

LABRANCHE & CO INC  
Form 10-Q  
November 09, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2006

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-15251

**LABRANCHE & Co INC.**

(Exact name of registrant as specified in its charter)

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

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

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

(Address of principal executive offices) (Zip Code)

**(212) 425-1144**

(Registrant's telephone number, including area code)

**Not Applicable**

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

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer       Accelerated filer       Non-accelerated filer

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

The number of shares of the registrant's common stock outstanding as of November 7, 2006 was 60,733,889.

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements.****LaBRANCHE & CO INC. and SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(UNAUDITED)****(000 s omitted except per share data)**

|  | <b>For the Three Months<br/>Ended September 30,</b> |                    | <b>For the Nine Months<br/>Ended September 30,</b> |                    |
|--|---|--------------------|--|--------------------|
|  | <b>2006</b>   | <b>2005</b>        | <b>2006</b>  | <b>2005</b>        |
|  | <b>(unaudited)</b>                                  | <b>(unaudited)</b> | <b>(unaudited)</b>                                 | <b>(unaudited)</b> |
| <b>REVENUES:</b>                                       |   |                    |  |                    |
| Net gain on principal transactions                     | \$ 45,129   | \$ 47,212          | \$ 134,917   | \$ 135,124         |
| Commissions  | 16,739  | 20,123             | 55,423   | 64,876             |
| Net(loss) gain on non-marketable investments           | (83)  | 1,059              | 60   | 1,381              |
| Net gain on NYX transaction                            | 17,645  |                    | 166,317  |                    |
| Stock borrow interest                                  | 38,170  | 9,459              | 99,843   | 16,185             |
| Other interest   | 7,671   | 5,056              | 18,386   | 11,567             |
| Other  | 177   | 822                | 254  | (354)              |
| <b>Total revenues</b>                                  | <b>125,448</b>                                      | <b>83,731</b>      | <b>475,200</b>                                     | <b>228,779</b>     |
| <b>EXPENSES:</b>                                       |   |                    |  |                    |
| Employee compensation and related benefits             | 20,098  | 25,747             | 63,621   | 72,527             |
| Margin interest  | 50,830  | 10,152             | 119,623  | 18,959             |
| Other interest   | 13,437  | 13,133             | 40,644   | 39,690             |
| Exchange, clearing and brokerage fees                  | 11,972  | 10,559             | 34,546   | 30,445             |
| Lease of exchange memberships and trading license fees | 1,340   | 1,008              | 3,651  | 3,003              |
| Depreciation and amortization of intangibles           | 3,195   | 3,008              | 9,255  | 9,100              |
| Other  | 10,815  | 9,374              | 31,903   | 30,579             |
| <b>Total expenses</b>                                  | <b>111,687</b>                                      | <b>72,981</b>      | <b>303,243</b>                                     | <b>204,303</b>     |
| <b>Income before provision for income taxes</b>        | <b>13,761</b>                                       | <b>10,750</b>      | <b>171,957</b>                                     | <b>24,476</b>      |
| <b>PROVISION FOR INCOME TAXES</b>                      | <b>5,924</b>  | <b>1,592</b>       | <b>74,224</b>                                      | <b>4,330</b>       |
| <b>Net income applicable to common stockholders</b>    | <b>\$ 7,837</b>                                     | <b>\$ 9,158</b>    | <b>\$ 97,733</b>                                   | <b>\$ 20,146</b>   |
| <b>Weighted-average common shares outstanding:</b>     |   |                    |  |                    |
| Basic  | 60,734  | 60,624             | 60,720   | 60,615             |
| Diluted  | 61,403  | 60,964             | 61,476   | 60,947             |
| <b>Earnings per share:</b>                             |   |                    |  |                    |
| Basic  | \$ 0.13   | \$ 0.15            | \$ 1.61  | \$ 0.33            |
| Diluted  | \$ 0.13   | \$ 0.15            | \$ 1.59  | \$ 0.33            |

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



**Table of Contents****LaBRANCHE & CO INC. and SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

(000 s omitted except per share data)

|   | As of               |                     |
|---|---------------------|---------------------|
|   | September 30,       | December 31,        |
|   | 2006                | 2005                |
|   | (unaudited)         | (audited)           |
| <b>ASSETS</b>   |                     |                     |
| Cash and cash equivalents   | \$ 481,881          | \$ 427,284          |
| Cash and securities segregated under federal regulations  | 8,317               | 6,554               |
| Securities purchased under agreements to resell   | 78,000              | 79,000              |
| Receivable from brokers, dealers and clearing organizations   | 112,273             | 596,796             |
| Receivable from customers   | 2,785               | 3,659               |
| Financial instruments owned, at fair value:   |                     |                     |
| Corporate equities, not readily marketable  | 210,362             |                     |
| Corporate equities  | 1,573,266           | 660,949             |
| Options   | 559,558             | 393,783             |
| Exchange-traded funds   | 630,913             | 743,853             |
| Government and corporate bonds  | 198,872             | 8                   |
| Commissions receivable  | 3,655               | 4,337               |
| Exchange memberships contributed for use, at market value   |                     | 24,500              |
| Exchange memberships owned, at adjusted cost (market value of \$3,566 and \$138,768, respectively)  | 1,314               | 59,664              |
| Office equipment and leasehold improvements, at cost, less accumulated depreciation and amortization of \$13,837 and \$12,364, respectively | 11,682              | 2,695               |
| Intangible assets, net of accumulated amortization:   |                     |                     |
| Specialist stock lists, less accumulated amortization of \$63,144 and \$55,362, respectively  | 343,046             | 350,828             |
| Trade name  | 25,011              | 25,011              |
| Goodwill  | 250,569             | 250,569             |
| Deferred tax assets   | 22,697              | 12,543              |
| Other assets  | 37,354              | 22,876              |
| <b>Total assets</b>   | <b>\$ 4,551,555</b> | <b>\$ 3,664,909</b> |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                     |                     |
| Liabilities:  |                     |                     |
| Payable to brokers and dealers  | \$ 167,397          | \$ 17,811           |
| Payable to customers  | 4,086               | 4,858               |
| Financial instruments sold, but not yet purchased, at fair value:   |                     |                     |
| Corporate equities  | 1,590,206           | 1,377,184           |
| Options   | 653,927             | 400,211             |
| Exchange-traded funds   | 498,696             | 321,316             |
| Government and corporate bonds  | 26,381              | 77,263              |
| Accrued compensation  | 3,934               | 22,722              |
| Accounts payable and other accrued expenses   | 37,043              | 21,133              |
| Other liabilities   | 16,945              | 11,859              |
| Income taxes payable  | 2,631               | 10,513              |
| Deferred tax liabilities  | 224,791             | 148,263             |
| Short term debt   | 24,622              | 3,000               |
| Long term debt  | 459,837             | 481,425             |
| Subordinated liabilities:   |                     |                     |
| Exchange memberships contributed for use, at market value   |                     | 24,500              |

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|   |                     |                     |
|---|---------------------|---------------------|
| Other subordinated indebtedness   | 6,395               | 9,395               |
| <b>Total liabilities</b>  | <b>3,716,891</b>    | <b>2,931,453</b>    |
| Commitments and contingencies   |                     |                     |
| Common stock, \$.01 par value, 200,000,000 shares authorized; 60,733,889 and 60,623,819 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively | 607                 | 606                 |
| Additional paid-in capital  | 693,462             | 689,988             |
| Retained earnings   | 140,595             | 42,862              |
| <b>Total stockholders' equity</b>   | <b>834,664</b>      | <b>733,456</b>      |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 4,551,555</b> | <b>\$ 3,664,909</b> |

