a specialist and market-maker in exchange-traded securities and other products.*

*We continue to focus our strategic initiatives on developing the best possible technology to address the needs of investors within the NYSE's current and future market structure and, in particular, the delivery of orders to the point of sale. Despite the current migration to an expanded electronic trading platform, equity exchanges aim to offer investors quality of execution and best price. We believe that this service can best be delivered by specialists who effectively manage market imbalances in stock prices of, and provide liquidity to, NYSE-listed companies.*

Our business, by its nature, does not produce predictable earnings. In any given period, our results can be materially affected by general economic and other conditions, especially those directly related to securities trading and market volume and volatility.

#### **New Accounting Developments**

In December 2004, the FASB issued a revision to SFAS No. 123, Accounting for Stock-Based Compensation, SFAS No. 123(R), Share Based Payment. SFAS No. 123(R) will require compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. SFAS No. 123(R) replaces SFAS No. 123 and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Effective April 15, 2005, the SEC issued final rule No. 33-8568, which amended the date for compliance with SFAS No. 123(R) for registrants that do not file as small business issuers to the first interim or annual reporting period of the registrant's fiscal year beginning on or after June 15, 2005, which for us is January 1, 2006. We do not expect the adoption of SFAS No. 123(R) to have a material impact on our financial condition or results of operations.

#### **Critical Accounting Estimates**

##### *Goodwill and Other Intangible Assets*

We determine the fair value of each of our reporting units and the fair value of each reporting unit's goodwill under the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets. In determining fair value, we use standard analytical approaches to business enterprise valuation (BEV), such as the market comparable approach and the income approach. The market comparable approach is based on comparisons of the subject company to similar companies engaged in an actual merger or



acquisition or to public companies whose stocks are actively traded. As part of this process, multiples of value relative to financial variables, such as earnings or stockholders' equity, are developed and applied to the appropriate financial variables of the subject company to indicate its value. The income approach involves estimating the present value of the subject company's future cash flows by using projections of the cash flows that the business is expected to generate, and discounting these cash flows at a given rate of return. Each of these BEV methodologies requires the use of management estimates and assumptions. For example, under the market comparable approach, we assign a certain control premium to the public market price of our common stock as of the valuation date in estimating the fair value of our specialist reporting unit. Similarly, under the income approach, we assume certain growth rates for our revenues, expenses, earnings before interest, income taxes, depreciation and amortization, returns on working capital, returns on other assets and capital expenditures, among others. We also assume certain discount rates and certain terminal growth rates in our calculations. Given the subjectivity involved in selecting which BEV approach to use and in determining the input variables for use in our analyses, it is possible that a different valuation model and the selection of different input variables could produce a materially different estimate of fair value of our goodwill.

We review the reasonableness of the carrying value of our goodwill annually as of December 31, unless an event or change in circumstances requires an interim reassessment of impairment. During the nine months ended September 30, 2005, there were no changes in circumstances that necessitated goodwill impairment testing. We cannot provide assurance that future goodwill impairment testing will not result in impairment charges in subsequent periods.

Our other intangible asset, as defined under SFAS No. 142, is our trade name. We determine the fair value of our trade name by applying the income approach using the royalty savings methodology. This method assumes that the trade name has value to the extent we are relieved of the obligation to pay royalties for the benefits received from it. Application of this methodology requires estimating an appropriate royalty rate, which is typically expressed as a percentage of revenue. Estimating an appropriate royalty rate includes reviewing evidence from comparable licensing agreements and considering qualitative factors affecting the trade name. Given the subjectivity involved in selecting which BEV approach to use and in determining the input variables for use in our analyses, it is possible that a different valuation model and the selection of different input variables could produce a materially different estimate of fair value of our trade name.

We review the reasonableness of the carrying amount of our trade name on an annual basis in conjunction with our goodwill impairment assessment. We cannot provide assurance that future trade name impairment testing will not result in impairment charges in subsequent periods.

#### *Exchange Memberships*

The determination of the fair value of our exchange memberships is a critical accounting estimate. Exchange memberships owned by us are originally carried at cost, pursuant to the American Institute of Certified Public Accountants (AICPA) *Audit and Accounting Guide - Brokers and Dealers in Securities*. Adjustments to carrying value are

made if we deem that an other-than-temporary decline in value, as defined in (a) Emerging Issues Task Force ( EITF ) Issue No. ~~03e1~~, *Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, and (b) Section M of Topic 5 of the SEC staff accounting bulletin series ( SAB No. 59 has occurred. In determining whether the value of our owned exchange memberships is impaired (*i.e.*, fair market value is below cost) and whether such impairment is temporary or other-than-temporary, we consider many factors, including, but not limited to, information regarding recent sale and lease prices of exchange memberships, historical trends of sale and lease prices of memberships on a particular exchange and their duration, the current condition of the particular exchange's market structure, legal and regulatory developments affecting the particular exchange's market structure and earnings capability, trends in new listings on the particular exchange, general global and national economic factors and our knowledge and judgment of the specialist and execution and clearing industries and the securities market as a whole. As a result of our analysis of the above-mentioned factors for the nine months ended September 30, 2005, we believe the carrying values of our owned exchange memberships were not impaired.

We cannot provide assurance that the consistent application of this accounting policy to future reporting periods will not result in further adjustments to the carrying value of our exchange memberships.

#### **Restructuring of Our LaBranche Structured Products-Related Subsidiaries**

In August 2005, we formed a new wholly-owned subsidiary, LaBranche Structured Holdings, Inc. ( LSHI ), as a holding company to own all our LaBranche Structured Products-affiliated entities. Pursuant to a contribution agreement among LSP, LSPS, LSHI and LaBranche & Co Inc, effective August 20, 2005, LSHI became the sole member of LSP, and, effective September 9, 2005, LSHI became the sole member of LSPS. Also effective August 20, 2005, LSHI became the sole stockholder of LSPE, which previously had been wholly-owned by LSP, pursuant to a distribution agreement between LSHI and LSP. Other than these restructuring transactions, the structure and operations of each of LSP, LSPS and LSPE have not changed. On August 25, 2005, we formed LaBranche Structured Products Hong Kong Limited, a Hong Kong single member private company ( LSPH ) to operate as a market-maker in ETFs and engage in hedging transactions in Asia. LSHI became the sole stockholder of LSPH in October 2005. LSPE and LSPH are in the process of registering as broker-dealers with London's FSA and Hong Kong's Securities and Futures Commission, respectively.

#### **Completed Senior Note Repurchase; Release of Lava Escrow**

In connection with the sale of our interest in Lava Trading Inc. ( Lava ) as part of an acquisition of Lava in August 2004, we received cash of approximately \$39.0 million at the closing. Additional consideration of approximately \$9.6 million was deposited in escrow to secure our indemnification obligations as a selling stockholder of Lava until November 2, 2005. Under the terms of the indenture governing our outstanding 9.5% Senior Notes due 2009 and our outstanding 11.0% Senior Notes due 2012 (collectively, the outstanding senior notes ), by the 35 day following the closing of the Lava acquisition, we were required to offer to purchase outstanding senior notes in an aggregate principal amount equal to the after-tax proceeds on the sale of our interest in Lava received in August 2004, at a price equal to

100.0% of the principal amount of such outstanding senior notes. Therefore, on July 29, 2005, we commenced an offer to purchase outstanding senior notes in the aggregate principal amount of up to approximately \$18.2 million. This excess proceeds offer expired on August 25, 2005, with \$63,000 principal amount having been tendered. Following the closing of this transaction, approximately \$199.8 aggregate principal amount of our Senior Notes due 2009 remained outstanding and approximately \$260.0 aggregate principal amount of our Senior Notes due 2012 remained outstanding.

On October 31, 2005, the escrow in connection with the Lava transaction was terminated and we received approximately \$9.6 million as additional consideration in connection with the Lava transaction. Therefore, under the indenture governing the outstanding senior notes we will again be required to offer to purchase our outstanding senior notes in an aggregate principal amount equal to the after-tax proceeds of this \$9.6 million on or prior to the 361<sup>st</sup> day following October 31, 2005.

