



**REUNITING + OPPORTUNITY**

# DARK DAYS

The cloud that settled over the financial markets in the last half of 2000 continued to cast its ominous shadow. Over 18 months, the market witnessed the largest top-to-bottom decline in history. Investors at retail broker-dealers stepped to the sidelines. Active traders exploited marketplace inefficiencies. Institutions traded cautiously.

Knight faced greater competition from an increased number of market participants. Knight began adjusting to market structure changes – decimalization, SuperSoes and Rule 11Ac1-5. Knight experienced its first-ever quarterly loss. Knight was forced to right-size with its first-ever staff reduction. Indeed, the dark days have settled in and there's no telling when the clouds will break.

## MARKET ENVIRONMENT

The story told of the past decade will speak of unprecedented success and excess. The story that has unfolded for this decade, thus far, is one of survival. The markets hit bottom in the third quarter 2001, and the search for recovery began. Today, market indices are still in a state of fluctuation, leaving investors with a feeling of uncertainty. The market remains unsettled and there is no timetable for a full recovery.



## ECONOMIC OUTLOOK

The bubble burst in 2000, throwing the markets into a prolonged correction and discouraging retail broker-dealer activity. The economy has been entrenched in a malaise for over a year-and-a-half. Significant regulatory changes forced Knight to rethink the way we capture revenue. The impact on Knight has been severe, but not overwhelming. As we move ahead, it is imperative that Knight capitalizes on this changing market structure.

## DECIMALIZATION

Decimalization moved quotes from 16 to 100 price points. MPV (minimum price variation) between the bid and the ask went from 1/16th (6 1/4 cents) to one cent. This resulted in a reduction in the depth of liquidity at each price point, making the price discovery process far more difficult. Decimalization and one-cent MPV compressed the average quoted spread from \$0.078 to \$0.038.\* Spread is traditionally one of the ways market makers are compensated for committing capital.

\*Nasdaq Economic Research June 11, 2001 Study

## 9/11

While the tragedy of 9/11 had a dramatic economic impact on many companies' performance, Knight was fortunate not to suffer the same fate. The horrific event, however, affected Knight on a very personal level. We witnessed it. We felt it. We lost clients, family and friends. What we found was a collective strength – a resiliency – that makes us better people.

## OVERCAPACITY

The bull market of the 1990's led to "irrational exuberance," producing an environment of high principal amount traded. The entrance of many new players created overcapacity.

As commoditization redefines the industry, the elements of differentiation will be order execution quality, capital commitment, technology and scale. Reduced margins will force many players out. Buy-side demands for greater returns are heightening awareness of implicit and explicit trading costs. The survivors will create cost-effective solutions around optimal order execution.

- > Competitive
- > Powerful
- > Unconventional
- > Independent
- > Experienced
- > Flexible
- > Visionary
- > Intelligent

# BRIGHT KNIGHT

- > Progressive
- > Talented
- > Innovative
- > Strategic
- > Creative
- > Bold
- > Assertive
- > Strong
- > Adapting
- > Enduring
- > Grounded
- > Knowledgeable

## MEETING THE CURRENT CHALLENGES AND EVOLVING IN A TIME OF TRANSITION

Knight has the tools to turn challenge into opportunity for our shareholders. Knight maintains a strong balance sheet. Knight has a diversified client mix. Knight is the leading wholesale market maker in equity securities, a top-tier options market maker, and a highly respected asset manager. Our value-added proposition – client focus, scale, technology, trading methodologies and unique culture – remains both valid and relevant. The bottom line: Optimal order execution, the heart and soul of what we do, will once again set us apart.

NASDAQ COMPOSITE

12\_31\_99

> 4069.13

12\_31\_00

> 2470.52

12\_31\_01

> 1950.40

Meeting the Challenges....Evolving....Turning Change Into Opportunity....Sound Business Strategy....Strong Balance Sheet....

> Knight is in transition. We're facing the most challenging business climate in our history and a shifting market structure.

