

KNIGHT CAPITAL GROUP, INC.

Form 10-Q

May 10, 2012

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2012**

OR

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

Commission File Number

KNIGHT CAPITAL GROUP, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or organization)

22-3689303

(I.R.S. Employer Identification Number)

545 Washington Boulevard, Jersey City, NJ 07310

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(Address of principal executive offices and zip code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer

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

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

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

As of May 4, 2012 the number of shares outstanding of the Registrant's Class A Common Stock was 98,210,924 and there were no shares outstanding of the Registrant's Class B Common Stock.

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KNIGHT CAPITAL GROUP, INC.

FORM 10-Q QUARTERLY REPORT

For the Quarter Ended March 31, 2012

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

	For the three months ended March 31, 2012 2011 (In thousands, except per share amounts)	
Revenues		
Commissions and fees	\$ 182,580	\$ 182,525
Net trading revenue	156,547	151,788
Interest, net	7,138	3,101
Investment income and other, net	2,760	2,360
 Total revenues	 349,025	 339,774
Expenses		
Employee compensation and benefits	147,254	148,963
Execution and clearance fees	53,255	53,449
Communications and data processing	22,330	20,723
Payments for order flow	21,688	20,709
Interest	13,458	9,880
Depreciation and amortization	13,313	13,209
Occupancy and equipment rentals	6,519	7,354
Professional fees	5,735	4,354
Business development	5,158	3,711
Writedown of assets and lease loss accrual	-	945
Other	6,315	6,394
 Total expenses	 295,025	 289,691
 Income from continuing operations before income taxes	 54,000	 50,083
Income tax expense	20,894	19,451
 Income from continuing operations, net of tax	 33,106	 30,632
Loss from discontinued operations, net of tax	-	(141)
 Net income	 \$ 33,106	 \$ 30,491
 Basic earnings per share from continuing operations		
	\$ 0.37	\$ 0.33
 Diluted earnings per share from continuing operations		
	\$ 0.36	\$ 0.33
 Basic earnings per share	 \$ 0.37	 \$ 0.33

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Diluted earnings per share	\$ 0.36	\$ 0.33
Shares used in computation of basic earnings per share	89,764	91,897
Shares used in computation of diluted earnings per share	92,175	93,668

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

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KNIGHT CAPITAL GROUP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	For the three months ended March 31,	
	2012	2011
	(In thousands)	
Net income	\$ 33,106	\$ 30,491
Other comprehensive income (loss):		
Cumulative translation adjustment	325	(295)
Comprehensive income	\$ 33,431	\$ 30,196

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

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

	March 31, 2012	December 31, 2011
	(In thousands)	
ASSETS		
Cash and cash equivalents	\$ 336,323	\$ 467,633
Financial instruments owned, at fair value, including securities pledged of \$3,384,754 at March 31, 2012 and \$2,672,709 at December 31, 2011:		
Equities	1,863,053	1,416,090
Listed equity options	207,344	280,384
Debt securities	108,276	134,631
Loan inventory	152,377	206,572
Other financial instruments	12,316	21,483
Securitized HECM loan inventory	2,248,164	1,722,631
Total financial instruments owned, at fair value	4,591,530	3,781,791
Collateralized agreements:		
Securities borrowed	1,530,579	1,494,647
Receivable from brokers, dealers and clearing organizations	703,697	623,897
Fixed assets and leasehold improvements, at cost, less accumulated depreciation and amortization	110,279	111,464
Investments	94,035	83,231
Goodwill	337,843	337,843
Intangible assets, less accumulated amortization	88,990	92,889
Other assets	210,436	159,556
Total assets	\$ 8,003,712	\$ 7,152,951
LIABILITIES & EQUITY		
Liabilities		
Financial instruments sold, not yet purchased, at fair value:		
Equities	\$ 1,461,481	\$ 1,369,750
Listed equity options	206,011	254,506
Debt securities	160,764	63,073
Other financial instruments	13,717	34,563
Total financial instruments sold, not yet purchased, at fair value	1,841,973	1,721,892
Collateralized financings:		
Securities loaned	689,725	697,998
Financial instruments sold under agreements to repurchase	560,215	420,320
Other secured financings	43,580	59,405
Liability to GNMA trusts, at fair value	2,230,072	1,710,627
Total collateralized financings	3,523,592	2,888,350
Payable to brokers, dealers and clearing organizations	438,103	322,660
Accrued compensation expense	83,627	188,939
Accrued expenses and other liabilities	192,817	144,747
Long-term debt	427,761	424,338
Total liabilities	6,507,873	5,690,926
Equity		
Class A common stock		
Shares authorized: 500,000 at March 31, 2012 and at December 31, 2011; Shares issued: 169,952 at March 31, 2012 and 166,362 at December 31, 2011;		