## **Results of Operations**

### **Specialist Segment Operating Results**

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| (000 s omitted)                                  | For the Three Months Ended September 30, |                    | For the Nine Months Ended September 30, |                  | Three Months 2005 vs. 2004 Percentage Change | Nine Months 2005 vs. 2004 Percentage Change |
|--|--|--------------------|---|------------------|--|---|
|  | 2005                                     | 2004               | 2005                                    | 2004             |  |   |
| <b>Revenues:</b>                                 |  |                    |   |                  |  |   |
| Net gain on principal transactions               | \$ 47,212                                | \$ 38,997          | 135,124                                 | \$ 131,740       | 21.1%  | 2.6%  |
| Commissions                                      | 10,313                                   | 11,612             | 32,465                                  | 36,430           | (11.2)                                       | (10.9)                                      |
| Interest   | 13,418                                   | 2,338              | 25,109                                  | 5,238            | 473.9  | 379.3                                       |
| Other  | 934                                      | 585                | (250)                                   | 897              | 59.7   | (127.8)                                     |
| <b>Total segment revenues</b>                    | <b>71,877</b>                            | <b>53,532</b>      | <b>192,448</b>                          | <b>174,305</b>   | <b>34.3</b>                                  | <b>10.4</b>                                 |
| Goodwill impairment                              | —  | 37,600             | —                                       | 37,600           | (100.0)                                      | (100.0)                                     |
| Exchange memberships impairment                  | —  | —                  | —                                       | 16,300           | —  | (100.0)                                     |
| Operating expenses                               | 47,179                                   | 36,240             | 122,792                                 | 107,265          | 30.2   | 14.5  |
| <b>Income before minority interest and taxes</b> | <b>\$ 24,698</b>                         | <b>\$ (20,308)</b> | <b>\$ 69,656</b>                        | <b>\$ 13,140</b> | <b>221.6</b>                                 | <b>430.1</b>                                |

Revenues from our Specialist segment consist primarily of net gain earned from principal transactions in securities for which we act as specialist and market-maker. Net gain on principal transactions represents trading gains, net of trading losses and SEC transaction fees, where applicable, and are earned by us when we act as principal buying and selling our specialist stocks, rights, options, ETFs and futures. Also included in net gain on principal transactions are (a) net gains and losses resulting from our market-making activities in ETFs, options and futures, (b) net gains and losses resulting from trading of foreign currencies, futures, equities and fixed income instruments underlying the rights, ETFs and options for which we act as specialist or market-maker, (c) accrued dividends receivable or payable on our equity positions and (d) accrued interest receivable/payable on our fixed income positions. These revenues are primarily affected by changes in share volume traded and fluctuations in

the prices of stocks, rights, options, ETFs and futures in which we are the specialist or in which we make a market.

Commissions revenue consists primarily of fees earned when our specialists act as agents by executing, after a specified period of time, limit orders in equities on behalf of brokers, professional traders and broker-dealers. We do not earn commissions when we match market orders or when we act as a market-maker.

Interest income consists of rebate income earned on stock borrow transactions, and interest income earned on cash balances and short term investments.

Other revenue at our Specialist segment consists primarily of proprietary trading gains or losses, and gains or losses from an investment in a hedge fund.

**Key Metrics of our NYSE Equity Specialist Business** When assessing the performance and financial results of a specific period, management examines certain metrics to ascertain their impact on our NYSE equity specialist's financial results. Some of the key metrics that we review, and their values for the three and nine month periods ended September 30, 2005 and 2004, are as follows:

|   | For the Three Months Ended September 30, |          | For the Nine Months Ended September 30, |            | Three Months 2005 vs. 2004 Percentage Change | Nine Months 2005 vs. 2004 Percentage Change |
|---|--|----------|---|------------|--|---|
|   | 2005                                     | 2004     | 2005                                    | 2004       |  |   |
| NYSE average daily share volume (in millions)                                       | 1,532.4                                  | 1,326.6  | 1,576.1                                 | 1,440.8    | 15.5%  | 9.4%  |
| LAB share volume on the NYSE (in billions)  | 24.7                                     | 22.1     | 74.6                                    | 71.3       | 11.8   | 4.6   |
| LAB dollar value on the NYSE (in billions)  | \$ 821.8                                 | \$ 636.3 | \$ 2,439.5                              | \$ 2,076.0 | 29.2   | 17.5  |
| Share volume of principal shares traded (in billions)                               | 4.6                                      | 4.9      | 14.6                                    | 16.8       | (6.1)  | (13.1)                                      |
| Dollar value of principal shares traded (in billions)                               | \$ 167.4                                 | \$ 148.6 | \$ 510.4                                | \$ 512.9   | 12.7   | (0.5)                                       |
| Average closing price of the CBOE Volatility Index                                  | 12.3                                     | 15.4     | 12.8                                    | 16.1       | (20.1)                                       | (20.5)                                      |
| Program trading as an approximate percentage of NYSE average daily share volume (1) | 55.9%                                    | 54.0%    | 56.8%                                   | 49.5%      | 1.9(2)                                       | 7.3(2)                                      |

(1) The program trading percentage is determined using the average of weekly percentages throughout the relevant time periods. Due to the weekly basis of our source data, the values indicated do not exactly coincide with our three and nine-month reporting periods.

(2) Change represents percentage points.



Generally, an increase in the average daily share volume on the NYSE, an increase in volatility (as measured by the average closing price of the Chicago Board of Options Exchange's Volatility Index®, or the VIX ), an increase in the dollar value and share volume

of stocks in which specialists trade, or a decline in the level of program trading enables the specialist to increase its level of principal trading participation and thus its ability to realize gains on principal transactions. While we monitor these metrics each period, they are not the sole indicators or factors that determine our level of revenues, profitability or overall performance in any given period. Other factors, such as extreme price movements, unanticipated listed company news and events and other uncertainties may influence our financial performance either positively or negatively.

#### **Three Months Ended September 30, 2005 versus September 30, 2004**

Net gain on principal transactions for the third quarter of 2005 increased as a result of strong performances by our equities, options and ETF specialist activities, and our options, futures and ETF market-making activities. The increase in the NYSE average daily share volume, along with increases in share volume and dollar value traded of our NYSE specialist stocks, provided our NYSE equity specialists with more opportunities to participate in trades as principal, which contributed to our increase in net gain on principal transactions. Partially mitigating these results were lower volatility and increased program trading. Net gain on principal transactions from our specialist and market-making activities also increased as a result of an increase in the number and diversity of derivative products we trade, as well as the size of our positions in these products.

Commission revenue during the third quarter of 2005 decreased as a result of a decrease in share volume of transactions with respect to which a specialist commission may be charged. Despite the increase in share volume on the NYSE and in our NYSE specialist stocks, there was an increase in program trading, which resulted in fewer opportunities to participate in block trades.

The increase in interest income was attributable primarily to an increase in interest income on our stock borrow transactions and higher interest income on short term investments. Stock-borrow rebate income was higher due primarily to increased stock borrow positions and higher interest rates during the 2005 third quarter, as compared to the 2004 third quarter. Interest income on our short-term investments increased due to higher interest rates during the three months ended September 30, 2005 as compared to the same period in 2004, as well as increases in excess cash balances.

#### **Nine Months Ended September 30, 2005 versus September 30, 2004**

The increase in our net gain on principal transactions is primarily due to an increase in revenues from our ETF, option and future specialist and market making revenues due to an increase in the number and diversity of derivative products we trade, as well as the size of our positions in these products. Partially offsetting these increases was a decrease in our equity specialist principal trading revenue for the nine months ended September 30, 2005 as compared to the same period in 2004, which was primarily attributable to reduced opportunities for our NYSE specialists to participate in trades as principal during the first quarter of 2005. These reduced opportunities were a reflection of lower volatility and higher levels of program trading.

Commission revenue during the nine months ended September 30, 2005 decreased as a result of a decrease in share volume of transactions with respect to which a specialist commission may be charged. Despite the increase in share volume on the NYSE and in our NYSE specialist stocks, there was an increase in program trading, which resulted in fewer opportunities to participate in block trades.

The increase in interest income was attributable primarily to an increase in interest income on our stock borrow transactions and higher interest income on short term investments. Stock-borrow rebate income was higher due primarily to increased stock borrow positions and higher interest rates during the nine months ended September 30, 2005, as compared to the same period in 2004. Interest income on our short term investments increased due to higher interest rates during the nine months ended September 30, 2005 as compared to the same period in 2004, as well as increases in excess cash balances.

For a discussion of operating expenses, see [Our Operating Expenses](#) below.