> Knight's core business strategy is sound, our balance sheet is strong, and we will move forward. Even in today's difficult market, our business model remains valid.

> Knight is executing our core market-making businesses while exploring opportunities. Our quest is to be every broker-dealer and institution's preferred provider of execution solutions.





# PRUDENT



.....Ethics.....Integrity.....Entrepreneurial Spirit.....Core Strategy.....Focus.....Highest Execution Quality.....Market Leadership.....Working Smarter and Faster.....

## Transitioning from entrepreneurial start-up to the next chapter

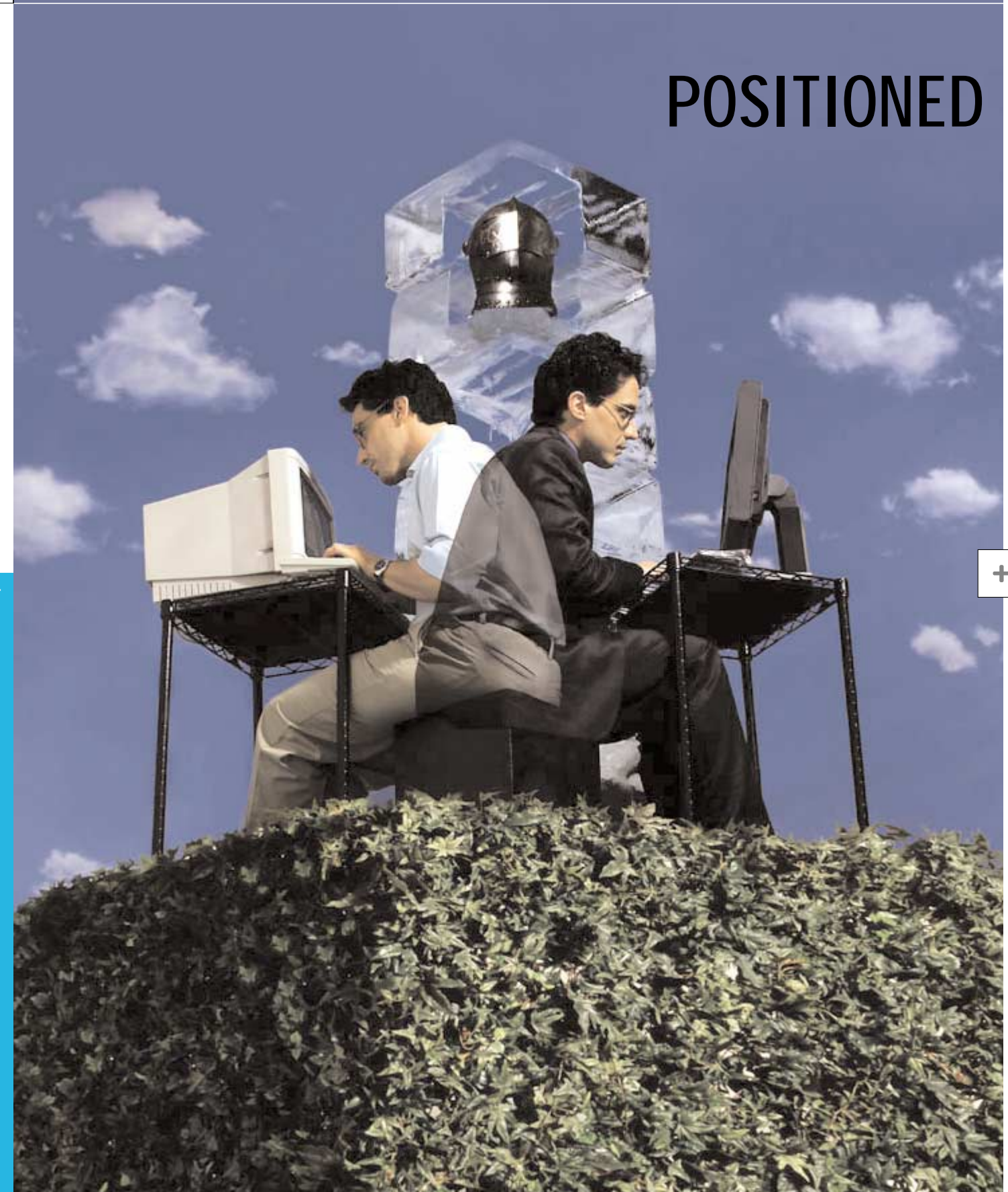
### QUALITY

Knight successfully built upon its foundation of quality execution solutions to become a premier service provider. In the face of an uncertain market and constantly changing market structure, our passion, experience, innovation and core strategy will guide us into the next chapter of the Knight story.

### TEAMWORK

The Knight team continues to think faster, work smarter and look relentlessly for creative opportunities to keep Knight a step ahead of the competition. We remain focused on the client and on delivering the highest execution quality. Our place atop the industry is a testament to the approval from broker-dealers and institutions who seek Knight's expertise. Knight is in the right place, at the right time.

# POSITIONED







LEADING

INVOLVED

.....Best of Breed.....Compliance Procedures and Systems.....Trailblazing in the New Market Structure.....Leading by Example.....Building the Benchmark.....

Working to elevate the level of compliance throughout the industry

**PREMIER MARKET MAKER**

Though many say the markets are “moving toward an agency platform,” the majority of all equities trading still occurs in an intermediated environment. Why not just trade with ECNs? Both institutions and retail broker-dealers require greater certainty of execution outcomes through continuous liquidity. They need to know that their trade will be executed completely – that someone will step into the role of principal, commit capital and be the other side of the trade.