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

**Table of Contents****LaBRANCHE & CO INC. and SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(000 s omitted)

|   | Nine Months Ended<br>September 30, |             |
|---|------------------------------------|-------------|
|   | 2006                               | 2005        |
|   | (unaudited)                        | (unaudited) |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                    |             |
| Net income  | \$ 97,733                          | \$ 20,146   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |             |
| Depreciation and amortization of intangibles                                      | 9,255                              | 9,100       |
| Amortization of debt issuance costs and bond discount                             | 1,427                              | 1,295       |
| Compensation expense related to stock-based compensation                          | 3,475                              | 2,330       |
| Deferred taxes, net   | 66,374                             | 17,221      |
| Net gain on NYX transaction   | (130,052)                          |             |
| Changes in operating assets and liabilities:                                      |                                    |             |
| Cash and securities segregated under federal regulations                          | (1,763)                            | 7,475       |
| Securities purchased under agreements to resell                                   | 1,000                              | (34,000)    |
| Receivable from brokers, dealers and clearing organizations                       | 484,523                            | (342,940)   |
| Receivable from customers   | 874                                | 8,135       |
| Financial instruments owned, at fair value:                                       |                                    |             |
| Corporate equities, not readily marketable  | (21,810)                           |             |
| Corporate equities  | (912,317)                          | (502,714)   |
| Options   | (165,775)                          | (247,833)   |
| Exchange-traded funds   | 112,940                            | (384,808)   |
| Government and corporate bonds  | (198,864)                          |             |
| Commissions receivable  | 682                                | 805         |
| Other assets  | (15,871)                           | 938         |
| Payable to brokers and dealers  | 149,586                            | (94,147)    |
| Payable to customers  | (772)                              | 2,897       |
| Financial instruments sold, but not yet purchased, at fair value:                 |                                    |             |
| Corporate equities  | 213,022                            | 1,011,020   |
| Options   | 253,716                            | 251,090     |
| Exchange-traded funds   | 177,380                            | 228,957     |
| Government and corporate bonds  | (50,882)                           | 92,925      |
| Accrued compensation  | (18,788)                           | (12,784)    |
| Accounts payable and other accrued expenses                                       | 15,910                             | 13,319      |
| Other liabilities   | 5,086                              | (599)       |
| Tax benefit from vesting of stock based compensation                              | (61)                               |             |
| Income taxes payable  | (7,882)                            | 5,138       |
| Net cash provided by operating activities   | 68,146                             | 52,966      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                    |             |
| Payments for purchases of office equipment and leasehold improvements             | (10,460)                           | (673)       |
| Payments for purchases of exchange memberships                                    | (150)                              | (325)       |
| Net cash used in investing activities   | (10,610)                           | (998)       |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                    |             |
| Payment to minority interest holder   |                                    | (356)       |
| Principal payments of subordinated debt   | (3,000)                            | (4,890)     |



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|  |            |            |
|--|------------|------------|
| Tax benefit from vesting of stock based compensation | 61         |            |
| Repayment of short term and long term debt           |            | (2,063)    |
| Net cash used in financing activities                | (2,939)    | (7,309)    |
| Increase in cash and cash equivalents                | 54,597     | 44,659     |
| CASH AND CASH EQUIVALENTS, beginning of period       | 427,284    | 444,446    |
| CASH AND CASH EQUIVALENTS, end of period             | \$ 481,881 | \$ 489,105 |

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

|              |            |           |
|--------------|------------|-----------|
| Interest     | \$ 146,546 | \$ 27,193 |
| Income taxes | \$ 15,486  | \$ 362    |

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

|  |              |          |
|--|--------------|----------|
| Net increase in additional paid-in capital related to stock-based awards                 | \$ 3,474     | \$ 2,329 |
| Net increase in corporate equities, not readily marketable from NYX exchange transaction | \$ (188,552) |          |
| Net increase from exchange of NYSE memberships for NYX common stock                      | \$ 58,500    |          |

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

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**LaBRANCHE & CO INC. and SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**1. ORGANIZATION AND DESCRIPTION OF BUSINESS**

The condensed consolidated financial statements include the accounts of LaBranche & Co Inc., a Delaware corporation (the Holding Company), and its subsidiaries, LaBranche & Co. LLC, a New York limited liability company, LaBranche Financial Services, Inc., a New York corporation ( LFSI ), LaBranche Structured Holdings, Inc., a Delaware corporation ( LSHI ), LABDR Services, Inc., a Delaware corporation ( LABDR ), and LaBranche & Co. B.V., a Netherlands private limited liability company ( BV ). The Holding Company is the sole member of LaBranche & Co. LLC, the 100% stockholder of LFSI, LSHI and LABDR and the sole owner of BV. LSHI is a holding company that is the sole member of LaBranche Structured Products, LLC, a New York limited liability company ( LSP ), LaBranche Structured Products Specialists LLC, a New York limited liability company ( LSPS ), LaBranche Structured Products Europe Limited, a United Kingdom single member private company ( LSPE ), LaBranche Structured Products Hong Kong Limited, a Hong Kong single member private company ( LSPH ), and LaBranche Structured Products Direct, Inc., a New York corporation ( LSPD ), and collectively with the Holding Company, LaBranche & Co. LLC, LFSI, LSHI, LABDR, LSP, LSPS, LSPE and LSPH, the Company ). LaBranche & Co. LLC is a registered broker-dealer that operates primarily as a specialist in equity securities and rights listed on the New York Stock Exchange ( NYSE ) and in equity securities on the American Stock Exchange ( AMEX ). LFSI is a registered broker-dealer and a member of the NYSE and other exchanges and provides securities execution, securities clearing and other related services to its own customers and customers of introducing brokers. LFSI also provides direct-access floor brokerage services to institutional customers. LSP is a registered broker-dealer that operates as a specialist in options, futures and Exchange-Traded Funds ( ETFs ) on several exchanges, and as a market-maker in options, ETFs and futures on several exchanges. LSPS is a registered broker-dealer that operates as a specialist in ETFs traded on the NYSE. LSPE is a United Kingdom-registered broker-dealer and operates as a market-maker for ETFs in Europe. LSPH was organized to operate as a market-maker for ETFs and engage in hedging transactions in Asia, and is in the process of registering as a broker-dealer with Hong Kong's Securities and Futures Commission. LSPD is an NASD member firm that was acquired by the Company in April 2006 and is in the process of obtaining an approval from the NASD to become a market-maker on the NASDAQ system. LABDR provides disaster recovery services and back-up facilities to other Holding Company subsidiaries. BV represents LaBranche & Co. LLC in European markets and provides client services to LaBranche & Co. LLC's European listed companies.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Cash and Cash Equivalents***

Included in cash and cash equivalents are currency positions that are being held in the prime brokerage account at the Company's clearing broker for its specialist and market-making operations. At September 30, 2006 and December 31, 2005 the balances were \$73.8 million and \$43.0 million, respectively. These balances represent cash that may be used only in connection with the Company's day-to-day specialist and market-making activities.

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### ***Securities Transactions***

The Company, at the subsidiary level, has proprietary security positions in which it maintains both long and short positions in separate proprietary trading accounts at its clearing broker. These long and short positions are treated as offsetting and are presented on a net basis. Prior-period amounts have been reclassified to conform to the current period's presentation.

Certain receivables from and payables to brokers, dealers and clearing organizations have been presented on a net-by-counterparty basis when the requirements of FIN No. 39, Offsetting of Amounts Related to Certain Contracts, are satisfied. Prior-period amounts have been reclassified to conform to the current period's presentation.

### **3. INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND FINANCIAL INFORMATION**

The unaudited interim condensed consolidated financial information as of September 30, 2006 and for the three and nine months ended September 30, 2006 and 2005 is presented in the accompanying condensed consolidated financial statements. The unaudited interim condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial information. The unaudited interim condensed consolidated financial information reflects all adjustments which are, in the opinion of management, necessary for a fair presentation of the results for such periods. The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates and assumptions. The unaudited interim condensed consolidated financial information as of September 30, 2006 should be read in conjunction with the audited consolidated financial statements and notes thereto as of December 31, 2005 included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission (SEC) on March 16, 2006 (the 2005 10-K). Results of the third quarter 2006 interim period are not necessarily indicative of results to be obtained for the full fiscal year.

### **4. INCOME TAXES**

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes, which requires the recognition of tax benefits or expenses based on the estimated future tax effects of temporary differences between the financial statement and tax bases of its assets and liabilities. Deferred tax assets and liabilities primarily

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relate to tax basis differences on unrealized gains on corporate equities, not readily marketable, stock-based compensation, other compensation accruals, amortization periods of certain intangible assets and differences between the financial statement and tax bases of assets acquired.

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

|   | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2006 | September 30, 2005 | September 30, 2006 | September 30, 2005 |
| Current federal, state and local taxes  | \$ (5,474)         | \$ 2,391           | \$ 7,850           | \$ (12,891)        |
| Deferred tax provision (benefit)        | 11,398             | (799)              | 66,374             | 17,221             |
| <b>Total provision for income taxes</b> | <b>\$ 5,924</b>    | <b>\$ 1,592</b>    | <b>\$ 74,224</b>   | <b>\$ 4,330</b>    |

**5. CAPITAL AND NET LIQUID ASSET REQUIREMENTS**

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

As of September 30, 2006 and December 31, 2005, LaBranche & Co. LLC's net capital, as defined under SEC Rule 15c3-1, was \$415.6 million and \$459.8 million, respectively, which exceeded the minimum requirements by \$414.2 million and \$458.1 million, respectively. LaBranche & Co. LLC's aggregate indebtedness to net capital ratio on those dates was .05 to 1 and .05 to 1, respectively.