#### **Execution and Clearing Segment Operating Results**

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| (000 s omitted)                                | For the Three Months Ended September 30, |            | For the Nine Months Ended September 30, |            | Three Months 2005 vs. 2004 Percentage Change | Nine Months 2005 vs. 2004 Percentage Change |
|--|--|------------|---|------------|--|---|
|  | 2005                                     | 2004       | 2005                                    | 2004       |  |   |
| <b>Revenues:</b>                               |  |            |   |            |  |   |
| Commissions                                    | \$ 9,810                                 | \$ 10,452  | 32,411                                  | \$ 34,881  | (6.1)%                                       | (7.1)%                                      |
| Interest                                       | 212                                      | 133        | 535                                     | 340        | 59.4   | 57.4  |
| Other  | 13                                       | 9          | 76                                      | 184        | 44.4   | (58.7)                                      |
| Total segment revenues                         | 10,035                                   | 10,594     | 33,022                                  | 35,405     | (5.3)  | (6.7)                                       |
| <b>Exchange memberships impairment</b>         |  |            |   |            |  |   |
|  | —  | —          | —                                       | 2,027      | —  | (100.0)                                     |
| Operating expenses                             | 10,592                                   | 12,007     | 35,176                                  | 39,678     | (11.8)                                       | (11.3)                                      |
| <b>Loss before minority interest and taxes</b> |  |            |   |            |  |   |
|  | \$ (557)                                 | \$ (1,413) | (2,154)                                 | \$ (6,300) | 60.6   | 65.8  |

Our Execution and Clearing segment's commissions revenue includes fees charged to customers for execution, clearance and direct-access floor brokerage services and net gains from riskless principal transactions.

Our Execution and Clearing segment's interest consist of interest income earned on customer margin balances, short term U.S. Treasury Bill investments and stock-borrow transactions.

Other revenues consist primarily of realized trading errors.

**Three Months Ended September 30, 2005 versus September 30, 2004**

Commission revenues decreased as a result of a decline in direct-access floor broker order flow and reduced trade volume from clearance customers. This decline was partially

offset by an increase in revenues from our institutional execution group as a result of general growth and expansion of its customer base.

**Nine Months Ended September 30, 2005 versus September 30, 2004**

Commission revenues decreased as a result of a decline in direct-access floor broker order flow and reduced trade volume from clearance customers. This decline was partially offset by an increase in revenues from our institutional execution group as a result of general growth and expansion of its customer base.

For a discussion of operating expenses, see [Our Operating Expenses](#) below.

**Other Segment Operating Results**

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| (000 s omitted)                            | For the Three Months<br>Ended September 30, |             | For the Nine Months<br>Ended September 30, |             | Three Months<br>2005 vs. 2004<br>Percentage<br>Change | Nine Months<br>2005 vs. 2004<br>Percentage<br>Change |
|--|---|-------------|--|-------------|---|--|
|  | 2005  | 2004        | 2005                                       | 2004        |   |  |
| Interest                                   | \$ 885                                      | \$ 240      | \$ 2,108                                   | \$ 920      | 268.8%  | 129.1%   |
| Other revenue                              | 934   | 294         | 1,201                                      | 24,645      | 217.7   | (95.1)   |
| Total segment revenues                     | 1,819                                       | 534         | 3,309                                      | 25,565      | 240.6   | (87.1)   |
| Debt repurchase premium                    | —   | —           | —  | 49,028      | —   | (100.0)  |
| Operating expenses                         | 15,210                                      | 16,647      | 46,335                                     | 52,853      | (8.6)   | (12.3)   |
| Loss before minority interest<br>and taxes | \$ (13,391)                                 | \$ (16,113) | \$ (43,026)                                | \$ (76,316) | 16.9  | 43.6   |

The portion of our revenues that is not generated from our two principal business segments consists primarily of interest income earned on cash balances and net gains or losses from non-marketable investments.

**Three Months Ended September 30, 2005 versus September 30, 2004**

The increase in interest income is a reflection of higher interest rates and an increase in excess cash balances for the three months ended September 30, 2005 as compared to the same period in 2004.

Other revenue increased primarily as a result of the appreciation in the fair value of our non-marketable investments

For a discussion of operating expenses, see [Our Operating Expenses](#) below.

**Nine Months Ended September 30, 2005 versus September 30, 2004**

The increase in interest income is a reflection of higher interest rates and an increase in excess cash balances for the nine months ended September 30, 2005, as compared to the same period in 2004.

Other revenue decreased primarily as a result of the \$24.9 million appreciation in fair value of our investment in Lava during the second and third quarter of 2004. Partially offsetting this decrease was an increase in our short-term interest income for the nine months ended September 30, 2005 as compared to the same period in 2004, due to higher interest rates and excess cash balances.

**Our Operating Expenses**

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| (000 s omitted)  | For the Three Months Ended September 30, |                | For the Nine Months Ended September 30, |                | Three months                    | Nine months                     |
|--|--|----------------|---|----------------|---------------------------------|---------------------------------|
|  | 2005                                     | 2004           | 2005                                    | 2004           | 2005 vs. 2004 Percentage Change | 2005 vs. 2004 Percentage Change |
| <b>Expenses:</b>   |  |                |   |                |                                 |                                 |
| Employee compensation and related benefits               | \$ 25,747                                | \$ 21,985      | \$ 72,527                               | \$ 72,421      | 17.1%                           | 0.1%                            |
| Interest   | 23,285                                   | 16,006         | 58,649                                  | 47,700         | 45.5                            | 23.0                            |
| Exchange, clearing and brokerage fees                    | 10,559                                   | 10,101         | 30,445                                  | 28,684         | 4.5                             | 6.1                             |
| Lease of exchange memberships                            | 1,008                                    | 3,804          | 3,003                                   | 11,902         | (73.5)                          | (74.8)                          |
| Goodwill impairment                                      | —  | 37,600         | —                                       | 37,600         | (100.0)                         | (100.0)                         |
| Exchange memberships impairment                          | —  | —              | —                                       | 18,327         | —                               | (100.0)                         |
| Debt repurchase premium                                  | —  | —              | —                                       | 49,028         | —                               | (100.0)                         |
| Other  | 12,382                                   | 12,998         | 39,679                                  | 39,089         | (4.7)                           | 1.5                             |
| <b>Total expenses before minority interest and taxes</b> | <b>72,981</b>                            | <b>102,494</b> | <b>204,303</b>                          | <b>304,751</b> | <b>(28.8)</b>                   | <b>(33.0)</b>                   |
| Provision (benefit) for income taxes                     | \$ 1,592                                 | \$ (1,533)     | \$ 4,330                                | \$ (16,958)    | 203.8                           | 125.5                           |

Our Specialist segment's employee compensation and related benefits expense consists of salaries, wages and performance-based compensation paid to our traders and related support staff. The employee compensation and related benefits expense associated with our Execution and Clearing segment consists of salaries, wages and performance-based compensation paid to our execution and clearing professionals, as well as incentive-based compensation paid to various trading professionals, which is based on their earned commissions. Performance-based compensation may include cash compensation and stock-based compensation granted to managing directors, trading professionals and other employees based on our operating results.

Interest expense is attributable primarily to our outstanding 9.5% \$199.8 million aggregate principal amount of Senior Notes due 2009 and 11.0% \$260.0 million aggregate principal amount of Senior Notes due 2012. Interest expense at our Specialist segment consists mainly of margin interest on derivatives trading positions and interest on subordinated indebtedness. Customers' free credit balances, bank loans and stock loans generate interest expense at our Execution and Clearing segment.



Exchange, clearing and brokerage fees expense at our Specialist segment consists of fees paid by us to the NYSE, AMEX, other exchanges, the Depository Trust Clearing Corporation ( DTCC ) and third-party execution and clearing companies. These fees are based primarily on the volume of transactions executed by us as principal and as agent, a fee based on exchange seat use, an allocation fee requiring specialist firms to share the cost of newly-allocated listings, exchange access and usage fees, a flat annual fee and execution and clearing fees. Our Execution and Clearing segment's exchange, clearing and brokerage fees expense consists of floor brokerage fees paid to direct-access floor brokers and fees paid to various exchanges.

### **Three Months Ended September 30, 2005 versus September 30, 2004**

Employee compensation and related benefits expense increased primarily as a result of higher compensation at our Specialist segment, which is a result of improved revenues and operating results. Employee compensation expense at our Specialist segment also increased due to an increase in the number of specialists and professionals making markets in options, indexes and ETFs, which was partially offset by a reduction in the number of employees acting as specialists in cash equities. Employee compensation and related benefits expense decreased at our Execution and Clearing segment due to a reduction in headcount during the third quarter of 2005 as compared to the headcount during the third quarter of 2004.