**COMPLIANCE WITHOUT COMPROMISE**

Business relationships with our clients are a key to Knight’s success. While taking risks to enhance shareholder value, we serve our clients with the highest ethical standards, committing capital under a tough umbrella of compliance and market regulation. Our compliance practices and procedures are sound. Without question, Knight’s trading policies are above reproach.



# LIQUIDITY

.....One-Stop Execution Solution.....Connectivity.....Access.....Willingness to Commit Capital.....Deep Pool of Liquidity.....Price Discovery .....Discretion .....

## Unlocking the value of Knight's capital in the marketplace

### VALUE-ADDED LIQUIDITY

As absolute returns become more elusive and market return expectations continue to fall, all investors are seeking new means of relative performance. Portfolio Managers are looking for more alpha from their trading desks which, in turn, has made institutional trading desks focus on reducing implicit and explicit trading costs.

### DESTINATION OF CHOICE

Where does Knight fit in? Trading desks are seeking out destinations to help them control these implicit and explicit costs. They are seeking out service providers who can help them lower their cost basis and increase the eventual yield of portfolio holdings. These are service providers who will commit capital, can leverage scale, focus on the client and are absent of conflicts when coupled with investment banking and sell-side research activities. Service providers like Knight.

WWW.KNIGHTTRADINGGROUP.COM

# DESTINATION



PASSIONATE

UNIQUE

.....Program Trading....Unmatched Competitive Position....Business to Business....Analytical Trading....Power of Choice....Altering the Client Mix....Multiple Product Lines.....

Leveraging competitive advantages to be the world's premier market maker

**CLIENT-DRIVEN**

As the single point of entry for order flow in more than 17,000 equity securities and approximately 2,500 OCC cleared option products, Knight provides order execution solutions with continuous liquidity, immediacy and certainty that no one can match. This is what our clients demand.