The NYSE generally requires its specialist firms to maintain a minimum dollar regulatory capital amount in order to establish that they can meet, with their own net liquid assets, their position requirement. Prior to September 1, 2006 LaBranche & Co. LLC's and LSPS' net liquid asset requirements were combined. The combined requirement was calculated by LaBranche & Co. LLC, this requirement was met with the LLC's net liquid assets. Subsequent to September 1, 2006, each company is required to compute and meet its own requirement. As of September 30, 2006 LaBranche & Co. LLC's NYSE minimum required dollar amount of net liquid assets, as defined, was \$313.8 million. LaBranche & Co. LLC's actual net liquid assets, as defined, were \$412.2 million as of September 30, 2006. As of December 31, 2005, LaBranche & Co. LLC's and LSPS' combined NYSE minimum required dollar amount of net liquid assets, as defined was \$447.0 million. LaBranche & Co. LLC's actual net liquid assets, as defined were \$459.3 million at December 31, 2005. As of September 30, 2006 and December 31, 2005, LaBranche & Co. LLC's actual net liquid assets exceeded the net liquid assets requirement. LaBranche & Co. LLC thus satisfied its respective net liquid asset requirement as of those dates. On July 25, 2006, the SEC approved a reduction of the minimum dollar regulatory capital for a specialist in cash equities and increased the requirement for a specialist in ETFs. This reduction is to be effected in four quarterly installments. After the receipt of the first installment, a dividend was paid to the Holding Company on September 1, 2006 in the amount of \$49 million, which also included pre-September 1, 2006 excess NLA held by the company. As a result, the Company anticipates that LaBranche & Co. LLC's aggregate required minimum NLA will be significantly reduced in additional installments on each of December 1, 2006, March 1, 2007 and June 1, 2007.

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The AMEX generally requires its equity specialist firms to maintain a cash or liquid asset position of the greater of (a) \$1.0 million or (b) an amount sufficient to assume a position of sixty trading units of each security in which the equity specialist is registered. As of September 30, 2006 and December 31, 2005, LaBranche & Co. LLC satisfied the AMEX equity specialist liquid asset requirements.

As a registered broker-dealer and member firm of the NYSE, LFSI is also subject to SEC Rule 15c3-1, as adopted and administered by the SEC and the NYSE. Under the alternative method permitted by this rule, the minimum required net capital is equal to the greater of \$1.5 million or 2.0% of aggregate debit items, as defined. As of September 30, 2006 and December 31, 2005, LFSI's net capital, as defined, was \$19.8 million and \$19.7 million, respectively, which exceeded minimum requirements by \$18.3 million and \$18.2 million, respectively.

As a clearing broker-dealer, LFSI is subject to SEC Rule 15c3-3, as adopted and administered by the SEC. As of October 2, 2006, to comply with its September 30, 2006 requirement, cash and U.S. Treasury Bills in the amount of \$2.6 million were segregated in a special reserve account for the exclusive benefit of customers, thus exceeding actual requirements by \$2.1 million. As of January 4, 2006, to comply with its December 31, 2005 requirement, cash and U.S. Treasury Bills in the amount of \$1.2 million were segregated in a special reserve account for the exclusive benefit of customers, exceeding actual requirements by \$1.2 million. In addition, the Proprietary Accounts of Introducing Brokers ( PAIB ) Calculation is computed in order for correspondent firms to classify their assets held by LFSI as allowable assets in the correspondents net capital calculation. As of October 2, 2006, to comply with LFSI's September 30, 2006 requirement, cash and U.S. Treasury Bills in the amount of \$5.5 million were segregated in a special reserve account for the exclusive benefit of customers, exceeding actual requirements by \$1.0 million. As of January 4, 2006, to comply with LFSI's December 31, 2005 requirement, cash and U.S. Treasury Bills in the amount of \$5.7 million were segregated in a special reserve account for the exclusive benefit of customers, thus exceeding actual requirements by \$2.0 million.

As a registered broker-dealer and AMEX member firm, LSP is subject to SEC Rule 15c3-1, as adopted and administered by the SEC and the AMEX. LSP is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. As of September 30, 2006 and December 31, 2005, LSP's net capital, as defined, was \$64.5 million and \$56.8 million, respectively, which exceeded minimum requirements by \$64.0 million and \$55.7 million, respectively. LSP's aggregate indebtedness to net capital ratio on those dates was .10 to 1 and .29 to 1, respectively.

LSPS, as a specialist and member of the NYSE, is subject to the provisions of SEC Rule 15c3-1, as adopted and administered by the SEC and NYSE. LSPS is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. As of September 30, 2006 and December 31, 2005, LSPS' net

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capital, as defined, was \$20.0 million and \$10.7 million, respectively, which exceeded the minimum requirements by \$19.8 million and \$10.6 million, respectively. LSPS' aggregate indebtedness to net capital ratio on those dates was .14 to 1 and .16 to 1, respectively. As of September 30, 2006, LSPS' NYSE minimum required dollar amount of net liquid assets, as defined, was \$12.5 million. LSPS' actual net liquid assets, as defined, were \$19.8 million. As of September 30, 2006 LSPS' actual net liquid assets exceeded the net liquid assets requirement. LSPS thus satisfied its respective net liquid asset requirement as of those dates. Prior to September 1, 2006 LSPS was not required to perform a net liquid assets calculation because LaBranche & Co. LLC's actual net liquid assets exceed the combined net liquid assets requirement of LaBranche & Co. LLC and LSPS.

LSPD is an NASD member firm which was acquired by the Company in April 2006. It is subject to the provisions of SEC Rule 15c3-1, as adopted and administered by the SEC and NYSE. LSPD is required to maintain minimum net capital, as defined, equivalent to the greater of \$5,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. As of September 30, 2006, LSPD's net capital, as defined, was \$3.0 million, which exceeded the minimum requirements by more than \$2.9 million.

**6. EARNINGS (LOSS) PER SHARE**

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

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

|   | <b>Three Months<br/>Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2006</b>                                     | <b>2005</b> | <b>2006</b>                                | <b>2005</b> |
| Numerator for basic and diluted earnings per share net income applicable to common stockholders | \$ 7,837  | \$ 9,158    | \$ 97,733                                  | \$ 20,146   |
| Denominator for basic earnings per share weighted-average number of common shares outstanding   | 60,734  | 60,624      | 60,720                                     | 60,615      |
| Dilutive shares:  |   |             |  |             |
| Restricted stock units  | 669   | 340         | 756  | 332         |
| Denominator for diluted earnings per share weighted-average number of common shares outstanding | 61,403  | 60,964      | 61,476                                     | 60,947      |
| Earnings per share:   |   |             |  |             |
| Basic   | \$ 0.13   | \$ 0.15     | \$ 1.61                                    | \$ 0.33     |
| Diluted   | \$ 0.13   | \$ 0.15     | \$ 1.59                                    | \$ 0.33     |

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Options to purchase an aggregate of 1,654,778 and 1,709,778 shares of common stock were outstanding during the three and nine months ended September 30, 2006 and 2005, respectively, but were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the Company's common stock. In addition, potential common shares relating to restricted stock and restricted stock units for the three months ended September 30, 2006 and 2005 totaling 922,185 and 728,706 shares and nine months ended September 30, 2006 and 2005 totaling 834,607 and 736,829 shares, respectively, were dilutive. The calculation of diluted earnings per share includes the dilutive effect of these stock-based awards.

**7. EMPLOYEE INCENTIVE PLANS**

In December 2004, the FASB issued SFAS No. 123(R), Share Based Payment. SFAS No. 123(R) is a revision of SFAS No. 123, Accounting for Stock-Based Compensation and supersedes APB opinion No. 25, Accounting for Stock Issued to Employees and amends SFAS No. 95, Statement of Cash Flows. SFAS No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. SFAS No. 123(R) was adopted as of January 1, 2006, using the modified prospective method. SFAS No. 123(R) requires expected forfeitures to be included in determining share-based employee compensation expense. Prior to the adoption of SFAS No. 123(R), forfeiture benefits were recorded as a reduction to compensation expense when an employee left the firm and forfeited the award. In the first quarter of 2006, the Company recorded a benefit for expected forfeitures on all outstanding share-based awards. The transition impact of adopting SFAS No. 123(R) as of the first day of the Company's 2006 fiscal year, including the effect of accruing for expected forfeitures on outstanding share-based awards, was not material to the Company's financial condition, results of operations, earnings per share or cash flows for the third quarter and first nine months of 2006.

