SONOSITE INC
Form 8-K
February 11, 2010

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 8-K

CURRENT REPORT
Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

February 11, 2010
Date of Report
(Date of Earliest Event Reported)

SONOSITE, INC.

(Exact Name of Registrant as Specified in Charter)

Washington	0-23791	91-1405022
(State or Other Jurisdiction of Incorporation)	(Commission File No.)	(IRS Employer Identification No.)

21919 30th Drive S.E., Bothell, Washington 98021-3904
(Address of Principal Executive Offices) (Zip Code)

(425) 951-1200
(Registrant's Telephone Number, Including Area Code)

None
(Former Name or Former Address, if Changed Since Last Report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

[ ] Written communication pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

[ ] Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

[ ] Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

[ ] Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e4(c))

Item 2.02 Results of Operations and Financial Condition.

On February 11, 2010, SonoSite issued a press release announcing its financial results for the fourth quarter and year ended December 31, 2009. A copy of this press release is attached hereto as Exhibit 99.1 and is incorporated into this current report by reference.

Item 9.01 Financial Statements and Exhibits.

(c) Exhibits

99.1	SonoSite, Inc. press release issued February 11, 2010, announcing its financial results for the fourth quarter and year ended December 31, 2009.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, SonoSite, Inc. has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

SONOSITE, INC.

Dated:	February 11, 2010	By:	/s/ MICHAEL J. SCHUH Michael J. Schuh Chief Financial Officer

EXHIBIT INDEX

Exhibit Number	Description
99.1	SonoSite, Inc. press release issued February 11, 2010, announcing its preliminary financial results for the fourth quarter and year ended December 31, 2009.

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Pre-Tax Operating Earnings

$265.0 $120.9 $82.6

Totals may not add due to rounding

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Consolidated revenues in 2006 increased $316.6 million, or 50% from 2005, while consolidated Operating Expenses increased $172.5 million or 34% from 2005. Overall, Consolidated Pre-Tax Operating Earnings increased $144.1 million, or 119% from 2005.

The changes in our Pre-Tax Operating Earnings by segment from 2005 to 2006 are summarized as follows:

Asset Management Our 2006 Pre-Tax Operating Earnings from Asset Management were up $48.3 million, or 182% from 2005, primarily due to higher incentive fees as a result of increased fund returns and higher assets under management.

Global Markets Our 2006 Pre-Tax Operating Earnings from Global Markets were up $113.7 million or 252% from 2005, primarily due to the expansion of our electronic trading effort and automated execution of most of our broker-dealer order flow, increased revenue capture and volumes, and improved market conditions.

Corporate The results from our Corporate segment were positively impacted in 2006 by realized gains from the sales of our corporate equity investment in the International Securities Exchange, Inc. (ISE), as well as higher returns on our corporate investment in the Deephaven Funds. The decrease in our 2006 Pre-Tax Operating Earnings compared to 2005 is primarily related to the sale of our investment in the Nasdaq Stock Market, Inc. (Nasdaq) in 2005.

A reconciliation of income (loss) from continuing operations before income taxes in accordance with GAAP (Pre-Tax GAAP Income) to Pre-Tax Operating Earnings and of total GAAP expenses to Operating Expenses is included elsewhere in this section.

Certain Factors Affecting Results of Operations

We have experienced, and expect to continue to experience, significant fluctuations in operating results due to a variety of factors, including, but not limited to, introductions or enhancements to trade execution services by us or our competitors; the value of our securities positions and our ability to manage the risks attendant thereto; the volume of our market-making activities; the dollar value of securities traded; volatility in the securities markets; our market share with institutional and broker-dealer clients; the performance, amount of, and volatility in, the results of our quantitative market-making and program trading portfolios; the performance of our international operations; our ability to manage personnel, overhead and other expenses, including our occupancy expenses under our office leases and expenses and charges related to our legal and regulatory proceedings; the strength of our client relationships; changes in payments for order flow and clearing, execution and regulatory transaction costs; the level of assets under management and fund returns; the addition or loss of executive management and asset management, sales and trading and technology professionals; legislative, legal and regulatory changes; legal and regulatory matters; geopolitical risk; the amount and timing of capital expenditures, acquisitions and divestitures; the integration, performance and operation of acquired businesses; the incurrence of costs associated with acquisitions and dispositions; investor sentiment; technological changes and events; seasonality; competition and market and economic conditions. Such factors may also have an impact on our ability to achieve our strategic objectives, including, without limitation, increases in our pre-tax profit margins, market share and revenue capture in our Global Markets segment and increases in our fund returns and assets under management in our Asset Management segment. If demand for our services declines in either of our segments due to any of the above factors, and we are unable to adjust our cost structure on a timely basis, our operating results and strategic objectives could be materially and adversely affected.