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Shares outstanding: 98,747 at March 31, 2012 and 96,645 at December 31, 2011	1,700	1,664
Additional paid-in capital	869,915	850,837
Retained earnings	1,466,426	1,433,320
Treasury stock, at cost; 71,205 at March 31, 2012 and 69,717 shares at December 31, 2011	(841,754)	(823,023)
Accumulated other comprehensive loss	(448)	(773)
Total equity	1,495,839	1,462,025
Total liabilities and equity	\$ 8,003,712	\$ 7,152,951

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

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KNIGHT CAPITAL GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the three months ended March 31,	
	2012	2011
	(In thousands)	
Cash flows from operating activities		
Net income	\$ 33,106	\$ 30,491
Loss from discontinued operations, net of tax	-	(141)
Income from continuing operations, net of tax	33,106	30,632
Adjustments to reconcile income from continuing operations, net of tax to net cash (used in) provided by operating activities		
Stock-based compensation	13,717	15,259
Depreciation and amortization	13,313	13,209
Debt discount accretion and other debt related expenses	4,201	3,578
Writedown of assets and lease loss accrual	-	945
Deferred rent	24	33
Unrealized gain on investments	(1,561)	(2,053)
Operating activities from discontinued operations	-	(182)
(Increase) decrease in operating assets		
Financial instruments owned, at fair value	(814,955)	(631,859)
Securities borrowed	(35,932)	(204,855)
Receivable from brokers, dealers and clearing organizations	(79,799)	(300,084)
Other assets	(52,809)	9,002
Increase (decrease) in operating liabilities		
Financial instruments sold, not yet purchased, at fair value	125,298	364,638
Securities loaned	(8,273)	425
Financial instruments sold under agreements to repurchase	139,895	244,767
Other secured financings	(15,825)	(11,438)
Liability to GNMA trusts, at fair value	519,446	-
Payable to brokers and dealers and clearing organizations	115,443	425,353
Accrued compensation expense	(101,008)	(88,985)
Accrued expenses and other liabilities	48,065	148,035
Net cash (used in) provided by operating activities	(97,654)	16,420
Cash flows from investing activities		
Distributions from investments	1,440	2,140
Purchases of investments	(9,532)	(14,706)
Purchases of fixed assets and leasehold improvements	(8,179)	(12,349)
Purchase of intangible asset	(50)	-
Net cash used in investing activities	(16,321)	(24,915)
Cash flows from financing activities		
Stock options exercised	891	380
Income tax benefit related to stock-based compensation	129	58
Cost of common stock repurchased	(18,680)	(12,308)
Net cash used in financing activities	(17,660)	(11,870)
Effect of exchange rate changes on cash and cash equivalents	325	(295)
Decrease in cash and cash equivalents	(131,310)	(20,660)

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Cash and cash equivalents at beginning of period	467,633	375,569
Cash and cash equivalents at end of period	\$ 336,323	\$ 354,909
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 12,295	\$ 8,880
Cash paid for income taxes	\$ 8,565	\$ 1,116

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

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Organization and Description of the Business

Knight Capital Group, Inc. (collectively with its subsidiaries, Knight or the Company) is a global financial services firm that provides access to the capital markets across multiple asset classes to a broad network of clients, including broker-dealers, institutions and corporations. The Company seeks to continually apply its expertise and innovation to the market making and trading process to build lasting client relationships through consistent performance and superior client service. The Company has four operating segments: (i) Market Making, (ii) Institutional Sales and Trading, (iii) Electronic Execution Services and (iv) Corporate and Other.

Market Making

The Market Making segment principally consists of market making in global equities and listed domestic options. As a market maker, the Company commits capital for trade executions by offering to buy securities from, or sell securities to, institutions and broker-dealers. The Market Making segment primarily includes client, and to a lesser extent, non-client electronic market making activities in which the Company operates as a market maker in equity securities quoted and traded on the Nasdaq Stock Market; the over-the-counter (OTC) market for New York Stock Exchange (NYSE), NYSE Amex Equities (NYSE Amex), NYSE Arca listed securities; and several European exchanges. As a complement to electronic market making, the Company's cash trading business handles specialized orders and also transacts on the OTC Bulletin Board, the OTC Pink Markets and the Alternative Investment Market (AIM) of the London Stock Exchange. The segment provides trade executions as an equities Designated Market Maker (DMM) on the NYSE and NYSE Amex. The Market Making segment also includes the Company's option market making business which trades on substantially all domestic electronic exchanges.