The following disclosures are also being provided pursuant to the requirements of SFAS No. 123(R):

The Company sponsors one share-based employee incentive plan—the LaBranche & Co Inc. Equity Incentive Plan (the Plan), which provides for grants of incentive stock options, nonqualified stock options, restricted shares of common stock, restricted stock units, unrestricted shares and stock appreciation rights. The fair value of the restricted stock awards is determined by using the closing price of the Company's common stock on the respective dates on which the awards are granted. Grant date is determined to be the date the compensation committee of the Board of Directors approves the grant. Amortization of compensation costs for grants awarded under the Plan recognized during the three and nine months ended September 30, 2006 was approximately \$1.0 million and \$3.3 million compared to \$333,000 and \$2.1 million, for the same periods in 2005. The tax benefit realized in the Consolidated Statements of Operations for the Plan was approximately \$435,000 and \$1.4 million for the three and nine months ended September 30, 2006 compared to \$144,000 and \$913,000 for the same periods in 2005, respectively.

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At September 30, 2006, unrecognized compensation cost related to the Company's non-vested stock option and restricted stock unit awards totaled \$8.3 million. The cost of these non-vested awards is generally expected to be recognized over a weighted-average period of approximately three years.

SFAS No. 123(R) generally requires share-based awards granted to retirement-eligible employees to be expensed immediately. The Company did not grant any share-based awards prior to the adoption of SFAS No. 123(R) to retirement-eligible employees or those with non-substantive non-compete agreements. In addition, no grants of any stock options or RSUs were changed or amended after the adoption of SFAS No. 123(R) to reflect retirement eligibility or non-compete agreements.

The total number of shares of the Company's common stock that may be issued under the Plan through fiscal 2009 may not exceed 7,687,500 shares. As of September 30, 2006 and December 31, 2005, 2,892,236 shares and 3,499,472 shares, respectively, were available for grant under the Plan.

*Restricted Stock Units*

The Company issued restricted stock units to employees under the Plan, primarily in connection with year-end compensation. All of the restricted stock units (RSUs) outstanding as of September 30, 2006 and December 31, 2005 required future service as a condition to the delivery of the underlying shares of common stock. In all cases, delivery of the underlying shares of common stock is conditioned on the grantees satisfying certain requirements outlined in the agreements. Generally, the restricted stock units become fully vested if the grantee's employment with the Company terminates by reason of death or disability prior to vesting. The grantee forfeits the unvested portion of the restricted stock units upon the termination of employment for any reason other than death or disability. When delivering the underlying shares of stock to employees, the Company generally issues new shares of common stock, as opposed to reissuing treasury shares.

The following table provides information about grants of RSUs:

|   | Number of<br>Shares | Weighted<br>Average Price<br>per Share |
|---|---------------------|--|
| RSUs Outstanding as of December 31, 2005  | 1,093,666           | \$ 8.76                                |
| Granted                                   | 695,500             | 10.68                                  |
| Vested                                    | (90,668)            | 9.38                                   |
| Forfeited                                 | (66,666)            | 8.38                                   |
| RSUs Outstanding as of March 31, 2006     | 1,631,832           | \$ 9.56                                |
| Granted                                   |                     |  |
| Vested                                    |                     |  |
| Forfeited                                 | (30,000)            | 9.80                                   |
| RSUs Outstanding as of June 30, 2006      | 1,601,832           | \$ 9.55                                |
| Granted                                   |                     |  |
| Vested                                    |                     |  |
| Forfeited                                 | (11,000)            | 9.34                                   |
| RSUs Outstanding as of September 30, 2006 | 1,590,832           | \$ 9.56                                |



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Under SFAS No. 123(R), the Company is required to estimate forfeitures of RSUs for purposes of determining the Company's share-based award expense. Applying SFAS No. 123(R) as of September 30, 2006, for purposes of determining share-based award expense, RSUs with respect to 1,428,169 shares of the Company's common stock were expected to vest, with a weighted average price of \$9.44 per share.

*Stock Options*

As of December 31, 2004, all stock options granted to employees were fully vested and exercisable. In general, all stock options expire on the tenth anniversary of grant, although they may be subject to earlier termination or cancellation in certain circumstances under the Plan and the stock option agreement, such as death, disability or other termination of employment prior to the tenth anniversary of grant. The dilutive effect of the Company's outstanding stock options is included in Weighted Average Common Shares Outstanding Diluted on the Condensed Consolidated Statement of Operations.

The following table provides information about options to purchase the Company's common stock:

|   | Number of<br>Shares | Weighted<br>Average Exercise<br>Price per Share |
|---|---------------------|---|
| Options Outstanding as of December 31, 2005 | 1,709,778           | \$ 25.39  |
| Options Granted                             |                     |   |
| Options Exercised                           |                     |   |
| Options Forfeited                           |                     |   |
| Options Outstanding as of March 31, 2006    | 1,709,778           | \$ 25.39  |
| Options Granted                             |                     |   |
| Options Exercised                           |                     |   |
| Options Forfeited                           | (55,000)            | 37.27   |
| Options Outstanding as of June 30, 2006     | 1,654,778           | \$ 25.00  |
| Options Granted                             |                     |   |
| Options Exercised                           |                     |   |
| Options Forfeited                           |                     |   |
| Options Outstanding as of Sept. 30, 2006    | 1,654,778           | \$ 25.00  |
| Options Exercisable as of:                  |                     |   |
| December 31, 2005                           | 1,709,778           | \$ 25.39  |
| March 31, 2006                              | 1,709,778           | \$ 25.39  |
| June 30, 2006                               | 1,654,778           | \$ 25.00  |
| September 30, 2006                          | 1,654,778           | \$ 25.00  |

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The following table summarizes information about stock options outstanding as of September 30, 2006:

| Range of Exercise Prices | Number of Shares | Options Outstanding                         | Weighted Average Exercise Price per Share | Options Exercisable                       |
|--------------------------|------------------|---|---|---|
|                          |                  | Weighted Average Remaining Contractual Life |   | Weighted Average Exercise Price per Share |
| \$11.00 - \$20.99        | 764,778          | 3.27  | \$ 13.93                                  | 764,778 \$ 13.93                          |
| 21.00 - 30.99            | 75,000           | 6.07  | 27.50                                     | 75,000 27.50                              |
| \$31.00 - \$40.99        | 815,000          | 5.27  | \$ 35.15                                  | 815,000 \$ 35.15                          |
|                          | 1,654,778        |   |   | 1,654,778                                 |

No options were exercised during the nine months ended September 30, 2006 and 2005.

**8. BUSINESS SEGMENTS**

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

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

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

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

|  | Three Months Ended<br>September 30, |              | Nine Months Ended<br>September 30, |              |
|--|-------------------------------------|--------------|------------------------------------|--------------|
|  | 2006                                | 2005         | 2006                               | 2005         |
| <b>Specialist and Market-Making Segment:</b> |                                     |              |                                    |              |
| Revenues                                     | \$ 114,078                          | \$ 71,877    | \$ 429,988                         | \$ 192,448   |
| Operating expenses                           | 82,534                              | 44,311       | 216,073                            | 114,117      |
| Depreciation and amortization of intangibles | 2,794                               | 2,868        | 8,425                              | 8,675        |
| Income before taxes                          | 28,750                              | 24,698       | 205,490                            | 69,656       |
| Segment goodwill                             | 250,569                             | 250,569      | 250,569                            | 250,569      |
| Segment assets                               | \$ 4,321,570                        | \$ 3,364,240 | \$ 4,321,570                       | \$ 3,364,240 |
| <b>Execution and Clearing Segment:</b>       |                                     |              |                                    |              |
| Revenues                                     | \$ 10,107                           | \$ 10,035    | \$ 41,712                          | \$ 33,022    |

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|                    |       |        |        |        |
|--------------------|-------|--------|--------|--------|
| Operating expenses | 9,920 | 10,484 | 30,079 | 34,845 |
|--------------------|-------|--------|--------|--------|