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

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Trends

We believe that our continuing operations are impacted by the following trends that may affect our financial condition and results of operations.

Broker-dealer clients continue to focus on statistics measuring the quality of equity executions (including speed of executions and price improvement). In an effort to improve the quality of their executions as well as increase efficiencies, market-makers have increased the level of automation within their operations. Over the past several years, the greater focus on execution quality has resulted in greater competition in the marketplace, which, along with market structure changes and market conditions, has negatively impacted the revenue capture metrics of the Company and other market-making firms.

Retail equity transaction volumes executed by broker-dealers have fluctuated over the past few years due to investor sentiment, market conditions and a variety of other factors. Retail equity transaction volumes may not be sustainable and are not predictable.

There has been consolidation among market centers over the past several years, and several regional exchanges have entered into joint ventures with broker-dealers to create their own alternative trading systems (i.e. ECNs) and compete within the OTC and listed trading venues. In addition, many broker-dealers are offering their own internal crossing networks creating further fragmentation in the marketplace.

Market structure changes, competition and market conditions have triggered an industry shift toward market-makers charging explicit commissions or commission equivalents to institutional clients for executions in OTC securities. For the majority of our institutional client orders, we charge explicit fees in the form of commissions or commission equivalents. Institutional commission rates have fallen in the past few years, and may continue to fall in the future.

Due to regulatory scrutiny over the past several years relating to equity sell-side research and the continued focus by investors on execution quality and overall transaction costs, more institutional clients allocate commissions to broker-dealers based on the quality of executions. In the past, institutional equity commissions were primarily allocated to broker-dealers in exchange for either research or soft dollar and commission recapture programs.

There has been increased scrutiny of market-makers, specialists, hedge funds and soft dollar practices by the regulatory and legislative authorities. New legislation or modifications to existing regulations and rules could occur in the future.

There has been a proliferation of alternative investment entities, which has had the effect of materially increasing competition for new investor assets.

Income Statement Items

The following section briefly describes the key components of, and drivers to, our significant revenues and expenses.

Revenues

Our revenues consist principally of Commissions and fees and Net trading revenue from Global Markets. Revenues on transactions for which we charge explicit commissions or commission equivalents, which include the majority of our institutional client orders, are included within Commissions and fees. Commissions and fees are primarily affected by changes in our equity transaction volumes with institutional clients, changes in commission rates, the growth of Direct Trading, Direct Edge, Hotspot and ValuBond and the growth of our soft dollar and commission recapture activity.

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Trading profits and losses on principal transactions are included within Net trading revenue. These revenues are primarily affected by changes in the amount and mix of U.S. equity trade and share volumes, our revenue capture, dollar value of equities traded, our ability to derive trading gains by taking proprietary positions, changes in our execution standards, volatility in the marketplace, our mix of broker-dealer and institutional clients, and regulatory changes and evolving industry customs and practices.

Asset management fees represent fees earned by Deephaven for sponsoring and managing the Deephaven Funds as well as fees earned from separately managed accounts. These fees consist of annual management fees, calculated as fixed percentages of assets under management, and incentive fees, generally calculated as a percentage of the funds and managed accounts year-to-date profits, if any.

We earn interest income from our cash held at banks and cash held in trading accounts at clearing brokers. The Company s 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. Net interest is primarily affected by interest rates, the level of cash balances held at banks and clearing brokers and our level of securities positions in which we are long compared to our securities positions in which we are short.