**HUMAN CAPITAL**

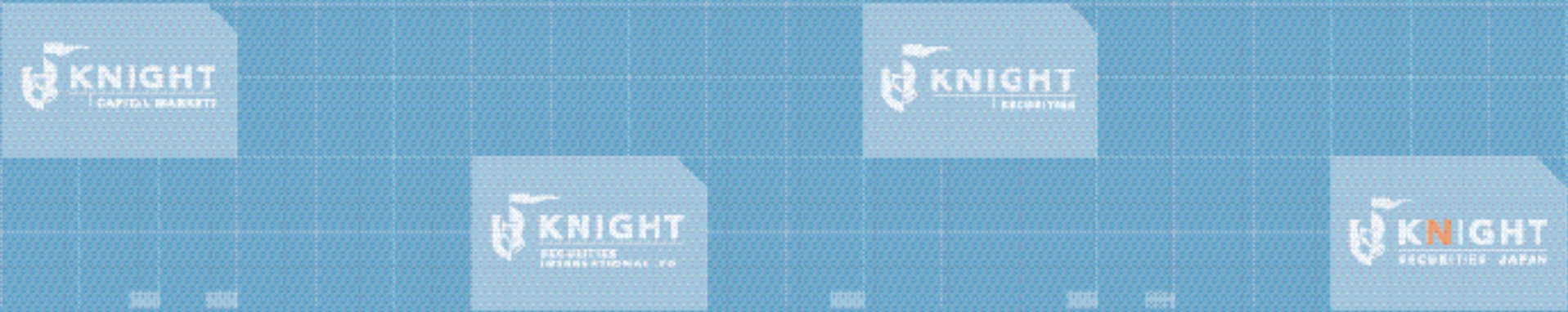
Knight values its human capital – the employees who add the human element to our technology and turn it into client service. Knight has made a major investment in its talent by building a culture that emphasizes personal and professional growth and rewards excellence.

**FLEXIBILITY AND SCALE**

Flexibility and scale set us apart. Our capacity and throughput is simply unrivaled. Knight's order processing system has redefined the way the world looks at order execution.



# PRODUCTS\*



Nasdaq National Market System..... Nasdaq Small Caps..... NASD's OTC Bulletin Board..... NBSE's Pink Sheets..... ADRs..... Jasdag..... Nasdaq InterMarket..... Nasdaq Europe..... London Stock Exchange..... Deutsche Börse..... Euronext..... Listed.....

## EQUITIES

**DOMESTIC**  
Knight is the premier destination for broker-dealers and institutions seeking equity order executions. We are the world's largest wholesale market maker with the ability to process order flow in more than 17,000 equity securities. In 2001, Knight traded 135 billion shares – a volume behind only Nasdaq and NYSE. Knight Securities is the #1 market maker in Nasdaq/OTC securities. Knight Capital Markets is the #1 market maker in the Nasdaq InterMarket™ and a top-five execution venue for block volume in NYSE-listed and AMEX-listed securities.\*\* We're on top

in the Bulletin Board and Nasdaq small-cap market, and we're making our move in foreign/ADR trading.  
Knight has an aggregate pool of natural retail and institutional liquidity to tap for complete execution solutions. Whether our clients need an execution for a large block of an illiquid security or a basket of Nasdaq 100 stocks, Knight has the scale to get the trade done. How? Our employees are focused on our clients. Our technology is built for speed, capacity and compliance. Knight has the right mix to make it happen.

\*\* TheAulEa Group

**INTERNATIONAL**  
Knight Securities International, a joint venture with the financial services firms of Knight Roundtable Europe, offers industry-leading execution services in U.S. equities to top institutions and broker-dealers in Europe and makes markets in European securities. Knight Securities Japan, established with our partner Nikko Cordial Group, makes markets and provides clients with reliable executions in Jasdag stocks.

National Full-Service Broker-Dealers..... Investment Advisors..... On-line/Discount Broker-Dealers..... Fund-of-Funds..... Professional Traders..... Trusts and Endowments..... Regional Broker-Dealers..... Public/State Funds..... Hedge Funds..... Pension Plan Sponsors..... Mutual Funds.....

Visit [www.knighttradinggroup.com](http://www.knighttradinggroup.com) for complete details on our products and execution standards.





CBOT AMEX ISE CBT PHILX CBOT PEL CBOT AMEX ISE CBT PHILX CBOT PEL

OPTIONS

Technology innovation and market structure reform have thrust the options industry into a period of dramatic change, and Knight has the expertise to benefit in this time of consolidation. Knight Financial Products is an industry leader with specialist capabilities for approximately 570 option classes, which cover more than half of all equity option order flow on all U.S. options exchanges. We provide liquidity and pricing efficiency to institutions, broker-dealers and the overall market.