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|  |              |              |              |              |
|--|--------------|--------------|--------------|--------------|
| Depreciation and amortization of intangibles | 101          | 108          | 307          | 331          |
| Income (loss) before taxes                   | 86           | (557)        | 11,326       | (2,154)      |
| Segment assets                               | \$ 64,429    | \$ 59,058    | \$ 64,429    | \$ 59,058    |
| <b>Other (1):</b>                            |              |              |              |              |
| Revenues                                     | \$ 1,263     | \$ 1,819     | \$ 3,500     | \$ 3,309     |
| Operating expenses                           | 16,038       | 15,178       | 47,836       | 46,241       |
| Depreciation and amortization of intangibles | 300          | 32           | 523          | 94           |
| Loss before taxes                            | (15,075)     | (13,391)     | (44,859)     | (43,026)     |
| Segment assets                               | \$ 165,556   | \$ 153,252   | \$ 165,556   | \$ 153,252   |
| <b>Total:</b>                                |              |              |              |              |
| Revenues                                     | \$ 125,448   | \$ 83,731    | \$ 475,200   | \$ 228,779   |
| Operating expenses                           | 108,492      | 69,973       | 293,988      | 195,203      |
| Depreciation and amortization of intangibles | 3,195        | 3,008        | 9,255        | 9,100        |
| Income before taxes                          | 13,761       | 10,750       | 171,957      | 24,476       |
| Goodwill                                     | 250,569      | 250,569      | 250,569      | 250,569      |
| Assets                                       | \$ 4,551,555 | \$ 3,576,550 | \$ 4,551,555 | \$ 3,576,550 |

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

**9. NYSE GROUP RESTRICTED STOCK EXCHANGE TRANSACTION**

As of December 31, 2005, the Company owned 39 NYSE memberships out of a total 1,366 NYSE memberships, representing a 2.9% ownership interest in the NYSE. The Company accounted for its investment in these memberships under the adjusted cost method since its inception. On March 7, 2006, the NYSE and Archipelago Holdings, Inc. combined their businesses and became wholly-owned subsidiaries of NYSE Group, Inc. (NYSE Group), a newly-created, for-profit and publicly-traded holding company (the NYSE Merger).

In the NYSE Merger each NYSE membership became entitled to receive in exchange for the NYSE membership \$300,000 in cash and 80,177 shares of NYSE Group common stock (the NYX stock). In addition, immediately prior to the consummation of the NYSE Merger, the NYSE announced a permitted dividend to be paid with respect to each NYSE membership in the amount of approximately \$70,570 (\$2.7 million in total for the Company's 39 NYSE memberships), which was equivalent to the membership's pro rata portion of the NYSE's excess cash, as defined in the merger agreement governing the NYSE Merger. The Company received the permitted dividend with respect to each of its 39 NYSE memberships on March 14, 2006.

In the NYSE Merger, the Company's 39 NYSE memberships were converted into the right to receive an aggregate of \$11.7 million cash (not including the permitted dividend) and 3,126,903 shares of NYX stock. The \$11.7 million cash distribution was treated as monetary consideration for which a realized gain was recognized in the first quarter of 2006.

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APB No. 29 (as amended) provides guidance on exchanges of assets in a non-monetary transfer. Accounting for non-monetary assets acquired in a substantially non-monetary exchange is at times based on cost or fair value of the assets relinquished and at times on the fair value of the assets received in the exchange. Based on the guidance under APB No. 29, the Company valued the shares of NYX stock received immediately after the exchange at fair value, which was deemed to be the value of the shares on the first day trading commenced for NYX stock, or \$67.00 per share. Based upon this interpretation the Company realized a \$130.1 million gain from the exchange of the NYSE memberships for 3.1 million shares of NYX stock, which includes the effect of a valuation allowance due to the restrictions on transfer applicable to the NYX stock.

After the consummation of the NYSE Merger, the Company accounts for its investment in the NYX stock as owned restricted stock and reflected at the estimated fair value of such restricted shares pursuant to the American Institute of Certified Public Accountants *Audit and Accounting Guide Brokers and Dealers in Securities*. At September 30, 2006, the NYSE closing market price for the NYX stock was \$74.75 per share as compared to the closing price of NYX stock on June 30, 2006, which was \$68.48. As such, this resulted in the Company's recognition of an unrealized gain of \$17.6 million for the three month period ended September 30, 2006, which includes a valuation allowance due to the share restrictions and is included in net gain on NYX transaction in the Company's Consolidated Statement of Operations. The Company's aggregate unrealized gain for the first nine months of 2006 was \$21.8 million. The shares of NYX stock received in the NYSE Merger are subject to a three-year restriction on transfer. The restriction will be removed in equal one-third installments on each of March 7, 2007, 2008 and 2009, unless the restrictions are removed earlier by the NYSE Group in its sole discretion.

Prior to the closing of the NYSE Merger, the Company participated in a Dutch auction for trading licenses, successfully bidding for 95 trading licenses at an annual price of \$49,290 each, the minimum bid accepted by the NYSE. The licenses became effective for trading on the NYSE on March 8, 2006. As of the end of October 2006 the Company had surrendered 13 of these licenses. The costs of the trading licenses for 2006 are approximately \$1.2 million per quarter and are included in lease of exchange memberships and trading license fees in the Company's Consolidated Statement of Operations.

On June 1, 2006, NYSE Group and Euronext N.V. announced an agreement to combine the leading U.S. and pan-European securities trading exchanges in a merger of equals with the new group, to be named NYSE Euronext. Subsequently, on September 21, 2006 NYSE Euronext, Inc. filed with the SEC a Form S-4 Registration Statement related to the proposed merger. The filing is subject to SEC review and a shareholder vote is proposed for December 2006, although a definitive date has not been set. According to the Form S-4 on file with the SEC, the current transfer restrictions will remain on the NYX stock subject to the same terms after the Euronext merger. The Company is evaluating the possible impact of this merger on the valuation of its restricted shares of NYX stock.

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### **10. CONTINGENCIES**

There have been no material new developments in the Company's legal proceedings since the Company's Form 10-Q for the quarter ended June 30, 2006, filed August 9, 2006 (the Second Quarter 10-Q), which updated the legal proceedings disclosed in the 2005 10-K and the Company's Form 10-Q for the quarter ended March 31, 2006, filed May 10, 2005 (the First Quarter 10-Q), except as follows:

Brown. The history of this litigation is reported in the Company's 2004 10-K for the year ended December 31, 2004 filed on March 16, 2005 and Form 10-Q for the quarter ended March 31, 2005 filed on May 10, 2005. On September 7, 2006, Florence Brown filed a motion for leave to file an amended shareholder derivative complaint alleging that her demand was wrongfully refused and asserting the same claims previously asserted in the action filed on November 6, 2003.

Henik. On August 28, 2006, Diane Henik made a demand, alleging breaches of fiduciary duties by the directors and certain executive officers of the Company and demanding that the Board commence a civil action against certain past or present directors and officers to recover for the benefit of the Company the amount of damages sustained by the Company as a result of their breaches of fiduciary duties and all bonuses, restricted stock, stock option, and other incentive compensation recoverable pursuant to Section 304 of the Sarbanes-Oxley Act of 2002 and/or Delaware law. The letter further states that [i]f within a reasonable period of time after receipt of this letter the Board has not commenced an action as demanded herein, Ms. Henik will commence a shareholder derivative action on behalf of the Company seeking appropriate relief. On October 19, 2006, the Company's Board of Directors determined to refuse the demand.

EEOC/Servidio Litigation. On August 11, 2006, the Company and its LaBranche & Co. LLC subsidiary entered into a settlement of the EEOC/Servidio actions in exchange for the payment of an immaterial sum.

The Company believes that the claims asserted against it by the plaintiffs in the pending proceedings described in the 2005 10-K, the First Quarter 10-Q, the Second Quarter 10-Q and above are without merit, and the Company denies all allegations of wrongdoing. There can be no assurance, however, as to the outcome or timing of the resolution of these proceedings. Therefore, the Company is unable to estimate the amount or potential range of any loss that may arise out of these proceedings. The range of possible resolutions could include determinations and judgments against the Company or settlements that could require substantial payments by the Company that could have a material adverse effect on the Company's financial condition, results of operations and cash flows.

In addition to the proceedings described in the 2005 10-K and above, the Company and its operating subsidiaries have been the target, from time to time, of various claims, lawsuits and regulatory inquiries in the ordinary course of their respective businesses. While the ultimate outcome of those claims and lawsuits which are currently pending cannot be predicted with certainty, the Company believes, based on its understanding of the facts of these proceedings, that their ultimate resolution will not, in the aggregate, have a material adverse effect on the Company's financial condition, results of operations or cash flows.

On May 26, 2006 the Company entered into a lease commitment for office space located at 33 Whitehall Street, New York, New York. The lease is for approximately 48,000 square feet and expires February 28, 2017. The approximate yearly cost will be \$1.6 million.