Investment income and other primarily represents income earned, net of losses, related to our corporate investment in the Deephaven Funds and our strategic investments. Such income is primarily affected by the level of our corporate investments in our Deephaven Funds and rates of return earned by the Deephaven Funds as well as the performance and activity of our strategic investments.

Transaction-based expenses

Transaction-based expenses include transaction-based variable expenses directly incurred in conjunction with generating Net trading revenue and Commissions and fees and consist of Execution and clearance fees, Soft dollar and commission recapture expense, and Payments for order flow and ECN rebates.

Execution and clearance fees primarily represent clearance fees paid to clearing brokers for equities transactions, transaction fees paid to Nasdaq and other exchanges and regulatory bodies, and execution fees paid to third parties, primarily for executing trades on the New York Stock Exchange (NYSE) and other exchanges, and for executing orders through third party ECNs. Execution and clearance fees primarily fluctuate based on changes in equity trade and share volume, clearance fees charged by clearing brokers and fees paid to ECNs, exchanges and certain regulatory bodies.

Soft dollar and commission recapture expense represent payments to institutions in connection with our soft dollar and commission recapture programs. Soft dollar and commission recapture expense fluctuates based on U.S. equity share volume executed on behalf of institutions.

Payments for order flow and ECN rebates represent payments to broker-dealer clients, in the normal course of business, for directing to us their order flow in U.S. equities and rebates for providing liquidity to our ECN, Direct Edge. Payments for order flow and ECN rebates fluctuate as we modify our rates and as our percentage of clients whose policy is not to accept payments for order flow varies. Payments for order flow and ECN rebates also fluctuate based on U.S. equity share volume, our profitability and the mix of market orders and limit orders.

Other direct expenses

Other direct expenses primarily consist of Employee compensation and benefits, Communications and data processing, Professional fees, Depreciation and amortization and Occupancy and equipment rentals.

Employee compensation and benefits expense, our largest expense, primarily consists of salaries and wages paid to all employees and profitability-based compensation, which includes compensation paid to sales personnel

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and incentive compensation paid to all other employees based on our profitability. Compensation for employees engaged in sales activities is determined primarily based on a percentage of their gross revenues net of certain transaction-based expenses. The majority of compensation in Asset Management is determined by formulas based upon the profitability of the Asset Management segment, subject to certain minimum guaranteed payments. Employee compensation and benefits expense fluctuates, for the most part, based on changes in our revenues, profitability and the number of employees.

Communications and data processing expense primarily consists of costs for obtaining market data, telecommunications services and systems maintenance.

Results of Operations

The following table sets forth the consolidated statements of operations data as a percentage of total revenues:

	For the years ended December 31,		
	2006	**2005**	**2004**
Revenues			
Commissions and fees	42.6%	46.7%	44.1%
Net trading revenue	25.6%	26.1%	40.1%
Asset management fees	22.5%	14.1%	12.4%
Interest and dividends, net	1.7%	1.4%	0.8%
Investment income and other	7.6%	11.7%	2.6%
Total revenues	100.0%	100.0%	100.0%
Transaction-based expenses			
Execution and clearance fees	11.2%	15.7%	17.9%
Soft dollar and commission recapture expense	6.9%	10.0%	9.6%
Payments for order flow and ECN rebates	4.4%	3.3%	5.9%
Total transaction-based expenses	22.6%	29.0%	33.3%
Revenues, net of transaction-based expenses	77.4%	71.0%	66.7%
Other direct expenses			
Employee compensation and benefits	37.0%	36.2%	39.1%
Communications and data processing	3.5%	5.1%	4.6%
Depreciation and amortization	2.2%	2.6%	2.3%
Professional fees	2.2%	3.1%	2.4%
Business development	1.5%	1.0%	1.3%
Occupancy and equipment rentals	1.4%	2.1%	2.7%
Writedown of assets and lease loss accrual	0.9%	1.6%	0.6%
Regulatory charges and related matters	0.0%	0.9%	12.7%
Other	1.8%	1.8%	1.1%
Total other direct expenses	50.5%	54.4%	66.8%
Income (loss) from continuing operations before income taxes	27.0%	16.6%	0.1%

Income tax expense	10.3%	6.1%	1.5%
Net income (loss) from continuing operations	16.6%	10.5%	1.6%
Income (loss) from discontinued operations, net of tax	0.0%	0.0%	16.1%
Net income	16.6%	10.5%	14.6%

Percentages may not add due to rounding.