The increase in interest expense for the third quarter of 2005 as compared to the same period in 2004 was due to the higher margin interest expense in our Specialist segment trading activities, which was the result of an increase in interest rates, as well as the size and number of our positions in our specialist and market making products.

While consolidated exchange, clearing and brokerage fees increased slightly for the three months ended September 30, 2005 as compared to the same period in 2004, there were material changes within the components of exchange, clearing and brokerage fees at our business segments quarter over quarter. The increase was primarily the result of higher commissions at our Specialist segment, which primarily is a reflection of the increased trading activity by our option, index and ETF specialists and professionals. Partially offsetting this increase were decreases in our Execution and Clearing subsidiary's floor brokerage expenses relating to direct-access commissions and decreases in our NYSE equity specialists fees due to lower allocation and exchange fees.

Lease of exchange memberships expense decreased due to lower average annual lease prices of our NYSE leased memberships for the third quarter of 2005 versus the 2004 comparable period. Average annual lease cost of an NYSE membership declined to approximately \$71,000 for the three months ended September 30, 2005 from \$233,000 for the 2004 comparable period. Additionally, we leased eleven fewer NYSE memberships as of September 30, 2005 than we did as of September 30, 2004.

### **Nine Months Ended September 30, 2005 versus September 30, 2004**

While consolidated employee compensation and related benefits expense increased only slightly for the nine months ended September 30, 2005 as compared to the same period in

2004, there were material changes within the components of employee compensation and related benefits expense at our Specialist segment period over period. Employee compensation and related benefits expense increased primarily as a result of higher compensation, resulting from improved revenues and operating results. Employee compensation and related benefits expense at our Specialist segment increased due to an increase in the number of specialists and professionals making markets in options, indexes and ETFs, which was partially offset by a reduction in the number of employees acting as specialist in cash equities. Employee compensation and related benefits expense decreased at our Execution and Clearing segment due to a reduction in headcount in the first nine months of 2005, as compared to the same period in 2004. Also contributing to the decrease was the expiration and payment of a retention bonus plan liability during the first quarter of 2004 and a decrease in deferred compensation expense, both related to a prior acquisition.

Interest expense increased for the nine months ended September 30, 2005 from the same period in 2004 mainly due to the increase in margin interest in the trading activities related to our option, index and ETF specialists and market making activities as a result of higher margin interest rates, coupled with an increase in the size of our positions in these products. Additionally, with the refinancing of our debt in May 2004, the first nine months of 2005 reflected the higher interest costs on our outstanding senior notes as compared to 2004. Partially offsetting these increases were charges we incurred during the second quarter of 2004 relating to the aforementioned refinancing of our debt. These charges included the acceleration of the debt issuance cost and discount accretion on the portion of the notes repurchased.

Exchange, clearing and brokerage fees expense increased for the nine months ending September 30, 2005 as compared to the same period in 2004 due to increased commission fees from increased trading activity from our option, index and ETF specialists and market makers. Partially offsetting these increases was a decline at our Execution and Clearing segment of floor brokerage expenses relating to direct-access commissions.

Lease of exchange memberships expense decreased due to the lower average annual lease prices of our NYSE leased memberships for the nine months ended September 30, 2005 versus the 2004 comparable period. The average annual lease cost of an NYSE membership declined to approximately \$70,000 for the nine months ended September 30, 2005 from \$235,000 for the 2004 comparable period. Additionally, we leased eleven fewer NYSE memberships as of September 30, 2005 than we did as of September 30, 2004.

## **Liquidity and Capital Resources**

### *Financial Overview*

Given the nature of our specialist, market-making, execution and clearing activities, certain line items on our balance sheet may fluctuate considerably from time to time. Our total assets at September 30, 2005 increased to \$3,760.3 million from \$2,055.1 million at December 31, 2004. The increase was primarily attributable to increases in receivable from brokers, dealers and clearing organizations, securities owned at market value, and cash and cash equivalents which were partially offset by decreases in deferred tax assets and cash segregated under federal regulations. Of our total assets at September 30, 2005, \$616.1 million consisted

of cash and short-term investments, primarily in government obligations maturing within three months, cash and securities segregated under federal regulations and overnight repurchase agreements. Our total capital base, which consists of long term obligations (inclusive of subordinated debt, other than those related to contributed exchange memberships) and total stockholders' equity, increased to \$1,209.3 million at September 30, 2005 from \$1,191.7 million at December 31, 2004. This change was mainly due to an increase in equity associated with higher additional paid-in capital and retained earnings, partially offset by a decrease in other subordinated indebtedness.

To date, we have financed our operations primarily with retained earnings from operations and proceeds from our debt and equity offerings. Due to the nature of the securities business and our role as a specialist, market-maker and execution and clearing agent, the amount of our cash and short-term investments, as well as operating cash flow, may vary considerably from period to period due to a number of factors, including but not limited to the dollar value of our positions as principal, whether we are net buyers or sellers of securities, the dollar volume of executions by our customers and clearing house requirements. Certain regulatory requirements constrain the use of a portion of our liquid assets for financing, investing or operating activities. Similarly, the nature of our business lines, the capital necessary to maintain current operations and our current funding needs subject our cash and cash equivalents to different requirements and uses.

#### *Capital Resources*

Our outstanding senior notes were issued pursuant to an indenture, which includes certain covenants that, among other things, limit our ability to make certain investments, engage in transactions with stockholders and affiliates, create liens on our assets and sell assets or engage in mergers and consolidations, except in accordance with certain specified conditions. In addition, our ability to take certain actions, including incurring additional indebtedness (other than certain permitted indebtedness), or making certain restricted payments (such as paying dividends, redeeming stock or repurchasing subordinated indebtedness prior to maturity), is limited if our consolidated fixed charge coverage ratio calculated on a trailing four-quarter basis is at or below a threshold of 2.00:1. The consolidated fixed charge coverage ratio reflects a comparison between (1) our consolidated earnings before interest, taxes, depreciation and amortization expenses, or EBITDA, and (2) the sum of our consolidated interest expense and a tax-effected multiple of any dividend payments that we might make with respect to preferred stock. As of September 30, 2005, our consolidated fixed charge coverage ratio was approximately 1.90:1, thereby limiting our ability to make these restricted payments. Under the indenture, however, we are permitted to make restricted payments of up to an aggregate amount of \$15.0 million over the life of the indenture, regardless of our consolidated fixed charge coverage ratio or the amount of our cumulative consolidated net income since July 1, 2004.

In addition, under the indenture governing our outstanding senior notes, even if our consolidated fixed charge coverage ratio is 2.00:1 or greater, we cannot make any such restricted payments if doing so will cause our cumulative restricted payments since May 18, 2004 to be greater than the sum of (A) 50.0% of our cumulative consolidated net income since July 1, 2004 (or, if such calculation is a loss, minus 100.0% of such loss) and (B) 100.0%

of the net cash proceeds received from any issuance or sale of our capital stock since July 1, 2004 and certain other amounts. In the event this restriction were to limit us from making restricted payments in the future, we also would be entitled to make such payments up to an aggregate of \$15.0 million over the life of the indenture, as described above. Although we have not made any restricted payments since May 18, 2004, we cannot be sure if, when or to what extent the covenants in the indenture will prevent us from making restricted payments higher than \$15.0 million in the future.

The indenture also permits us to redeem some or all of the Senior Notes due 2009 on or after May 15, 2007 and some or all of the Senior Notes due 2012 on or after May 15, 2008 at varying redemption prices, depending on the date of redemption. In addition, we have the option to redeem up to 33.0% of the aggregate principal amount of the Senior Notes due 2009 at a redemption price of 109.5% and up to 33.0% of the aggregate principal amount of the Senior Notes due 2012 at a redemption price of 111.0% using the proceeds of certain equity offerings which we may complete on or prior to May 15, 2007. We have no current intention of conducting any such equity offerings. Under the terms of the indenture, if we sell substantially all our assets or experience specific kinds of changes in control, we will be required to offer to repurchase our outstanding senior notes, on a pro rata basis, at a price in cash equal to 101.0% of their principal amount, plus accrued and unpaid interest, if any, to the date of purchase.