Institutional Sales and Trading

The Institutional Sales and Trading segment includes global equity, exchange traded funds (ETFs), and fixed income sales; reverse mortgage origination and securitization; capital markets; and asset management activities. The primary business of the Institutional Sales and Trading segment is to execute and facilitate equities, ETFs and fixed income transactions as an agent on behalf of institutional clients, and commits capital on behalf of clients when needed. This is predominantly a full-service execution business, in which much of the interaction is based on the Company's client relationships. This segment also facilitates client orders through program and block trades and riskless principal trades and provides capital markets services, including equity and debt private placement.

Electronic Execution Services

The Electronic Execution Services segment offers access via its electronic agency-based platforms to markets and self-directed trading in equities, options, fixed income, foreign exchange and futures. In contrast to Market Making, the businesses within this segment generally do not act as a principal to transactions that are executed and generally earn commissions for acting as an agent between the principals to the trade.

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

Corporate and Other

The Corporate and Other segment invests in strategic financial services-oriented opportunities, allocates, deploys and monitors all capital, and maintains corporate overhead expenses and all other income and expenses that are not attributable to the other segments. The Corporate and Other segment houses functions that support the Company's other segments such as self-clearing services, including stock lending activities.

Discontinued Operations

Discontinued operations comprises costs associated with shutting down the Company's former Deephaven Capital Management business which was discontinued in 2009.

2. Significant Accounting Policies

Basis of consolidation and form of presentation

The accompanying unaudited Consolidated Financial Statements, prepared in conformity with accounting principles generally accepted in the United States of America (GAAP), should be read in conjunction with the audited Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. These unaudited Consolidated Financial Statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. All such adjustments are of a normal recurring nature. Certain footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to U.S. Securities and Exchange Commission (SEC) rules and regulations, although the Company believes that the disclosures herein are adequate to make the information presented not misleading. All significant intercompany transactions and balances have been eliminated. Interim period operating results may not be indicative of the operating results for a full year.

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

The Company consolidates all of its wholly-owned subsidiaries as well as any investment in which it is considered to be the primary beneficiary of a variable interest entity (VIE). The Company performs a qualitative assessment to determine if a VIE should be consolidated. As described in more detail below, the primary attributes the Company assesses include the entity's capital structure and power. The Company will consolidate a VIE if it has both (i) the power to direct the activities of a VIE that most significantly impact the entity's economic performance and (ii) the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE. As of March 31, 2012 and December 31, 2011, the Company was not considered to be a primary beneficiary of any VIE.

Table of Contents**KNIGHT CAPITAL GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued****(Unaudited)***Cash and cash equivalents*

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

Market making, sales, trading and execution activities

Financial instruments owned and Financial instruments sold, not yet purchased, which relate to market making and trading activities, include listed and OTC equity securities, listed equity options and fixed income securities which are recorded on a trade date basis and carried at fair value. Net trading revenue (trading gains, net of trading losses) and commissions (which includes commission equivalents earned on institutional client orders and home equity conversion mortgages (HECMs) loan origination and securitization activities) and related expenses are also recorded on a trade date basis. The Company's third party clearing agreements call for payment or receipt of interest income, net of transaction-related interest charged by clearing brokers, for facilitating the settlement and financing of securities transactions. The Company also nets interest income on its securitized HECM loan inventory against interest expense on its liability to Government National Mortgage Association (GNMA) trusts. Interest income and interest expense which have been netted on the Consolidated Statements of Operations are as follows (in thousands):

	For the three months ended March 31,	
	2012	2011
Interest Income	\$ 31,023	\$ 6,602
Interest Expense	(23,885)	(3,501)
Interest, net	\$ 7,138	\$ 3,101

Dividend income relating to securities owned and dividend expense relating to securities sold, not yet purchased, derived from the Company's market making activities are included as a component of Net trading revenue on the Consolidated Statements of Operations. Net trading revenue includes dividend income and expense as follows (in thousands):

	For the three months ended March 31,	
	2012	2011
Dividend Income	\$ 6,960	\$ 4,607
Dividend Expense	\$ (5,026)	\$ (4,753)

Payments for order flow represent payments to broker-dealer clients, in the normal course of business, for directing their order flow in U.S. equities and options to the Company. Payments for order flow also include fees paid to third party brokers with respect to wholesale loan production at the Company's reverse mortgage business.

Fair value of financial instruments

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

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

The fair value hierarchy can be summarized as follows:

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

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

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

Changes in fair value are recognized in earnings each period for financial instruments that are carried at fair value. See Footnote 3 Fair Value of Financial Instruments for a description of valuation methodologies applied to the classes of financial instruments at fair value.