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Years Ended December 31, 2006 and 2005

Continuing Operations

Revenues

Asset Management

	For the years ended December 31, 2006	2005	Change	% of Change
Total Revenues from Asset Management (millions)	$ 214.9	$ 89.8	$ 125.1	139.3%
Average month-end balance of assets under management (millions)	$ 3,420.4	$ 3,291.1	$ 129.3	3.9%
Annual fund return to investors*	22.8%	7.2%	15.6%	218.4%

* Annual fund return represents the blended annual return across all assets under management.

Total revenues from the Asset Management segment, which primarily consists of Asset management fees, increased 139.3% to $214.9 million in 2006, from $89.8 million in 2005. The increase is primarily due to higher incentive fees as a result of increased fund returns and higher assets under management. The average month-end balance of assets under management increased to $3.4 billion in 2006, from $3.3 billion in 2005. The blended annual fund return across all assets under management for 2006 was a gain of 22.8%, up from a gain of 7.2% in 2005.

Global Markets

	For the years ended December 31, 2006	2005	Change	% of Change
Commissions and fees (millions)	$ 405.3	$ 296.2	$ 109.1	36.8%
Net trading revenue (millions)	243.8	165.6	78.1	47.2%
Interest and dividends, net (millions)	12.2	6.6	5.5	83.6%
Investment income and other (millions)	8.4	2.2	6.2	283.2%
Total Revenues from Global Markets (millions)	$ 669.7	$ 470.7	$ 199.0	42.3%
U.S equity dollar value traded ($ billions)	2,033.6	1,882.2	151.4	8.0%
U.S. equity trades executed (millions)	225.5	204.1	21.4	10.5%
Nasdaq and Listed equity shares traded (billions)	94.3	106.3	(12.0)	11.3%
OTC Bulletin Board and Pink Sheet shares traded (billions)	1,063.1	718.8	344.3	47.9%
Average revenue capture per U.S. equity dollar value traded (bps)	2.1	1.8	0.4	21.6%

Total revenues from the Global Markets segment, which primarily comprises Commissions and fees and Net trading revenue from our domestic businesses, increased 42.3% to $669.7 million in 2006, from $470.7 million in 2005. Revenues in 2006 were positively impacted by improved market conditions, higher dollar volumes, an increase in revenue capture per U.S. equity dollar value traded, the expansion of our electronic trading effort and the automation of executions of most of our broker-dealer order flow. Revenues in 2006 were also positively impacted by the addition of Direct Trading, Direct Edge, Hotspot and ValuBond, which were acquired in June 2005, October 2005, April 2006 and October 2006, respectively. Excluding the impact of these acquisitions, total revenues from Global Markets would have increased 26.6% to $563.2 million in 2006, from $444.9 million in 2005. Revenues were also positively impacted by new fees charged to clients in connection with certain transaction-based regulatory costs incurred by the Company. These fees increased Commissions and fees by $19.2 million in 2006. Approximately $9.4 million of these fees related to client transaction activity in 2006 while the remaining $9.8 million related to client transaction activity in 2005 and prior years.

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Average revenue capture per U.S. equity dollar value traded was 2.1 basis points (bps) in 2006, up from 1.8 bps in 2005. Average revenue capture per U.S. equity dollar value traded is calculated as the total of net domestic trading revenues plus U.S. institutional commissions and commission equivalents (included in Commissions and fees), less certain transaction-related regulatory fees (included in Execution and clearance fees), (collectively Core Equity Revenues) divided by the total dollar value of the related equity transactions. Core Equity Revenues were $434.6 million and $330.4 million in 2006 and 2005, respectively. Core Equity Revenues do not include revenues from KEMIL s European institutional business, Donaldson, Direct Trading, Direct Edge, Hotspot and ValuBond.