In connection with the sale of our interest in Lava as part of an acquisition of Lava in August 2004, we received cash of approximately \$39.0 million at the closing. Additional consideration of approximately \$9.6 million was deposited in escrow to secure our indemnification obligations as a selling stockholder of Lava until November 2, 2005. Under the terms of the indenture governing our outstanding senior notes, on the 361<sup>st</sup> day following the closing of the Lava acquisition, we were required to offer to purchase outstanding senior notes in an aggregate principal amount equal to such after-tax proceeds of the sale of our interest in Lava in August 2004, at a price equal to 100.0% of the principal amount of such outstanding senior notes. Therefore, on July 29, 2005, we commenced an offer to purchase outstanding senior notes in the aggregate principal amount of up to approximately \$18.2 million. This excess proceeds offer expired on August 25, 2005, with \$63,000 principal amount having been tendered. Following the closing of this transaction, approximately \$199.8 aggregate principal amount of our Senior Notes due 2009 remained outstanding and approximately \$260.0 aggregate principal amount of our Senior Notes due 2012 remained outstanding.

On October 31, 2005, the escrow fund in connection with the Lava transaction was terminated and we received approximately \$9.6 million as additional consideration in connection with the Lava transaction. Therefore, under the indenture governing the outstanding senior notes we will again be required to offer to purchase outstanding senior notes in an aggregate principal amount equal to the after-tax proceeds of this \$9.6 million on or prior to the 361<sup>st</sup> day following October 31, 2005.

We also have outstanding \$13.6 million aggregate principal amount of 12.0% senior subordinated notes due 2007 (the 2007 Notes ) that were not tendered for repurchase in

connection with our May 2004 debt refinancing. Until their maturity on March 2, 2007, the 2007 Notes will continue to accrue interest at a rate of 12.0% per annum.

As of September 30, 2005, the subordinated indebtedness of LaBranche & Co. LLC (excluding subordinated liabilities related to contributed exchange memberships) aggregated \$12.4 million. This subordinated debt is comprised of senior subordinated notes and junior subordinated notes, which mature on various dates between August 2006 and June 2008 and bear interest at annual rates ranging from 7.7% to 10.0%. The senior subordinated notes were originally issued in the aggregate principal amount of \$15.0 million, and, in accordance with their terms, \$3.0 million in principal amount must be repaid on June 3 of each of 2004, 2005, 2006, 2007 and 2008. On June 3, 2005, LaBranche & Co. LLC repaid \$3.0 million principal amount of this senior subordinated indebtedness, plus accrued interest, thus leaving \$9.0 million principal amount of this senior subordinated indebtedness outstanding. LaBranche & Co. LLC may prepay, at a premium, all or any part of these remaining senior subordinated notes at any time, provided that the amount prepaid is not less than 5.0% of the aggregate principal amount of such senior subordinated notes then outstanding. Upon the occurrence of a change of control, LaBranche & Co. LLC may, but is not required to, make one irrevocable separate offer to each holder of the senior subordinated notes to prepay all the senior subordinated notes then held by that holder. The occurrence of a change of control also constitutes an event of acceleration under the senior subordinated notes. The junior subordinated notes, which aggregate \$3.4 million principal amount, have an automatic rollover provision, which extends the maturity for an additional year, unless the lender provides at least seven months advance notice of its intention not to renew at maturity. LaBranche & Co. LLC is entitled to prepay with written consent from the NYSE the junior subordinated notes without penalty under the terms of the agreements relating thereto.

As of September 30, 2005, \$8.0 million of our outstanding indebtedness consisted of eight separate notes, each in the principal amount of \$1.0 million, which mature in August 2007 and bear interest at an annual rate of 9.0%.

A potential source of liquidity for LaBranche & Co. LLC is the committed line of credit that it maintains with a bank. In October 2005, LaBranche & Co. LLC extended this \$200.0 million committed credit agreement to October 27, 2006 on the same terms and conditions as the expiring agreement. In connection with the credit agreement, we pay annual fee of 0.25% of the total committed line of credit. Amounts outstanding under this credit facility would be secured by our inventory of specialist stocks and bear interest at the bank's broker loan rate. This facility can only be used to finance inventory requirements at LaBranche & Co. LLC. To date, we have not utilized this facility. In order to maintain the availability of funds under this credit facility, we must comply with certain financial and other covenants.

#### *Regulated Subsidiaries*

As a specialist and market-maker, we are required to maintain certain levels of capital and liquid assets as promulgated by various regulatory agencies, which regulate our business. As part of our overall risk management procedures (for further discussion, refer to Part I, Item 3.

Quantitative and Qualitative Disclosures about Market Risk ), we balance our responsibility as specialist, market-maker and broker-dealer with our overall capital resources.

These requirements may restrict our ability to make use of cash and other liquid assets for corporate actions, such as repaying our debt, repurchasing stock or making acquisitions.

As a broker-dealer, LaBranche & Co. LLC is 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. LaBranche & Co. LLC is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. NYSE Rule 326(c) also prohibits a broker-dealer from repaying subordinated borrowings, paying cash dividends, making loans to any parent, affiliates or employees or otherwise entering into transactions which would result in a reduction of its total net capital to less than 150.0% of its required minimum capital. Moreover, broker-dealers are required to notify the SEC prior to repaying subordinated borrowings, paying dividends and making loans to any parent, 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 SEC has the ability to prohibit or restrict such transactions if the result is deemed detrimental to the financial integrity of the broker-dealer. As of September 30, 2005, LaBranche & Co. LLC's net capital, as defined, was \$463.2 million, which exceeded the minimum requirements by \$461.9 million.

The NYSE generally requires its specialist firms to maintain a minimum dollar regulatory capital amount in order to establish that they can meet, with their own net liquid assets, their position requirement. As of September 30, 2005, LaBranche & Co. LLC's and LSPS's minimum required combined dollar amount of net liquid assets, as defined, was \$447.0 million. LaBranche & Co. LLC's actual net liquid assets, as defined, were \$459.0 million as of September 30, 2005. As of September 30, 2005, since LaBranche & Co. LLC's actual net liquid assets exceeded the combined net liquid assets requirement of LaBranche & Co. LLC and LSPS, both LaBranche & Co. LLC and LSPS satisfied their respective net liquid asset requirements. In addition, as of September 30, 2005, LaBranche & Co. Inc. had an additional \$121.0 million invested in overnight repurchase agreements, which is not subject to regulatory capital requirements.

On May 26, 2005, the NYSE filed with the SEC a proposal to establish a new method of calculating its net liquid asset requirements for specialists such as LaBranche & Co. LLC. Current rules, based partly on classes of allocated securities, would be replaced by a focus on market risk, volatility and market share. Although the proposed new rule would likely reduce LaBranche & Co. LLC's net liquid asset requirement, the extent of any such reduction has not been finally determined. A reduction in LaBranche & Co. LLC's net liquid asset requirement would be phased in over a nine-month period in four tranches and would allow funds no longer needed for purposes of satisfying the net liquid asset requirement to be used for other corporate purposes.

The AMEX generally requires its equities specialist firms to maintain a cash or liquid asset position of the greater of (a) \$1.0 million or (b) an amount sufficient to assume a position of sixty trading units of each security in which the specialist is registered. As of September 30, 2005, LaBranche & Co. LLC satisfied the AMEX equities specialist liquid asset requirements.

As a registered broker-dealer and member firm of the NYSE, LFSI also is subject to SEC Rule 15c3-1, as adopted and administered by the NYSE and the SEC. Under the alternative method permitted by the rule, the minimum required net capital of LFSI as of September 30, 2005 was equal to the greater of \$1.5 million or 2.0% of aggregate debit items, as defined. As of September 30, 2005, LFSI's net capital, as defined, was \$8.2 million, which exceeded its minimum net capital requirement by \$6.7 million.

As a clearing broker-dealer, LFSI is subject to SEC Rule 15c3-3, as adopted and administered by the SEC. As of October 4, 2005, to comply with its September 30, 2005 requirement, cash and U.S. Treasury Bills in the amount of \$2.0 million were segregated in a special reserve account for the exclusive benefit of customers exceeding the actual requirements by \$2.0 million. In addition, the Proprietary Accounts of Introducing Brokers ( PAIB ) calculation is computed in order for correspondent firms to classify their assets held by LFSI as allowable assets in the correspondents' net capital calculation. As of October 4, 2005, to comply with LFSI's September 30, 2005 requirement, cash and U.S. Treasury Bills in the amount of \$5.2 million were segregated in a special reserve account for the exclusive benefit of customers, thus exceeding actual requirements by \$1.2 million.

As a registered broker-dealer and AMEX member firm, LSP is subject to SEC Rule 15c3-1, as adopted and administered by the AMEX and the SEC. LSP is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. As of September 30, 2005, LSP's net capital, as defined, was \$45.9 million, which exceeded its minimum net capital requirement by \$45.4 million.