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

*Unless the context otherwise requires, the Company or we shall mean LaBranche & Co Inc. and its wholly-owned subsidiaries.*

*This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 (the 2005 10-K ) and our Condensed Consolidated Financial Statements and the Notes thereto contained in this report.*

#### **Executive Overview**

Revenues for our 2006 third quarter increased to \$125.4 million from \$83.7 million for last year's third quarter. The 2006 third quarter revenues included a pre-tax gain of approximately \$17.6 million in connection with the increase of the estimated fair value of our restricted shares of NYSE Group, Inc., or NYX, common stock. On an after-tax basis, the Company earned net income of \$7.8 million, or \$0.13 per diluted share, for the 2006 third quarter, as compared to net income of \$9.2 million, or \$0.15 per diluted share, for the third quarter of 2005. Excluding the net gain attributable to the increase in value of our NYX restricted shares, our net operating loss for the third quarter of 2006 was \$2.1 million, or \$0.03 per diluted share. However, we generated positive cash operating income on a pro forma basis, which excludes the effects of the NYX restricted shares, depreciation, amortization, stock based compensation and non-cash tax adjustments. Excluding these non-cash items, our cash operating income was \$1.4 million for the quarter ended September 30, 2006, compared to \$8.0 million for the prior year period.

Our specialist and market-making principal trading revenues nearly doubled from \$24.8 million for the second quarter to \$45.1 million for the third quarter of 2006. Overall, year over year, our trading revenues are relatively flat at \$134.9 million in 2006 versus \$135.1 million in 2005. The options, futures and ETF's specialist and market-making business results remained lower in the third quarter of 2006. New ETF specialist assignments require, at times, to provide significant seed capital in the form of investments in ETFs. Those positions are subsequently hedged with additional securities. These strategies require higher inventory financing costs, such as margin interest and capital charges, which are partially offset by stock rebate income. In the third quarter of 2006, for several reasons, including the assignment of new ETF listings, the difference between our inventory financing costs and stock borrow rebates was a net expense of \$12.6 million, which is higher than historical levels. We are continuing to evaluate our growth strategies in this segment as well as the costs that are related to the growth.

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We are continuing to make substantial progress in enhancing and maintaining technology for our specialist and market-making businesses, as we believe that these businesses still will generate significant cash. Most of our investments in these businesses run through our financial statements and currently primarily consist of compensation which is expensed and the costs of new technology and equipment which are capitalized. We are actively writing trading code and algorithms to actively participate in the increasingly electronic marketplaces. We believe that these expenditures are necessary to operate and compete within increasingly electronic securities marketplaces, and will help us both in our newer specialist and market-making businesses, as well as in our cash equity specialist operations on the NYSE's new hybrid trading platform.

Our business today continues to be in transition for several reasons, the most important one being the implementation of the hybrid model on the NYSE. The head count in our cash equities specialist operations continues to be reduced. Since 2001, our head count has declined in the cash equities business by approximately fifty percent. As new technology continues to be introduced, we may require fewer on-floor personnel to conduct our business, depending on technology and trading volumes. We believe that our proprietary technology, as well as the new technology and trading systems on securities exchanges will help us control and reduce our costs.

As we previously have disclosed, on July 25, 2006, the Securities and Exchange Commission (the SEC) approved a reduction in the net liquid asset (NLA) requirements applicable to our NYSE Specialist and Market-Making business. In connection with this approval, on September 1, 2006, the Company reduced regulatory capital at its specialist and market-making segment by \$49.0 million, representing a portion of the NYSE reduction in the net liquid asset (NLA) requirements applicable to that business. Additional reductions of NLA are expected to be completed in three additional installments on December 1, 2006, March 1, 2007 and June 1, 2007, with the aggregate NLA reduction expected to be approximately \$170.0 million to \$180.0 million although we cannot be certain of the eventual reduction amount. We also believe that changes in market structure will warrant a further reduction in NLA requirements which will be more consistent with SEC Rule 15c3-1.

We continue to believe that the NLA reduction, our operating cash generation, the cash we received in connection with the NYSE/Archipelago merger and our ownership of approximately 3.1 million shares of NYX stock will provide us with financial flexibility going forward.

We currently have outstanding an aggregate of \$24.6 million of short-term debt with an average interest rate of above 10% per annum. We intend to retire this short-term indebtedness on schedule and expect our annual interest charges related to non-margin debt to be at least \$2.0 million lower in 2007. We anticipate that we will further be able to reduce our interest expense in the next year if we exercise the May 2007 call option on our outstanding 9 1/2% senior notes due 2009. If we exercise this call option, which allows us to repurchase these senior notes at 104.75%, the repurchase would cost approximately \$204.0 million after consideration of tax benefits.



**Table of Contents***Regulation G Reconciliation of Non-GAAP Financial Measures Excluding Corporate Equities, Not readily Marketable (NYX)*

In evaluating our financial performance as described above in Executive Overview, management reviews operating results from operations, which exclude non-operating charges. Pro-forma earnings per share is a non-GAAP (generally accepted accounting principles) performance measure, but we believe that it is useful to assist investors in gaining an understanding of the trends and operating results for our core business. Pro-forma earnings per share should be viewed in addition to, and not in lieu of, our reported results under U.S. GAAP.

The following is a reconciliation of U.S. GAAP results to pro-forma results for the periods presented (unaudited):

|   | Three Months Ended September 30, |                 |                      |                             |             |                      |
|---|----------------------------------|-----------------|----------------------|-----------------------------|-------------|----------------------|
|   | 2006                             |                 |                      | 2005                        |             |                      |
|   | Income as originally stated      | Adjustments (1) | Pro forma net income | Income as originally stated | Adjustments | Pro forma net income |
| Total revenues  | \$ 125,448                       | \$ (17,645)     | \$ 107,803           | \$ 83,731                   | \$          | \$ 83,731            |
| Total expenses  | 111,687                          |                 | 111,687              | 72,981                      |             | 72,981               |
| Income (loss) before provision (benefit) for income taxes | 13,761                           | (17,645)        | (3,884)              | 10,750                      |             | 10,750               |
| Provision (benefit) for income taxes                      | 5,924                            | (7,676)         | (1,752)              | 1,592                       |             | 1,592                |
| Earnings (loss) per share                                 | \$ 7,837                         | \$ (9,969)      | \$ (2,132)           | \$ 9,158                    | \$          | \$ 9,158             |
| Basic   | \$ 0.13                          | \$ (0.16)       | \$ (0.03)            | \$ 0.15                     | \$          | \$ 0.15              |
| Diluted   | \$ 0.13                          | \$ (0.16)       | \$ (0.03)            | \$ 0.15                     | \$          | \$ 0.15              |
|   | Nine Months Ended September 30,  |                 |                      |                             |             |                      |
|   | 2006                             |                 |                      | 2005                        |             |                      |
|   | Income as originally stated      | Adjustments (1) | Pro forma net income | Income as originally stated | Adjustments | Pro forma net income |
| Total revenues  | \$ 475,200                       | \$ (166,317)    | \$ 308,883           | \$ 228,779                  | \$          | \$ 228,779           |
| Total expenses  | 303,243                          |                 | 303,243              | 204,303                     |             | 204,303              |
| Income (loss) before provision (benefit) for income taxes | 171,957                          | (166,317)       | 5,640                | 24,476                      |             | 24,476               |
| Provision (benefit) for income taxes                      | 74,224                           | (71,510)        | 2,714                | 4,330                       |             | 4,330                |
| Earnings (loss) per share                                 | \$ 97,733                        | \$ (94,807)     | \$ 2,926             | \$ 20,146                   | \$          | \$ 20,146            |
| Basic   | \$ 1.61                          | \$ (1.56)       | \$ 0.05              | \$ 0.33                     | \$          | \$ 0.33              |
| Diluted   | \$ 1.59                          | \$ (1.54)       | \$ 0.05              | \$ 0.33                     | \$          | \$ 0.33              |

- (1) Reflects gains and losses in each accounting period, based on the fair market value of the restricted shares of NYX common stock at the end of each such period.

**Table of Contents***Regulation G Reconciliation of Non-GAAP Financial Measures Excluding Material Non-Cash Items*

We believe cash operating income is an additional meaningful measure of performance as it represents the cash generation performance of our business. Internally, we use this measure to evaluate our performance. The presentation of such non-GAAP measures enables investors to focus on period-over period performance, and thereby enhances the users' overall understanding of our current financial performance and provides a better baseline for modeling future cash operating income. We believe the inclusion of such non-GAAP measures enables investors to more thoroughly evaluate our current performance compared to past performance. However, this information will necessarily be different from comparable information provided by other companies and should not be used alone or as an alternative to our operating and other information as determined under U.S. GAAP.