Corporate

	For the years ended December 31, 2006	2005	Change	% of Change
Total Revenues from Corporate (millions)	$ 66.6	$ 74.2	$ (7.5)	10.1%
Average corporate investment balance in the Deephaven Funds (millions)	$ 230.2	$ 272.6	$ (42.5)	15.6%

Total revenues from the Corporate segment, which primarily represents income from our corporate investments in the Deephaven Funds and other strategic investments, decreased 10.1% to $66.6 million, from $74.2 million in 2005. Included in 2006 is a pre-tax gain of $30.1 million related to the sale of the remaining portion of the Company s equity investment in the ISE. In 2005, the Company sold 70% of its original equity ownership of the ISE and its entire Nasdaq equity investment which resulted in pre-tax gains of $34.2 million and $21.7 million, respectively. Excluding these gains on our strategic investments, total revenues from the Corporate segment were $36.5 million in 2006, up 99.9% from $18.3 million in 2005. Income from our corporate investments in the Deephaven Funds rose 109.4% to $34.2 million in 2006 from $16.3 million in 2005. This increase was due to a higher average return on investment, offset in part by a lower average investment balance.

Transaction-based expenses

Execution and clearance fees increased 7.5% to $106.9 million in 2006, from $99.4 million in 2005. As a percentage of total revenue, Execution and clearance fees decreased to 11.2% in 2006, from 15.7% in 2005. Excluding gains on the sales of our strategic investments, Execution and clearance fees as a percentage of total revenue were 11.6% in 2006 and 17.2% in 2005. Execution and clearance fees fluctuate based on changes in transaction volumes, regulatory fees and efficiencies in processing the transactions.

Soft dollar and commission recapture expense increased 2.8% to $65.5 million in 2006, from $63.7 million in 2005, primarily due to the inclusion of a full year s results from Direct Trading in 2006, which was acquired in the middle of 2005.

Payments for order flow and ECN rebates increased to $42.2 million in 2006, from $21.2 million in 2005. As a percentage of total revenue, Payments for order flow and ECN rebates increased to 4.4% in 2006, from 3.3% in 2005. This expense increased primarily due to increased profitability-based rebates paid to broker-dealers and the full year inclusion of, and higher volumes within, the Direct Edge business which was acquired in October 2005.

Other direct expenses

Employee compensation and benefits expense increased 53.6% to $352.4 million in 2006, from $229.5 million in 2005. The increase was primarily due to stronger overall results, which led to higher profitability-based compensation, as well as additional compensation related to Direct Trading, Direct Edge, Hotspot and ValuBond. As a percentage of total revenue, Employee compensation and benefits increased slightly to 37.0% in 2006 from 36.2% in 2005. Excluding gains from the sales of our ISE and Nasdaq investments, Employee

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compensation and benefits as a percentage of total revenues decreased slightly to 38.3% in 2006 from 39.6% in 2005. The number of full time employees in our continuing operations increased to 844 employees at December 31, 2006, from 720 employees at December 31, 2005, primarily due to the acquisitions of Hotspot and ValuBond.

Communications and data processing expense increased 1.9% to $33.1 million in 2006, from $32.5 million in 2005, due to technology costs incurred relating to our new businesses within Global Markets segment in 2005 and 2006. Depreciation and amortization expense increased 26.2% to $20.6 million in 2006, from $16.4 million in 2005, due to the purchase or acquisition of fixed assets and the amortization of intangible assets in connection with our acquisitions. Occupancy and equipment rentals expense decreased slightly to $13.5 million in 2006, from $13.6 million in 2005.

Professional fees increased 5.2% to $20.6 million in 2006, from $19.6 million in 2005. The increase in 2006 was primarily due to increases in legal expenses, which fluctuate based on the activity relating to various legal and regulatory proceedings, and consulting expenses.

Business development expense increased to $14.3 million in 2006, compared to $6.4 million in 2005. The primary reason for the increase was higher expenses related to the corporate brand campaign, marketing and travel and entertainment costs.

Other expenses increased to $17.1 million in 2006, compared to $11.5 million in 2005. Other expenses in 2006 include a short swing profit settlement of approximately $2.8 million relating to trading by two Deephaven funds in the shares of a company while the funds owned in aggregate more than 10% of the outstanding shares of the stock of that company. Additionally, employee recruitment costs increased to $3.4 million in 2006, compared to $1.5 million in 2005.