As a specialist and member of the NYSE, LSPS is subject to the provisions of SEC Rule 15c3-1, as adopted and administered by the SEC and NYSE. LSPS is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. As of September 30, 2005, LSPS' net capital, as defined under SEC Rule 15c3-1, was \$3.9 million, which exceeded the minimum requirement by \$3.7 million.

Failure by any of our broker-dealer subsidiaries to maintain its required net capital and net liquid assets, where applicable, may subject it to suspension or revocation of its SEC registration or its suspension or expulsion by the NYSE, the AMEX and/or any other exchange of which it is a member firm.

As evidenced by the foregoing requirements, our broker-dealer subsidiaries require a substantial amount of capital. In particular, LaBranche & Co. LLC's and LSPS' combined net liquid asset requirement of \$447.0 million limits our ability to utilize a substantial portion of our liquid assets for other corporate purposes. Although a portion of the combined net liquid asset requirement of \$447.0 million is met by LaBranche & Co. LLC's and LSPS' securities positions, pending trades and other assets associated with its equities, options, futures and ETF specialist activities, a substantial portion of LaBranche & Co. LLC's cash and cash equivalents as of September 30, 2005 was used to meet their combined net liquid asset requirement.

*Other Contractual Obligations*

In connection with our acquisition of ROBB PECK McCOOEY Financial Services, Inc. ( RPM ) in March 2001, we assumed its liabilities and obligations under its deferred compensation plan. The deferred compensation plan provides for the payment, on or before December 15, 2007, of approximately \$30.2 million, plus interest at a rate of 8.0% per year, to certain former employees of RPM. While the payment of benefits under this deferred compensation plan may be accelerated in certain circumstances, no more than \$6.0 million in deferred compensation benefits (including interest) may be paid in any 12 consecutive month period beginning March 15, 2001. After taking into account all payments of deferred compensation plan benefits through September 30, 2005, approximately \$14.4 million, including interest, remains payable under the RPM deferred compensation plan. Our board of directors is entitled to terminate the deferred compensation plan at any time. Upon any such termination, the deferred compensation benefits (including interest) of all participants in the plan to the extent not previously paid must be distributed immediately to the participants in one lump sum.

*Cash Flows*

Our cash and cash equivalents during the nine-month period ended September 30, 2005 increased \$44.7 million to \$489.1 million. The increase was the result of (a) \$53.0 million provided by our operating activities primarily from increases in cash flow from operations, our securities sold, but not yet purchased, partially offset by decreases in receivable from brokers, dealers and clearing organizations, deferred tax assets and securities owned, at market value; (b) \$1.0 million used in investing activities for capital expenditures and purchases of exchange memberships; and (c) \$7.3 million used in financing activities primarily from payments on short term debt and subordinated debt.

We currently anticipate that we will be able to meet our working capital, regulatory capital and capital expenditure requirements through at least the next twelve months.

**Credit Ratings**

Following our May 2004 debt refinancing, \$13.6 million aggregate principal amount of our 2007 Notes remain outstanding. These 2007 Notes are publicly held but are no longer rated. The following table sets forth the credit ratings on our Senior Notes due 2009 and our Senior Notes due 2012 as of September 30, 2005:

|                       | Moody's<br>Investors Service | Standard &<br>Poor's |
|-----------------------|------------------------------|----------------------|
| Senior Notes due 2009 | Ba2                          | B                    |
| Senior Notes due 2012 | Ba2                          | B                    |



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

Because our equity specialist activities on the NYSE and AMEX expose our capital to significant risks, managing these risks is a constant priority for us. Our central role in the auction process helps us to manage risks by incorporating up-to-date market information in the management of our inventory, subject to our specialist obligations. We have developed a risk management process that is designed to balance our ability to profit from our specialist activities with our exposure to potential losses.

*Compliance Risk*

LaBranche & Co. LLC's risk management process includes participation by our corporate compliance committee, executive operating committee, floor management committee, post managers, floor captains and specialists. These parties' roles are as follows:

*Corporate Compliance Committee.* Our corporate compliance committee was established in February 2002 and consists of representatives from executive and senior management, compliance personnel, including our on-floor compliance officer, our general counsel and several additional senior floor specialists, known as post managers. The role of the corporate compliance committee is to implement, monitor and report to senior management on the statutory and regulatory compliance efforts of our specialist business. The corporate compliance committee also establishes, reviews and revises policies and procedures governing LaBranche & Co. LLC's regulatory compliance structure.

*Executive Operating Committee.* Our executive operating committee is composed of two executive officers of LaBranche & Co. LLC. This committee is responsible for approving all risk management procedures and trading guidelines for our specialist stocks, after receiving recommendations from our floor management committee. In addition, our executive operating committee reviews all unusual situations reported to it by our floor management committee.

*Floor Management Committee.* Our floor management committee is composed of six post managers. This committee is responsible for formulating and overseeing our overall risk management procedures and trading guidelines for each of our specialist stocks. In determining these procedures and guidelines, our floor management committee considers the recommendations of our floor captains. Our post managers meet with their respective floor captains on a weekly basis to review and, if necessary, revise the risk management procedures and trading guidelines for LaBranche & Co. LLC and/or for particular specialist stocks. In addition, post managers are always available on the trading floor to review and assist with any unusual trading situations reported by any floor captain. Our floor management committee reports to our executive operating committee about each of these unusual trading situations as they occur.

*Floor Captains.* We have thirteen floor captains who monitor the activities of LaBranche & Co. LLC's specialists throughout the trading day from various positions at their trading posts. The floor captains observe trades and constantly review trading activities on a real-time basis. In addition, the floor captains are readily available to assist LaBranche & Co. LLC's specialists in determining when to deviate from our procedures and guidelines in reacting to any unusual situations or market conditions. The floor captains report these unusual situations and any deviations from our procedures and guidelines to their respective post managers. Floor captains meet with each specialist at least once a week to evaluate each specialist's adherence to our risk management procedures and trading guidelines. Floor



captains also meet to review risk procedures and guidelines and, if appropriate, make recommendations to the floor management committee.

*Specialists.* LaBranche & Co. LLC's specialists conduct auctions of our specialist stocks based on the conditions of the marketplace. In doing so, specialists observe our risk management procedures and trading guidelines in tandem with their responsibility to create and maintain a fair and orderly market. Specialists immediately notify a floor captain of any unusual situations or market conditions requiring a deviation from our procedures and guidelines.

We believe that the enhancements we have made to our compliance procedures and guidelines in connection with the undertakings set forth in the March 2004 settlement of the SEC and NYSE investigation of our specialist trading activities have improved our risk management process.

Our equities specialist operations on the AMEX are conducted by various equity specialists. Our post manager(s) on the AMEX monitor the trading activities of the AMEX equity specialists by observing trades and reviewing positions on a real-time basis. As members of the floor management committee, post managers regularly communicate with other members of the floor management committee regarding any deviations from the AMEX procedures and guidelines established by LaBranche & Co. LLC's executive operating committee.

*Circuit Breaker Rules.* The NYSE and AMEX have certain circuit breaker rules intended to halt trading in all NYSE/AMEX listed stocks in the event of a severe market decline. The circuit breaker rules impose temporary halts in trading when the Dow Jones Industrial Average drops a certain number of points. Current circuit breaker levels are set quarterly at 10, 20 and 30 percent of the Dow Jones Industrial Average closing values of the previous month, rounded to the nearest 50 points. These rules provide investors extra time to respond to severe market declines and provide us an additional opportunity to assure compliance with our risk management procedures.

#### *Equity Market Risk*

We have developed a risk management process, which is intended to balance our ability to profit from our equity specialist activities with our exposure to potential losses. We have invested substantial capital, along with the NYSE, in real-time, on-line systems which give our management instant access to specific trading information at any time during the trading day, including our aggregate long and short positions and our capital and profit-and-loss information on an aggregate or per issue basis. Subject to the specialist's obligation to maintain a fair and orderly market and to applicable regulatory requirements, we constantly seek to manage our trading positions relative to existing market conditions.

A high concentration of LaBranche & Co. LLC's principal trading revenue is generated from its ten and twenty-five most profitable NYSE specialist stocks. The percentage of LaBranche & Co. LLC's cash equity specialist trading revenue generated from its ten most profitable specialist stocks has decreased from 17.5% to 16.7% of total principal trading

revenue for the nine months ended September 30, 2004 and 2005, respectively. The percentage of LaBranche & Co. LLC's cash equity specialist trading revenue generated from its twenty-five most profitable specialist stocks has also decreased from 35.0% to 32.0% of total principal trading revenue for the nine months ended September 30, 2004 and 2005, respectively. LaBranche & Co. LLC is not overly reliant on a particular group of specialist stocks, as the composition of its ten and twenty-five most profitable specialist stocks changes frequently.