Knight Execution Partners, which routes client options order flow to all domestic options exchanges, has the capacity to process order flow in more than 2,500 OCC cleared options products. We offer the highest level of service to our institutional and broker-dealer clients through quality executions at the best price, with speed and scale.

ASSET MANAGEMENT

Brand name and a focus on capital preservation attract institutions and high net worth investors to Deephaven Capital Management's market neutral fund. The fund offers a diversified strategy including sophisticated arbitrage trading (convertible, statistical and risk) with low correlation to the equities markets.

Top Industry Player.....Technologically Advanced.....Specialist on All U.S. Options Exchanges.....Unique Routing Capabilities.....Reliability.....Leading Market Neutral Asset Manager.....Strong Brand Name.....Sophisticated Arbitrage Trading.....Analytical Approach



# BRIGHT FUTURE

- Leading = Superior Execution Solutions
- Destination = Franchise Trading Platform
- Passionate = Focused Client Service
- Positioned = Surviving and Adapting



Chief Executive Officer's Letter

GO

KENNETH D. PASTERNAK  
Retired Chief Executive Officer

ANTHONY M. SANFILIPPO  
Interim Chief Executive Officer



DEAR FELLOW KNIGHT SHAREHOLDER,

We refer to 2001 as the dark days for Knight. We experienced our first-ever quarterly loss. We were forced to right-size with our first-ever staff reduction. After growing at a furious pace—a compound annual growth rate of more than 50% a year for four years—suddenly we had to shift our primary business objective from success to survival. This past year's financial performance was, indeed, a bitter pill to swallow. We need to understand every aspect of it to make sure history does not repeat itself. To make sure we survive these dark days and have progress to report next year.

Financially, 2001 was Knight's most difficult year. Our 2001 revenues decreased 46% to \$684.7 million from \$1,257.3 million in 2000. Pre-tax income decreased to \$54.3 million, an 87% decline from 2000 pre-tax income of \$418.5 million. Net income was \$38.5 million, down from 2000 net income of \$259.9 million. EPS for the full year was \$0.31. International expansion efforts resulted in an approximate \$0.30 charge to 2001 EPS. On an annualized basis, our return on equity was 4.7% for the full year 2001.

KNIGHT: HIT HARD

After years of rapid acceleration—technological innovations, growth in trading volumes, the Nasdaq topping the 5000 mark—the bull market of the century came to an abrupt end. We witnessed the greatest top-to-bottom decline the markets have ever known. Market indices fluctuated, with the Nasdaq Composite Index down 21%, DJIA down 7%, S&P 500 down 13%, and international market indices from Europe to Japan weakened. Retail broker-dealer participation in the equity markets evaporated. Institutions traded cautiously. A new breed of active traders exploited marketplace inefficiencies. Simply, the markets declined and Knight's profitability followed. The roar we heard a short 18 months ago was silenced, leaving all investors with a feeling of uncertainty and doubt.

Even more than the market decline, decimalization with one-penny minimum price variation (MPV) had the greatest impact on the industry last year. According to Nasdaq's Economic Research Study, effective spread contracted by 46% in the first full month of decimalized trading, greater than the projected decline of 10%. Historically, Knight made money through a combination of the revenue captured by the number of shares traded, disciplined inventory management, spread retention, market volume and volatility, and principal amount traded. How did the market structure changes of 2001 affect Knight? We experienced a dramatic reduction in one element of our profitability mix – spread retention. Knight is working through these changes, putting the pieces together to reclaim profitability.

When Knight was founded in 1995, we latched on for the heady ride of the on-line trading boom. As we benefited from this trend in self-directed investing in the U.S. and rode to the top of the bull market, we scrambled to pull together the resources necessary to keep pace with demand. We prepared for the same investing trend to take hold overseas. Our rapid growth put us at a disadvantage when the market cycle headed downward. Our infrastructure remained. As did the costs associated with maintaining it. What are we going to do to get back on top of our game?