Securitization activities

The Company securitizes HECMs under its GNMA issuance authority. Securitization and transfer of financial assets to a third party are generally accounted for as sales when an issuer has relinquished control over the transferred assets. Based upon the current structure of the GNMA securitization program, the Company believes that it has not met the GAAP criteria for relinquishing control over the transferred assets and therefore its securitizations fail to meet the GAAP criteria for sale accounting. As such, the Company continues to recognize the HECMs in Financial Instruments owned, at fair value, and the Company recognizes a corresponding liability in Liability to GNMA trusts, at fair value on the Consolidated Statements of Financial Condition. The associated change in fair value of the securitized HECM loan inventory is recorded in Commissions and fees on the Consolidated Statements of Operations.

Collateralized agreements and financings

Collateralized agreements consist of collateralized financings which include securities borrowed and securities loaned, financial instruments sold under agreements to repurchase, liability to GNMA trusts, at fair value and other secured financings.

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

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

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

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

Liability to GNMA trusts, at fair value, represents the liability associated with the Company's securitization of HECMs where the securitization does not meet the GAAP criteria for sale treatment.

The Company's securities borrowed, securities loaned, financial instruments sold under agreements to repurchase and other secured financings are recorded at amounts that approximate fair value. These items are recorded based upon their contractual terms and are not materially sensitive to shifts in interest rates because they are short-term in nature and are fully collateralized. These items would be categorized as Level 2 in the fair value hierarchy if they were required to be recorded at fair value.

Investments

Investments primarily comprise strategic investments and deferred compensation investments. Strategic investments include noncontrolling equity ownership interests and debt instruments held by the Company within its non-broker-dealer subsidiaries, primarily in financial services-related businesses. Strategic investments are accounted for under the equity method, at cost or at fair value. The equity method of accounting is used where the Company is considered to exert significant influence on the investee. Strategic investments are held at cost, less impairment if any, when the Company is not considered to exert significant influence on operating and financial policies of the investee. Deferred compensation investments primarily consist of mutual funds, which are accounted for at fair value.

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

The Company maintains a non-qualified deferred compensation plan related to certain employees and directors. This plan provides a return to the participants based upon the performance of various investments. In order to hedge its liability under this plan, the Company generally acquires the

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

underlying investments and holds such investments until the deferred compensation liabilities are satisfied. Changes in value of such investments are recorded in Investment income and other, net, with a corresponding charge or credit to Employee compensation and benefits on the Consolidated Statements of Operations.

Goodwill and intangible assets

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

Treasury stock

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

Foreign currency translation and foreign currency forward contracts

The Company's European subsidiary utilizes the Pound Sterling as its functional currency while the Company's Hong Kong subsidiary utilizes the Hong Kong dollar as its functional currency. For all other entities, the Company's functional currency is the U.S. dollar.

Assets and liabilities of foreign subsidiaries having non-U.S. dollar functional currencies are translated at exchange rates at the end of a period. Revenues and expenses are translated at average exchange rates during the period. Gains and losses resulting from translating foreign currency financial statements into U.S. dollars are included in Accumulated other comprehensive loss on the Consolidated Statements of Financial Condition and the Consolidated Statements of Comprehensive Income. Gains or losses resulting from foreign currency transactions are included in Investment income and other, net on the Company's Consolidated Statements of Operations. For the three months ended March 31, 2012 and 2011, a loss of \$0.2 million and a loss of \$0.1 million, respectively, were recorded in Investment income and other, net on the Company's Consolidated Statements of Operations.

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

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

Soft dollar expense

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

Depreciation, amortization and occupancy

Fixed assets are depreciated on a straight-line basis over their estimated useful lives of three to seven years. Leasehold improvements are being amortized on a straight-line basis over the shorter of the term of the related office lease or the expected useful life of the assets. The Company capitalizes certain costs associated with the acquisition or development of internal-use software and amortizes the software over its estimated useful life of three years, commencing at the time the software is placed in service. The Company reviews fixed assets and leasehold improvements for impairment whenever events or changes in circumstances indicate that the related carrying amounts may not be recoverable.

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

Lease loss accrual

The Company's policy is to identify excess real estate capacity and where applicable, accrue for related future costs, net of estimated sub-lease income. In the event the Company is able to sub-lease the excess real estate after recording a lease loss, such accrual is adjusted to the extent the actual terms of sub-leased property differ from the assumptions used in the calculation of the accrual. In the event that the Company concludes that previously determined excess real estate is needed for the Company's use, such lease loss accrual is adjusted accordingly. Any such adjustments to previous lease loss accruals are recorded in Writedown of assets and lease loss accrual on the Consolidated Statements of Operations.