Our cash equity specialist trading activities are subject to a number of risks, including risks of price fluctuations, rapid changes in the liquidity of markets and foreign exchange risk related to American Depositary Receipts ( ADRs ). In any period, we may incur trading losses in our specialist stocks for a variety of reasons, including price fluctuations of our specialist stocks and carrying out our specialist obligations. From time to time, we may have large position concentrations in securities of a single issuer or issuers engaged in a specific industry. In general, because our inventory of securities is marked-to-market on a daily basis, any significant price movement in these securities could result in a reduction of our revenues and operating profits.

#### *Derivatives Market Risk*

As a specialist in options, ETFs and futures, LSP has a responsibility to maintain a fair and orderly market, and trades securities as principal out of both obligation and inclination. LSP's options, ETFs, futures, fixed income instruments and foreign currency trading exposes it to certain risks, such as price and interest rate fluctuations, volatility risk, credit risk, foreign currency movements and changes in the liquidity of markets. LSP maintains a market-making capacity in options, ETFs and futures and trades as principal out of inclination. In its market-making function, LSP brings immediacy and liquidity to the markets when it chooses to participate. LSP's market-making activities expose it to certain risks including, but not limited to, price fluctuations and volatility.

As a specialist in ETFs on the NYSE, LSPS is responsible for maintaining a fair and orderly market and trades ETFs as principal out of both obligation and inclination. LSPS' ETF trading exposes it to certain risks, including price fluctuations, foreign currency movements and changes in the liquidity of markets.

Certain members of LSP's and LSPS' management are responsible for managing these risks. These individuals utilize a third-party software application to monitor LSP's and LSPS' positions on a real-time basis. By monitoring actual and theoretical profit and loss, volatility and other standard risk measures, these individuals seek to assure that all LSP and LSPS traders operate within the parameters set by management. LSP's and LSPS' traders purchase and sell futures, options, the stocks underlying certain positions, fixed income instruments and foreign currencies in an attempt to hedge market and foreign currency risk. LSP's and LSPS' aggregate risk is under constant evaluation by certain members of management and its traders, and all significant trading strategies and positions are closely monitored. LSP's and LSPS' options, futures and ETF trading is executed on national and foreign exchanges. These trades clear through the Options Clearing Corporation, the National Securities Clearing Corporation or the applicable exchange clearing organization, thereby reducing potential credit risk.

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The following chart illustrates how specified movements in the underlying securities prices of LSP's and LSPS' entire portfolios would have impacted profits and losses from their trading activities:

| (000's omitted)         | Profit or (Loss) if the underlying securities move: |           |         |           |           |
|-------------------------|---|-----------|---------|-----------|-----------|
|                         | -15.0%  | -5.0%     | 0%      | +5.0%     | +15.0%    |
| <b>Portfolio as of:</b> |   |           |         |           |           |
| March 31, 2005          | \$ (10,167)   | \$ 8,609  | \$ (20) | \$ 6,028  | \$ 15,930 |
| June 30, 2005           | \$ (20,676)   | \$ 13,324 | \$ (75) | \$ 21,513 | \$ 53,516 |
| September 30, 2005      | \$ (4,996)  | \$ 840    | \$ (28) | \$ 2,125  | \$ 4,318  |

The information in the above table is based on certain theoretical assumptions, and thus does not fully represent the profit or loss exposure to certain market conditions, including, but not limited to, changes in volatility, interest rates and dividends. Other risk models may yield different results. The zero percent change column represents the profit or loss LSP and LSPS would experience on a daily basis if the relevant market remained unchanged.

### *Foreign Currency Risk*

In connection with LaBranche & Co. LLC's trading of U.S.-registered shares of foreign issuers, it is exposed to varying degrees of foreign currency risk. The pricing of these securities is based on the value of the ordinary securities as denominated in their local currencies. Thus, a change in a foreign currency rate relative to the U.S. dollar will result in a change in the value of U.S.-registered shares in which LaBranche & Co. LLC acts as the specialist.

LSP and LSPS trade international ETFs that are denominated and settled in U.S. dollars, but the pricing of these ETFs is also affected by changes in the relevant foreign currency rates. LSP and LSPS hold various foreign currencies in order to lessen the risks posed by changing foreign currency rates. In addition, LSP and LSPS trade derivatives denominated in foreign currencies, which creates exposure to foreign currency risk for these entities.

The following chart illustrates how the specified movements in foreign currencies relative to the U.S. dollar to which LSP, LSPS and LaBranche & Co. LLC are exposed would have impacted profits and losses from their trading activities:

| (000's omitted)         | Profit or (Loss) if the foreign currencies relative to the U.S. dollar move: |          |          |            |
|-------------------------|--|----------|----------|------------|
|                         | -15.0%   | -5.0%    | +5.0%    | +15.0%     |
| <b>Portfolio as of:</b> |  |          |          |            |
| March 31, 2005          | \$ (1,487)   | \$ (496) | \$ 496   | \$ 1,487   |
| June 30, 2005           | \$ (532)   | \$ (177) | \$ 177   | \$ 532     |
| September 30, 2005      | \$ 2,296   | \$ 765   | \$ (765) | \$ (2,296) |

The information in the above table is based on certain assumptions and it does not fully represent the profit and loss exposure to changes in security prices, volatility, interest rates and other related factors.



*Execution and Clearing Risk*

In connection with their specialist and market-making activities, LaBranche & Co. LLC, LSP and LSPS are engaged in various securities trading and lending activities and assume positions in stocks, rights, options, ETFs, fixed income instruments, futures and foreign currencies for which they are exposed to credit risk associated with the nonperformance of counterparties in fulfilling their contractual obligations pursuant to these securities transactions. LaBranche & Co. LLC, LSP and LSPS are also exposed to market risk associated with the sale of securities not yet purchased, which can be directly impacted by volatile trading on the NYSE, AMEX and other exchanges. Additionally, in the event of nonperformance and unfavorable market price movements, LaBranche & Co. LLC, LSP and LSPS may be required to purchase or sell financial instruments at a loss.

LFSI's execution and clearing activities require that LFSI execute transactions in accordance with customer instructions and accurately record and process the resulting transactions. Any failure, delay or error in executing, recording and processing transactions, whether due to human error or failure of LFSI's information or communication systems, could cause substantial losses for brokers, customers and/or LFSI and could subject LFSI to claims for losses.

Clearing activities include settling each transaction with both the contra broker and the customer. In connection with LFSI's institutional and direct access floor brokerage activities, a transaction is settled either when the customer pays for securities purchased and takes delivery, or delivers securities sold for payment. Settling transactions for retail customers and professional investors involves financing the transaction until the customer makes payment or, for margin accounts, advancing credit to the customer within regulatory and internal guidelines. Clearing direct access brokers' transactions includes guaranteeing their transactions to the contra broker on the exchange floor.

These clearing activities may expose LFSI to off-balance sheet risk in the event customers or brokers are unable to fulfill their contractual obligations and it is necessary to purchase or sell securities at a loss. For margin transactions, LFSI may be exposed to off-balance sheet risk in the event margin requirements are not sufficient to fully cover losses that customers may incur in their accounts.

The amount of risk related to LFSI's execution and clearance activities is linked to the size of the transaction, market volatility and the creditworthiness of customers and brokers. LFSI's largest transactions involve those for institutional and direct access floor brokerage customers.

LFSI systematically monitors its open transaction risk starting when the transaction occurs and continuing until the designated settlement date. Transactions that remain unsettled after settlement date are scrutinized and necessary action to reduce LFSI's risk is taken. Credit risk that could result from contra brokers defaulting is minimized since much of the settlement risk for transactions with brokers is essentially transferred to the National Stock Clearing Corporation. The credit risk associated with institutional and direct access clearing customers is minimized since these customers have been qualified by the Depository Trust Company

( DTC ) or the DTC participants or have met the prime broker qualification standards at other brokerage firms. Before conducting business with a prospective customer, LFSI's senior management, in conjunction with its compliance department, reviews the prospective customer's experience in the securities industry, financial condition and personal background, including a background check with a risk reporting agency. For retail customers and professional investors, LFSI seeks to control the risks associated with customer activities by requiring customers to maintain margin collateral in compliance with various regulatory and internal guidelines. LFSI monitors margin levels daily pursuant to such guidelines and requires customers to deposit additional collateral or reduce positions when necessary.