During 2006, the Company incurred charges of $8.5 million in writedowns of assets and lease loss accruals primarily relating to costs associated with excess real estate capacity in Jersey City, N.J. During 2005, the Company incurred charges of $15.8 million, consisting of $10.1 million of writedowns of assets and lease loss accruals primarily related to the costs associated with excess real estate capacity in our Jersey City, N.J. facilities, and $5.7 million related to charges for regulatory and related matters.

Our effective tax rate for 2006 from continuing operations of 38% differed from the federal statutory rate of 35% primarily due to state income taxes and non-deductible charges.

Years Ended December 31, 2005 and 2004

Continuing Operations

Revenues

Asset Management

	For the years ended December 31, 2005	2004	Change	% of Change
Total Revenues from Asset Management (millions)	$ 89.8	$ 78.2	$ 11.6	14.9%
Average month-end balance of assets under management (millions)	$ 3,291.1	$ 2,963.5	$ 327.7	11.1%
Annual fund return to investors*	7.2%	6.5%	0.6%	9.6%

* Annual fund return represents the blended annual return across all assets under management.

Total revenues from the Asset Management segment, which primarily consists of Asset management fees, increased 14.9% to $89.8 million in 2005, from $78.2 million in 2004. The increase is due to higher incentive fees as a result of an increase in fund returns as well as higher management fees due to the growth in the average

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month-end balance of assets under management. The average month-end balance of assets under management increased to $3.3 billion in 2005, from $3.0 billion in 2004. The blended annual fund return across all assets under management for 2005 was 7.2%, up from 6.5% in 2004.

Global Markets

	For the years ended December 31, 2005	2004	Change	% of Change
Commissions and fees (millions)	$ 296.2	$ 276.0	$ 20.2	7.3%
Net trading revenue (millions)	165.6	251.0	(85.4)	34.0%
Interest and dividends, net (millions)	6.6	3.8	2.8	74.1%
Investment income and other (millions)	2.2	0.2	2.0	1180.8%
Total Revenues from Global Markets (millions)	$ 470.7	$ 531.0	$ (60.3)	11.4%
U.S equity dollar value traded ($ billions)	1,882.2	1,730.7	151.5	8.8%
U.S. equity trades executed (millions)	204.1	205.9	(1.8)	0.9%
Nasdaq and Listed equity shares traded (billions)	106.3	125.5	(19.2)	15.3%
OTC Bulletin Board and Pink Sheet shares traded (billions)	718.8	1,349.6	(630.8)	46.7%
Average revenue capture per U.S. equity dollar value traded (bps)	1.8	2.5	(0.7)	28.2%

Total revenues from our Global Markets segment, which primarily comprises Commissions and fees and Net trading revenue from the domestic businesses, decreased 11.4% to $470.7 million in 2005, from $531.0 million in 2004. Revenues in 2005 were negatively impacted by lower revenue capture per U.S. equity dollar value traded, offset by new revenues from Direct Trading and Direct Edge, which were acquired in June 2005 and October 2005, respectively, and higher dollar volumes. Our revenue capture was impacted during 2005 by greater competition, regulatory changes and market conditions. Excluding the impact of Direct Trading and Direct Edge, total revenues from Global Markets would have decreased 16.2% to $444.9 million in 2005, from $531.0 million in 2004. In 2004, the Company recorded a reserve of $6.5 million against the amount the Company believes it is owed by a counterparty in a trading dispute (the Dispute Reserve). This reserve reduced net trading revenues by $6.5 million in 2004.

Average revenue capture per U.S. equity dollar value traded was 1.8 bps in 2005, down 28.2% from 2.5 bps in 2004. We removed the impact of the Dispute Reserve of $6.5 million from our revenue capture calculation for 2004. Core Equity Revenues were $330.4 million and $424.7 million in 2005 and 2004, respectively. As previously noted, Core Equity Revenues do not include revenues from KEMIL s European institutional business, Donaldson, Direct Trading and Direct Edge.