Income taxes

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

Discontinued operations

Revenues and expenses associated with a separate segment or reporting unit that has been disposed of through closure or sale are included in Loss from discontinued operations, net of tax on the

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KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

(Unaudited)

Consolidated Statements of Operations. Assets and liabilities of discontinued operations are included in Other assets and Accrued expenses and other liabilities, respectively, on the Consolidated Statements of Financial Condition. Cash flows from discontinued operations are presented on the Consolidated Statements of Cash Flows within operating, investing and financing activities, as applicable.

Stock-based compensation

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

Expected forfeitures are considered in determining stock-based employee compensation expense. For all periods presented, the Company recorded a benefit for expected forfeitures on all outstanding stock-based awards. The benefit recorded did not have a material impact on the results of operations in any of the periods presented.

The Company applies a non-substantive vesting period approach for stock-based awards whereby the expense is accelerated for those employees and directors that receive options and restricted stock units (RSUs) and are eligible to retire prior to the options or RSUs vesting.

Variable interest entities

A VIE is an entity that lacks one or more of the following characteristics (i) the total equity investment at risk is sufficient to enable the entity to finance its activities independently and (ii) the equity holders have the power to direct the activities of the entity that most significantly impact its economic performance, the obligation to absorb the losses of the entity and the right to receive the residual returns of the entity. The Company has a controlling financial interest and will consolidate a VIE if it has both (i) the power to direct the activities of the VIE that most significantly impact the VIE's economic performance and (ii) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

VIEs generally finance the purchase of assets by issuing debt and equity securities that are either collateralized by or indexed to the assets held by the VIE. The debt and equity securities issued by a VIE may include tranches of varying levels of subordination. The Company's involvement with VIEs includes purchased interests and commitments to VIEs.

The Company is principally involved with VIEs through the following business activities:

Mortgage-backed securities (MBS) The Company purchases and sells beneficial interests issued by mortgage-backed VIEs in connection with its trading activities

Securitized HECM loan inventory The Company sells HECM loans to GNMA trusts which have the characteristics of a VIE and retains certain commitments and obligations to these trusts

Maximum exposure to loss in nonconsolidated VIEs

Commitments	12,874	-
Purchased interests	-	16,399
<i>Use of estimates</i>		

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

Table of Contents**KNIGHT CAPITAL GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued****(Unaudited)***Accounting Standards Updates*

In December 2011, the FASB issued an Accounting Standard Update (ASU) that requires additional disclosures about financial assets and liabilities that are subject to netting arrangements. Under the ASU, financial assets and liabilities must be disclosed at their respective gross asset and liability amounts, the amounts offset on the balance sheet and a description of the respective netting arrangements. The new disclosures are required for annual reporting periods beginning on or after January 1, 2013, and are to be applied retrospectively. Other than the change in presentation, the Company has determined that the adoption of this ASU will not have an impact on its Consolidated Financial Statements.

3. Fair Value of Financial Instruments

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

March 31, 2012	Assets and Liabilities Measured at Fair Value on a Recurring Basis			Total
	Level 1	Level 2	Level 3	
Assets				
Financial instruments owned, at fair value:				
Equities ⁽¹⁾	\$ 1,863,053	\$ -	\$ -	\$ 1,863,053
Listed equity options	207,344	-	-	207,344
U.S. government obligations	6,897	-	-	6,897
Corporate debt	47,182	-	-	47,182
Mortgage-backed securities	11,534	42,663	-	54,197
Loan inventory	-	152,377	-	152,377
Purchased call options	-	12,316	-	12,316
Securitized HECM loan inventory ⁽²⁾	-	2,248,164	-	2,248,164
Total Financial instruments owned, at fair value	2,136,010	2,455,520	-	4,591,530
Deferred compensation investments ⁽³⁾	-	22,225	-	22,225
Investment in Deephaven Funds ⁽³⁾	-	2,156	-	2,156
Total fair value of financial instrument assets	\$ 2,136,010	\$ 2,479,901	\$ -	\$ 4,615,911
Liabilities				
Financial instruments sold, not yet purchased, at fair value:				
Equities ⁽¹⁾	\$ 1,461,481	\$ -	\$ -	\$ 1,461,481
Listed equity options	206,011	-	-	206,011
U.S. government obligations	112,740	-	-	112,740
Corporate debt	48,024	-	-	48,024
Embedded conversion derivative	-	12,316	-	12,316
Foreign currency forward contracts	-	1,401	-	1,401
Total Financial instruments sold, not yet purchased, at fair value	1,828,256	13,717	-	1,841,973