The following is a reconciliation of U.S. GAAP results to pro-forma cash operating income for the periods presented (unaudited):

|  | Three Months Ended |          | Nine Months Ended |           |
|--|--------------------|----------|-------------------|-----------|
|  | September 30,      |          | September 30,     |           |
|  | 2006               | 2005     | 2006              | 2005      |
| GAAP net income                          | \$ 7,837           | \$ 9,158 | \$ 97,733         | \$ 20,146 |
| Non-cash adjustments:                    |                    |          |                   |           |
| (Gain) on NYX (1)                        | (17,645)           |          | (151,862)         |           |
| Loss (gain) on non-marketable securities | 21                 | (471)    | (238)             | (904)     |
| Depreciation and amortization (2)        | 3,195              | 3,008    | 9,255             | 9,100     |
| Stock based compensation (2)             | 972                | 333      | 3,475             | 2,330     |
| Debt issuance costs (2)                  | 488                | 446      | 1,426             | 1,295     |
| Interest on contingent liabilities (2)   | 722                |          | 1,384             |           |
| Deferred rent expense (2)                | 330                |          | 440               |           |
| Taxes (3)                                | 5,432              | (4,468)  | 63,834            | (11,577)  |
| Cash operating income                    | \$ 1,352           | \$ 8,006 | \$ 25,447         | \$ 20,390 |

- (1) Reflects gains and losses in each accounting period, based on the fair market value of our restricted shares of NYX common stock at the end of each such period and the non-marketable investments held at the reporting date.
- (2) The expenses have been adjusted to exclude depreciation, amortization, deferred rent and stock based compensation costs charged in the period as well as increases or decreases to accrued interest costs on contingent liabilities, all constituting non-cash items.
- (3) The tax expense has been adjusted for the non-cash effects from the 2005 tax rate change to the net deferred tax liabilities and other adjustments.

**New Accounting Developments***Employee Incentive Plans*

We adopted the fair value recognition provisions for share-based awards pursuant to SFAS No. 123(R) effective January 1, 2006. Please refer to Footnote 7, *Employee Incentive Plans* of our consolidated financial statements in this report for additional information and disclosure.

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### *Accounting for Tax Uncertainties*

In July 2006, the FASB issued Interpretation No. 48 Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 will be effective beginning in the first quarter of 2007. We are currently evaluating the potential impact, if any, that the adoption of FIN 48 will have on our consolidated financial statements.

### *Accounting for Defined Benefit Pension and Other Postretirement Plans*

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans ( SFAS 158 ). SFAS 158 requires recognition in the Consolidated Statement of Financial Condition of the over or underfunded status of postretirement plans, measured as the difference between the fair value of the plan assets and the benefit obligation. For pension plans, the benefit obligation is the projected benefit obligation, for other postretirement plans, the benefit obligation is the accumulated postretirement obligation. Upon adoption, SFAS 158 will require the recognition of previously unrecognized actuarial gains and losses and prior service costs within accumulated other comprehensive income, net of tax. SFAS 158 is effective as of the end of the fiscal year ending after December 15, 2006, with earlier application permitted and encouraged. SFAS 158 will have no impact on our consolidated financial statements as we currently do not have a defined benefit pension plan.

### *Fair Value Measurements*

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measurements required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 nullifies the guidance in EITF 02-3 which precluded the recognition of a trading profit at the inception of a derivative contract, unless the fair value of such derivative is obtained from a quoted market price, or other valuation technique incorporating observable market data. SFAS 157 also precludes the use of a liquidity or block discount, when measuring instruments traded in an active market at fair value. SFAS 157 requires that costs related to acquiring financial instruments carried at fair value should not be capitalized, but rather should be expensed as incurred. SFAS 157 also clarifies that an issuer's credit standing should be considered when measuring liabilities at fair value. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, with earlier application permitted and encouraged. SFAS 157 must be applied prospectively, except that the provisions related to block discounts and the guidance in EITF 02-3 are to be applied as a one time cumulative effect adjustment to opening retained earnings in the first interim period for the fiscal year in which SFAS 157 is initially applied. We are currently evaluating the potential impact, if any, that the adoption of SFAS 157 will have on our consolidated financial statements.

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### **Critical Accounting Estimates**

#### *Goodwill and Other Intangible Assets*

We determine the fair value of each of our reporting units and the fair value of each reporting unit's goodwill under the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 142, Goodwill and Other Intangible Assets. In determining fair value, we use standard analytical approaches to business enterprise valuation ( BEV ), such as the market comparable approach and the income approach. The market comparable approach is based on comparisons of the subject company to similar companies engaged in an actual merger or acquisition or to public companies whose stocks are actively traded. As part of this process, multiples of value relative to financial variables, such as earnings or stockholders' equity, are developed and applied to the appropriate financial variables of the subject company to indicate its value. The income approach involves estimating the present value of the subject company's future cash flows by using projections of the cash flows that the business is expected to generate, and discounting these cash flows at a given rate of return. Each of these BEV methodologies requires the use of management estimates and assumptions. For example, under the market comparable approach, we assign a certain control premium to the public market price of our common stock as of the valuation date in estimating the fair value of our specialist reporting unit. Similarly, under the income approach, we assume certain growth rates for our revenues, expenses, earnings before interest, income taxes, depreciation and amortization, returns on working capital, returns on other assets and capital expenditures, among others. We also assume certain discount rates and certain terminal growth rates in our calculations. Given the subjectivity involved in selecting which BEV approach to use and in determining the input variables for use in our analyses, it is possible that a different valuation model and the selection of different input variables could produce a materially different estimate of the fair value of our goodwill.

We review the reasonableness of the carrying value of our goodwill annually as of December 31, unless an event or change in circumstances requires an interim reassessment of impairment. During the three months ended September 30, 2006, there were no changes in circumstances that necessitated goodwill impairment testing. We cannot provide assurance that future goodwill impairment testing will not result in impairment charges in subsequent periods.

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

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Our stock listing rights are an intangible asset, as defined under SFAS No. 142. We amortize our identifiable intangible stock listing rights over their estimated useful lives in accordance with SFAS No. 142, and test for potential impairment whenever events or changes in circumstances suggest that an asset or asset group's carrying value may not be fully recoverable in accordance with SFAS No. 144. An impairment loss, calculated as the difference between the estimated fair value and the carrying value of an asset or asset group is recognized if the sum of the estimated undiscounted cash flows relating to the asset or asset group is less than the corresponding carrying value.

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

### *Valuation Allowance on Restricted NYX Shares*

As part of the NYSE/Archipelago merger on March 7, 2006, we received 3,126,903 restricted shares of NYX stock. We will mark to market these shares of NYX stock on a going-forward basis and apply the appropriate discount as long as the transfer restrictions are in effect. As a result, we will be recognizing a loss or gain in each accounting period, based on the fair market value of NYX stock as of the end of such accounting period. The fair market value of our shares of NYX stock at September 30, 2006 includes a valuation allowance against the market price to reflect the restricted nature of the NYX stock. The carrying value of the NYX stock as of September 30, 2006 is shown on our Balance Sheet as Corporate Equities, Not-Readily Marketable with a carrying value of approximately \$210.4 million. The valuation discount described above required judgment by our management based on the market price of the NYX stock and the restrictions on transfer applicable to our shares of NYX stock. Although we have retained an independent valuation consultant in determining the valuation discount for our shares of NYX stock, it is possible that a reasonable person, applying different factors or analysis to the value of the restricted shares of NYX stock, could reach different conclusions as to the valuation discount to be applied to the NYX stock.

### **Use of Estimates**

The use of generally accepted accounting principles requires management to make certain estimates. In addition to the estimates we make in connection with fair value measurements and the accounting for goodwill and identifiable intangible assets, the use of estimates is also important in determining provisions for potential losses that may arise from litigation, regulatory proceedings and tax audits.

We estimate and provide for potential losses that may arise out of litigation, regulatory proceedings and tax audits to the extent that such losses are probable and can be estimated, in accordance with SFAS No. 5, Accounting for Contingencies. Significant judgment is required in making these estimates and our final liabilities may ultimately be materially different. Our total liability in respect of litigation and regulatory proceedings is determined on a case-by-case basis and represents an estimate of probable losses after considering, among other factors, the progress of each case or proceeding, our experience and the experience of others in similar cases or proceedings, and the opinions and views of legal counsel. Given the inherent difficulty of predicting the outcome of our litigation and regulatory matters, particularly in cases or proceedings in which substantial or indeterminate damages or fines are

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sought, we cannot estimate losses or ranges of losses for cases or proceedings where there is only a reasonable possibility that a loss may be incurred. See Legal Proceedings in Part II, Item 1 of this Quarterly Report on Form 10-Q for information on our judicial, regulatory and arbitration proceedings.