Corporate

	For the years ended December 31, 2005	2004	Change	% of Change
Total Revenues from Corporate (millions)	$ 74.2	$ 16.6	$ 57.5	346.4%
Average corporate investment balance in the Deephaven Funds (millions)	$ 272.6	$ 216.9	$ 55.7	25.7%

Total revenues from the Corporate segment, which primarily represents income from our corporate investments in the Deephaven Funds and other strategic investments, increased to $74.2 million. In 2005, the Company sold 70% of its original equity ownership of the ISE and its entire Nasdaq equity investment which resulted in pre-tax gains of $34.2 million and $21.7 million, respectively. Excluding these gains on our strategic

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investments, total revenues from the Corporate segment were $18.3 million in 2005, up 10% from 2004. Income from our corporate investments in the Deephaven Funds rose 28.0% to $16.3 million in 2005 from $12.8 million in 2004. This increase was due to a higher average investment balance and higher average returns on such investment.

Transaction-based expenses

Execution and clearance fees decreased 11.1% to $99.4 million in 2005, from $111.8 million in 2004. As a percentage of total revenue, execution and clearance fees decreased to 15.7% in 2005, from 17.9% in 2004. Execution and clearance fees were 17.2% of 2005 total revenues excluding gains on the sales of our strategic investments. Execution and clearance fees fluctuate based on changes in transaction volumes, regulatory fees and efficiencies in processing the transactions.

Soft dollar and commission recapture expense increased 5.9% to $63.7 million in 2005, from $60.1 million in 2004, primarily due to the addition of the Direct Trading business in the middle of 2005.

Payments for order flow and ECN rebates decreased 42.1% to $21.2 million in 2005, from $36.6 million in 2004. As a percentage of total revenue, Payments for order flow and ECN rebates decreased to 3.3% in 2005, from 5.9% in 2004. The decrease on a dollar basis is primarily due to changes in our payment for order flow policies initiated in the second quarter of 2005.

Other direct expenses

Employee compensation and benefits expense decreased 6.2% to $229.5 million in 2005, from $244.5 million in 2004. As a percentage of total revenue, employee compensation and benefits decreased to 36.2% in 2005 from 39.1% in 2004. Excluding gains from the sales of our ISE and Nasdaq investments, Employee compensation and benefits as a percentage of total revenues increased slightly to 39.6% in 2005 from 39.1% in 2004. The number of full time employees in our continuing operations increased to 720 employees at December 31, 2005, from 683 employees at December 31, 2004, primarily due to the acquisitions of Direct Trading and Direct Edge.

Communications and data processing expense increased 12.5% to $32.5 million in 2005, from $28.9 million in 2004. This increase was attributable to additional costs from Direct Trading and a general increase in technology and market data costs.

Depreciation and amortization expense increased 14.8% to $16.4 million in 2005, from $14.2 million in 2004. This increase was primarily due to purchases of fixed assets and leasehold improvements at our new facility at 545 Washington Boulevard, Jersey City, N.J., as well as depreciation and amortization related to Direct Trading and Direct Edge. Occupancy and equipment rentals expense decreased 19.6% to $13.6 million in 2005, from $16.9 million in 2004, primarily due to lease loss accruals related to our Jersey City, N.J. office locations.

Professional fees increased 31.1% to $19.6 million in 2005, from $14.9 million in 2004. The increase in 2005 was primarily due to an increase in legal expenses, which have fluctuated based on the activity relating to various legal and regulatory proceedings, and consulting expenses.

Business development expense decreased to $6.4 million in 2005, compared to $8.3 million in 2004. The primary reason for the decrease was lower travel and entertainment costs.

Other expenses increased to $11.5 million in 2005, compared to $6.8 million in 2004. Other expenses in 2004 included a benefit of approximately $3.0 million related to an adjustment to legal reserves established during 2003. Excluding the impact of this one-time adjustment in 2004, Other expenses increased 17% due to costs associated with the move of our corporate headquarters, as well as higher general and administrative costs.

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During 2005, the Company incurred charges of $15.8 million, consisting of $10.1 million of writedowns of assets and lease loss accruals primarily related to the costs associated with excess real estate capacity in our Jersey City, N.J. facilities, and $5.7 million related to charges for regulatory and related matters.