#### *Operational Risk*

Operational risk relates to the risk of loss from external events, and from failures in internal processes or information systems. In each of our business segments, we rely heavily on our information systems in managing our risk. Accordingly, working in conjunction with the NYSE, we have made significant investments in our trade processing and execution systems. Our use of, and dependence on, technology has allowed us to sustain our growth over the past several years. Management members and floor captains at our NYSE and AMEX operations must constantly monitor our positions and transactions in order to mitigate our risks and identify troublesome trends should they occur. The substantial capital we have invested, along with the NYSE, in real-time, on-line systems affords management instant access to specific trading information at any time during the trading day, including:

our aggregate long and short positions;

the various positions of each of our trading professionals;

our overall position in a particular stock; and

capital and profit-and-loss information on an aggregate, per specialist or per issue basis.

Our information systems send and receive data from the NYSE and AMEX through dedicated data feeds. The NYSE supplies us with specialist position reporting system terminals both on the trading floor and in our offices. These terminals allow us to monitor our NYSE trading profits and losses, as well as our positions. For our AMEX equity operations, our in-house technology staff has developed applications to monitor our current positions and profits and losses. Our derivative trading operation utilizes a third-party software application to monitor its positions and profits and losses on a real-time basis.

We have developed, implemented and maintain a business continuity plan, which includes a comprehensive disaster recovery plan. We have back-up disaster recovery centers in New York and New Jersey.





*Legal and Regulatory Risk*

Substantial legal liability or a significant regulatory action against us could have a material adverse effect on our financial condition or cause significant harm to our reputation, which in turn could negatively affect our business prospects.

As registered broker-dealers, LaBranche & Co. LLC, LFSI, LSP and LSPS are subject to certain regulatory requirements intended to insure their general financial soundness and liquidity. These subsidiaries are subject to SEC Rules 15c3-1, 15c3-3 and other requirements adopted and administered by both the NYSE and AMEX.

The USA PATRIOT Act of 2001 requires U.S. financial institutions, including banks, broker-dealers, futures commission merchants and investment companies, to implement policies, procedures and controls which are reasonably designed to detect and report instances of money laundering and the financing of terrorism. We actively monitor and update our anti-money laundering practices.

**Item 4. Controls and Procedures**

As of the end of the period covered by this report, an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) was performed under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that these disclosure controls and procedures were effective as of the end of the period covered by this report. In addition, no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings

There have been no material new developments in our legal proceedings since the filing of our Form 10-Q for the quarter ended June 30, 2005, filed August 9, 2005 (the Second Quarter 10-Q ), which updated the legal proceedings disclosed in our 2004 10-K and the Company's Form 10-Q for the quarter ended March 31, 2005, filed May 10, 2005 (the First Quarter 10-Q ), except as follows:

Last Atlantis/Rule/Martin. On October 4, 2005, the court in the Last Atlantis action granted the plaintiffs' motion for leave to file a second amended complaint and to join Bryan Rule and River North Investors LLC as plaintiffs. On October 5, 2005, the second amended complaint was filed.

On September 28, 2005, Bryan Rule and River North Investors LLC, who, as stated above, now are plaintiffs in the Last Atlantis action, commenced an action in the United States District Court for the Northern District of Illinois, Rule et al. v. Chicago Board Options Exchange, Inc., et al., No. 05 C 5600. The complaint in this action is substantially similar to the second amended complaint in the Last Atlantis action, making substantially the same allegations and seeking the same relief against the same defendants, including LaBranche & Co Inc. and LSP, except that the complaint in this action also asserts a federal antitrust law claim (Section 1 of the Sherman Act).

On September 30, 2005, Brad Martin commenced an action in the United States District Court for the Northern District of Illinois, Martin v. Chicago Board Options Exchange, Inc., et al., No. 05 C 5671. The complaint in this action is substantially similar to the second amended complaint in the Last Atlantis action and the complaint in the Rule action, making substantially the same allegations and seeking the same relief against the same defendants, including us and LSP, except that the complaint in this action, like the complaint in the Rule action, also asserts a federal antitrust law claim (Section 1 of the Sherman Act). To our knowledge, neither we nor LSP has been served with the complaint in this action.

EEOC Claim. On September 27, 2005, the Equal Employment Opportunity Commission (the EEOC ) commenced an action in the United States District Court for the Southern District of New York, EEOC v. LaBranche & Co Inc., No. 05 CV 8304, on behalf of a former employee of LaBranche. The complaint in this action alleges that we harassed and discriminated against the employee on the basis of a disability, retaliated against him for complaining about the alleged harassment and constructively discharged him. The complaint seeks injunctive relief and monetary damages, including reinstatement, back pay and front pay.

We believe that the claims asserted against us by the plaintiffs in the pending proceedings described in the 2004 10-K, the First Quarter 10-Q, the Second Quarter 10-Q and above are without merit, and we deny all allegations of wrongdoing. There can be no assurance, however, as to the outcome or timing of the resolution of these proceedings. We therefore are unable to estimate the amount or potential range of any loss that may arise out of



these proceedings. The range of possible resolutions could include determinations and judgments against us or settlements that could require substantial payments by us that could have a material adverse effect on our financial condition, results of operations and cash flows.

In addition to the proceedings described in the 2004 10-K, the First Quarter 10-Q, the Second Quarter 10-Q and above, we and our operating subsidiaries have been the target, from time to time, of various claims, lawsuits and regulatory inquiries in the ordinary course of our and their respective businesses. While the ultimate outcome of those claims and lawsuits which currently are pending cannot be predicted with certainty, we believe, based on our understanding of the facts of these proceedings, that their ultimate resolution will not, in the aggregate, have a material adverse effect on our financial condition, results of operations or cash flows.

#### **Item 5. Other Information.**

*Effective September 15, 2005, Todd A. Graber, our Principal Accounting Officer, resigned. Jeffrey M. Chertoff, our Senior Vice President and Chief Financial Officer, and our Principal Financial Officer, succeeded Mr. Graber as our Principal Accounting Officer. The information required by Items 401(b), (d) and (e) and 404(a) of Regulation S-K with respect to Mr. Chertoff was disclosed in Items 1.01 and 5.02 of our Current Report on Form 8-K filed with the Securities and Exchange Commission on July 7, 2005, which is incorporated herein by reference thereto.*

*We have included in this Form 10-Q filing, and from time to time our management may make, statements which may constitute forward-looking statements within the meaning of the safe harbor provisions of The Private Securities Litigation Reform Act of 1995. Our quarterly and annual operating results are affected by a wide variety of factors that could materially and adversely affect actual results, including a decrease in trading volume on the NYSE or the AMEX, excessive volatility in the equity securities market and changes in the value of our securities positions. As a result of these and other factors, we may experience material fluctuations in future operating results on a quarterly or annual basis, which could materially and adversely affect our business, financial condition, operating results and stock price. An investment in us involves various risks, including those mentioned above and those that are detailed from time to time in our SEC filings.*

Certain statements contained in this report, including without limitation, statements containing the words believe, intend, expect, anticipate and words of similar import, also may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Readers are cautioned that any such forward-looking statements are not guarantees of future performance, and since such statements involve risks and uncertainties, our actual results and performance and the performance of the specialist industry as a whole, may turn out to be materially different from the results expressed or implied by such forward-looking statements. Given these uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. We also disclaim any obligation to update our view of any such risks or uncertainties or to publicly announce the result of any revisions to the forward-looking statements made in this report.

**Item 6. Exhibits.**

- 31.1 Certification of George M.L. LaBranche, IV, Chairman, Chief Executive Officer and President, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Jeffrey M. Chertoff, Senior Vice President and Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of George M.L. LaBranche, IV, Chairman, Chief Executive Officer and President, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, regarding the information contained in LaBranche & Co Inc. s Quarterly Report on Form 10-Q for the period ended September 30, 2005.
- 32.2 Certification of Jeffrey M. Chertoff, Senior Vice President and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, regarding the information contained in LaBranche & Co Inc. s Quarterly Report on Form 10-Q for the period ended September 30, 2005.

All other items of this report are inapplicable.

**SIGNATURES**





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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.

November 9, 2005

LABRANCHE & CO INC.

By: /s/ Jeffrey M. Chertoff  
Name: Jeffrey M. Chertoff  
Title: Senior Vice President and Chief  
Financial Officer

EXHIBIT INDEX

| <b>Exhibit No.</b> | <b>Description of Exhibit</b>   |
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