#### KNIGHT: A SURVIVOR

Knight is reexamining its market-making approach and making adjustments to both technology and human capital to address these changing market dynamics. We are exploring new trading methodologies and developing sophisticated routing algorithms to identify the profit opportunities in each trade. Our trading systems can't be entirely rule-based when releasing liquidity into the marketplace. After all, we are deploying capital to smooth the gaps where no natural liquidity exists. This capital commitment has value, which must reflect the diversity of individual stocks, market situations and client demands. We are charging commissions on certain transactions, albeit a very small percentage of them. We are watching as the industry begins to rationalize the costs associated with order execution.

Relative risk-adjusted performance is creating a fundamental shift on the buy-side. Portfolio Managers are developing new strategies around order executions, rationalizing implicit and explicit costs. Inefficient order execution can raise their cost basis. It can also decrease the eventual yield of portfolio holdings. Institutional trading desks are seeking service providers with the technology and expertise to help them create alpha for their Portfolio Managers. So, where does Knight fit in?

Optimal execution service is the heart and soul of our value-added proposition. Knight offers solutions that afford our clients timely, superior executions. We provide price improvement, liquidity, speed of executions for market orders and high fulfillment rates coupled with rapidity for limit orders. The challenge we must overcome is how we can recover the revenue lost and, ultimately, improve profitability.

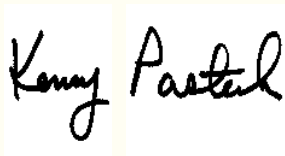
#### KNIGHT: THE FUTURE

Knight is evolving at a critical time, and in the right place to capitalize on the changes in our industry. In the U.S. equity markets, implementation of SEC Rules 11Ac1-5 and 11Ac1-6 brought enhanced disclosure of execution quality and order routing practices to the marketplace. Statistics indicate that Knight's execution quality is highly competitive. Our value-added proposition remains valid and relevant. We maintain a strong balance sheet. We are debt-free. However, there is work to be done before we will see significant steps towards profitability.

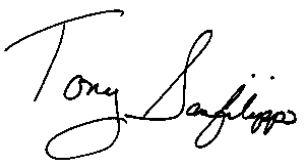
During 2002, Knight will hire a new CEO to manage our progress as we rethink the way we do business. However, that does not mean we will wait a single minute to start our work. We are reviewing costs. We are deploying our human capital wisely. We are reevaluating investments both abroad and domestically. We are adjusting our trading methodologies in our equities businesses. We are preparing for the introduction of Nasdaq's SuperMontage. We are focusing our options business on increasing margins in an environment where revenue per option contract continues to decline due to lower underlying prices of equities and increased competition. We are emphasizing fund returns over pure asset gathering in our asset management business.

Looking at Knight today, we are working together to transition the company to the next chapter of its story. If ways exist to create more value around the execution process, we will find them. If ways exist to better service our clients and help them succeed, we will find them. We will turn the challenges we face into opportunities. This past year knocked us down, but not out. We are still the market leader and understand our space better than any of our competitors. We will leverage our knowledge. We will survive. We are Knight.