During 2004, the Company incurred charges of $83.2 million, consisting of $79.3 million related to charges for regulatory and related matters and $3.8 million of writedowns of assets and lease loss accruals primarily related to the costs associated with excess real estate capacity in Jersey City, N.J. For a discussion of the $79.3 million charge for regulatory and related matters, refer to Footnote 12 Regulatory Charges and Related Matters included in Part II, Item 8 Financial Statements and Supplementary Data of our 2005 Form 10-K.

Our effective tax rate for 2005 from continuing operations of 37% differed from the federal statutory rate of 35% primarily due to non-deductible penalties related to charges for regulatory and related matters and state income taxes.

Reconciliation of Total GAAP Expenses and Pre-Tax GAAP Income to Operating Expenses and Pre-Tax Operating Earnings, Respectively

In an effort to provide additional information regarding the Company s results as determined by GAAP, the Company also discloses certain non-GAAP information which management believes provides useful information to investors. Within this Form 10-K, the Company has disclosed its Operating Expenses and its Pre-Tax Operating Earnings to assist the reader in understanding the impact of Writedown of assets and lease loss accrual and Regulatory charges and related matters on the Company s annual results for 2006, 2005 and 2004 by segment, thereby facilitating more useful period-to-period comparisons of the Company s continuing businesses. For additional information related to segments, see Footnote 20 Business Segments included in Part II, Item 8 Financial Statements and Supplementary Data included in this document. Charts are presented in millions.

Total GAAP Expenses to Operating Expenses

	For the year ended December 31, 2006			
	Asset Mgmt	Global Markets	Corporate	Total
Transaction-based Expenses	$	$ 214.6	$	$ 214.6
Other Direct Expenses	140.0	304.8	35.3	480.1
Total GAAP Expenses	140.0	519.4	35.3	694.7
Writedown of assets and lease loss accrual		(8.5)		(8.5)
Operating Expenses	$ 140.0	$ 510.9	$ 35.3	$ 686.2

	For the year ended December 31, 2005			
	Asset Mgmt	Global Markets	Corporate	Total
Transaction-based Expenses	$	$ 184.3	$	$ 184.3
Other Direct Expenses	69.0	251.3	24.9	345.2
Total GAAP Expenses	69.0	435.6	24.9	529.5
Writedown of assets and lease loss accrual		(10.0)		(10.0)
Regulatory charges and related matters	(5.7)			(5.7)

Operating Expenses	$ 63.2	$ 425.6	$ 24.9	$ 513.7

	For the year ended December 31, 2004			
	Asset Mgmt	Global Markets	Corporate	Total
Transaction-based Expenses	$	$ 208.5	$	$ 208.5
Other Direct Expenses	48.6	335.7	33.5	417.7
Total GAAP Expenses	48.6	544.2	33.5	626.3
Writedown of assets and lease loss accrual		(3.8)		(3.8)
Regulatory charges and related matters		(79.3)		(79.3)
Operating Expenses	$ 48.6	$ 461.1	$ 33.5	$ 543.2

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Pre-Tax GAAP Income to Pre-Tax Operating Earnings

	For the year ended December 31, 2006			
	Asset Mgmt	Global Markets	Corporate	Total
Pre-Tax GAAP Income	$ 74.8	$ 150.3	$ 31.4	$ 256.5
Writedown of assets and lease loss accrual		8.5		8.5
Pre-Tax Operating Earnings	$ 74.8	$ 158.8	$ 31.4	$ 265.0

	For the year ended December 31, 2005			
	Asset Mgmt	Global Markets	Corporate	Total
Pre-Tax GAAP Income	$ 20.8	$ 35.1	$ 49.3	$ 105.2
Writedown of assets and lease loss accrual		10.0		10.0
Regulatory charges and related matters	5.7			5.7
Pre-Tax Operating Earnings	$ 26.5	$ 45.1	$ 49.3	$ 120.9

	For the year ended December 31, 2004			
	Asset Mgmt	Global Markets	Corporate	Total
Pre-Tax GAAP Income	$ 29.6	$ (13.2)	$ (16.9)	$ (0.5)
Writedown of assets and lease loss accrual		3.8		3.8
Regulatory charges and related matters				