Sincerely,

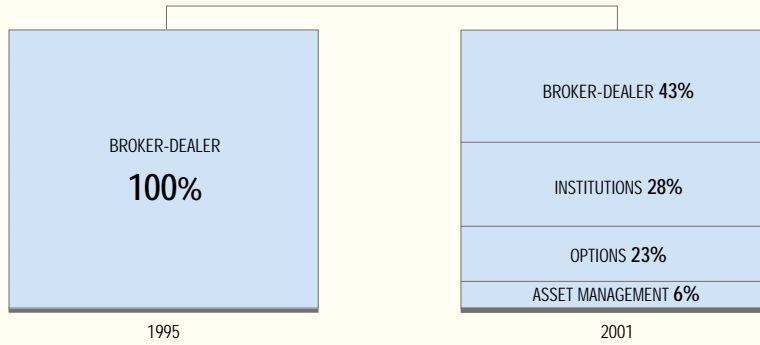


Kenny Pasternak

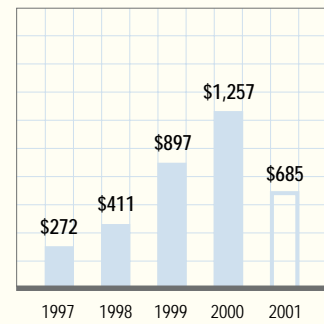


Tony Sanfilippo

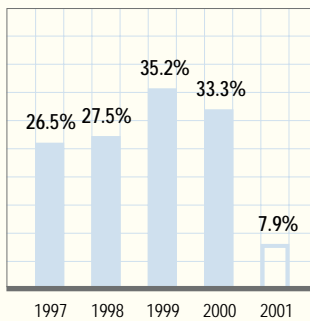
#### CLIENT MIX: PERCENTAGE OF REVENUES



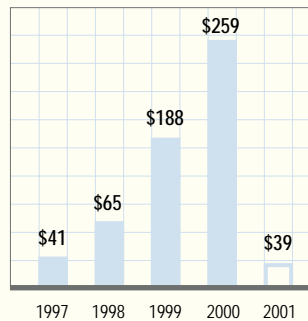
#### TOTAL REVENUES (in millions)



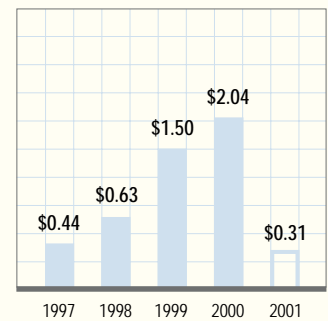
#### PRE-TAX MARGINS\*



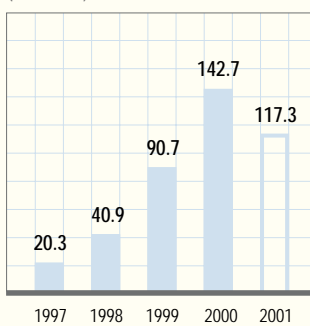
#### NET INCOME\* (in millions)



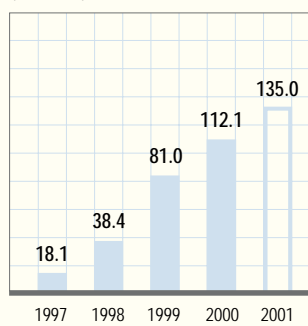
#### DILUTED EARNINGS PER SHARE\*



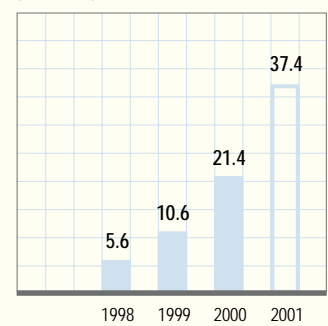
#### TOTAL U.S. EQUITY TRADES EXECUTED (in millions)



#### TOTAL U.S. EQUITY SHARES TRADED (in billions)



#### TOTAL U.S. OPTION CONTRACTS TRADED (in millions)



\* CALCULATIONS ARE BASED ON PRO FORMA NUMBERS FOR THE YEARS ENDED 1997, 1998, 1999 AND THE PERIOD ENDED JANUARY 12, 2000. SEE FOOTNOTES 2 AND 3 ON PAGE 25.





CORPORATE\_HEADQUARTERS  
KNIGHT\_TRADING\_GROUP,\_INC.  
NEWPORT\_TOWER  
525\_WASHINGTON\_BOULEVARD  
JERSEY\_CITY,\_NEW\_JERSEY\_07310  
TEL:\_201.222.9400  
FAX:\_201.557.6853  
TOLL\_FREE:\_800.544.7508  
[WWW.KNIGHTTRADINGGROUP.COM](http://WWW.KNIGHTTRADINGGROUP.COM)  
NASDAQ:\_NITE