**Execution and Clearing Risk**

Our Execution and Clearing segment, through the normal course of business, enters into various securities transactions as agent. The execution, settlement and financing of these transactions can result in unrecorded market risk and concentration of credit risk. Our execution and clearing activities involve settlement and financing of various customer securities transactions on a cash or margin basis. These activities may expose us to risk in the event the customer or other broker is unable to fulfill its contractual obligations and we have to purchase or sell securities at a loss. For margin transactions, we may be exposed to significant market risk in the event margin requirements are not sufficient to fully cover losses that customers may incur in their accounts.

**Results of Operations****Specialist and Market-Making Segment Operating Results**

|                                    | For the Three Months Ended September 30, |           | For the Nine Months Ended September 30, |           | Three Months 2006 vs. 2005 | Nine Months 2006 vs. 2005 |
|------------------------------------|--|-----------|---|-----------|----------------------------|---------------------------|
|                                    | 2006                                     | 2005      | 2006                                    | 2005      | Percentage Change          | Percentage Change         |
| <b>(000 s omitted)</b>             |  |           |   |           |                            |                           |
| <b>Revenues:</b>                   |  |           |   |           |                            |                           |
| Net gain on principal transactions | \$ 45,129                                | \$ 47,212 | 134,917                                 | 135,124   | (4.4)%                     | (0.2)%                    |
| Commissions                        | 8,397                                    | 10,313    | 27,821                                  | 32,465    | (18.6)                     | (14.3)                    |
| Stock borrow interest              | 38,041                                   | 9,367     | 99,445                                  | 15,958    | 306.1                      | 523.2                     |
| Other interest                     | 6,140                                    | 4,051     | 14,239                                  | 9,150     | 51.6                       | 55.6                      |
| Net gain on NYX transaction        | 16,288                                   |           | 153,524                                 |           | 100.0                      | 100.0                     |
| Other                              | 83                                       | 934       | 42                                      | (249)     | (91.1)                     | 116.9                     |
| Total segment revenues             | 114,078                                  | 71,877    | 429,988                                 | 192,448   | 58.7                       | 123.4                     |
| Operating expenses                 | 85,328                                   | 47,179    | 224,498                                 | 122,792   | 80.9                       | 82.8                      |
| Income before taxes                | \$ 28,750                                | \$ 24,698 | \$ 205,490                              | \$ 69,656 | 16.4                       | 195.0                     |

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

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

Interest revenue generated by our Specialist and Market-Making segment consists primarily of interest earned in securities lending transactions and inventory financing in connection with our trading in options, futures and ETFs.

Net gain on the NYX transaction reflects the net gain associated with the exchange of the NYSE memberships owned in connection with our Specialist and Market-Making operations for shares of NYX stock and cash on March 7, 2006, and the subsequent change in fair market value of such NYX stock.

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

**Key Metrics of our Specialist and Market-Making Business** When assessing the performance and financial results of a specific period, management examines certain metrics to ascertain their impact on cash equity specialist financial results. Some of the key metrics that we review, and their values for the three and nine month periods ended September 30, 2006 and 2005, are as follows:

|  | For the Three Months<br>Ended September 30, |          | For the Nine Months<br>Ended September 30, |            | Three Months<br>2006 vs. 2005<br>Percentage<br>Change | Nine Months<br>2006 vs.<br>2005<br>Percentage<br>Change |
|--|---|----------|--|------------|---|---|
|  | 2006  | 2005     | 2006                                       | 2005       |   |   |
| NYSE average daily share volume (in millions)  | 1,727.4                                     | 1,575.3  | 1,830.1                                    | 1,612.6    | 9.7%  | 13.5%   |
| LAB share volume on the NYSE (in billions)   | 25.7  | 24.7     | 79.5                                       | 74.6       | 4.0   | 6.6   |
| LAB dollar value on the NYSE (in billions)   | \$ 870.5                                    | \$ 821.8 | \$ 2,837.3                                 | \$ 2,439.5 | (5.9)   | 16.3  |
| Share volume of principal shares traded (in billions)  | 4.0   | 4.6      | 13.9                                       | 14.6       | (13.0)  | (4.8)   |
| Dollar value of principal shares traded (in billions)  | \$ 147.4                                    | \$ 167.4 | \$ 523.4                                   | \$ 510.4   | (11.9)  | 2.5   |
| Average closing price of the CBOE Volatility Index   | 13.6  | 12.3     | 13.4                                       | 12.8       | 10.6  | 4.7   |
| Program shares bought, sold and sold short as an approximate percentage of NYSE shares bought, sold and sold short (1) | 30.4%                                       | 27.9%    | 30.7%                                      | 28.4%      | 9.0   | 8.1   |
| Number of Specialist ETFs  | 73  | 52       | 73   | 52         | 40.4  | 40.4  |
| Number of Specialist Options   | 761   | 561      | 761  | 561        | 35.7%   | 35.7%   |

- (1) Program trading as a percent of NYSE volume was formerly calculated as program buy volume plus program sell volume as a percentage of NYSE volume. Program trading percentage is now calculated as program shares bought, sold and sold short as a percentage of NYSE shares bought, sold and sold short.

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Generally, an increase in the average daily share volume on the NYSE, an increase in volatility (as measured by the average closing price of the Chicago Board of Options Exchange's Volatility Index<sup>®</sup>, or the VIX<sup>®</sup>), an increase in the dollar value and share volume of stocks in which specialists trade, or a decline in the level of program trading enables the specialist to increase its level of principal trading participation and thus its ability to realize gains on principal transactions. While we monitor these metrics each period, they are not the sole indicators or factors that determine our level of revenues, profitability or overall performance in any given period. Other factors, such as extreme price movements, unanticipated listed company news and events and other uncertainties may influence our financial performance either positively or negatively.

### **Three Months Ended September 30, 2006 versus September 30, 2005**

Net gain on principal transactions for the third quarter of 2006 decreased slightly as a result of a decrease in principal shares traded and due to lower net trading results with respect to our options, indexes, futures and ETF specialist and market-making operations. Costs associated with providing ETF specialist seed capital and continued increased program trading also affected these results. This was partially offset by increased volatility.

Commissions revenue during the third quarter of 2006 decreased as a result of a decrease in share volume of transactions with respect to which a specialist commission may be charged. Despite the increase in share volume on the NYSE and in our NYSE specialist stocks, there was an increase in program trading, which resulted in fewer opportunities to participate in block trades.

The increase in stock borrow interest income was primarily due to increased stock borrow positions and higher interest rates during the 2006 third quarter, as compared to the 2005 third quarter.

Interest income on our short-term investments increased primarily due to a 1.5% increase in the Fed Funds rate year over year.

Net gain on NYX transaction is directly related to an increase in the fair value of our shares of NYX restricted stock during the third quarter of 2006.

Other revenue is mainly comprised of non-material proprietary trading gains or losses which vary from period to period.

### **Nine Months Ended September 30, 2006 versus September 30, 2005**

The decrease in our net gain on principal transactions reflects a decrease in our equity specialist principal trading revenue for the nine months ended September 30, 2006 as compared to the same period in 2005, which was partially caused by the poor trading conditions in the second quarter of 2006.



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Commissions revenue during the first nine months of 2006 decreased as a result of a decrease in share volume of transactions with respect to which a specialist commission may be charged. Despite the increase in share volume on the NYSE and in our NYSE specialist stocks, the increase in program trading, which facilitates fast executions, has reduced the number of limit orders and therefore decreased our commission revenue.

The increase in stock borrow interest income was primarily due to continued significantly increased stock borrow positions and slightly higher interest rates during the 2006 first nine months, as compared to the 2005 first nine months.

Interest income on our short-term investments increased primarily due to a 1.5% increase in the Fed Funds rate year over year.

Net gain on the NYX transaction was the result of the consummation of the NYSE/Archipelago merger in which the 36 NYSE memberships used in our Specialist and Market-Making segment were exchanged for approximately 2.9 million restricted shares of NYX stock and approximately \$13.3 million in cash, and the subsequent changes in the fair value of our restricted shares of NYX stock at September 30, 2006.

Other revenue is mainly comprised of non-material proprietary trading gains or losses and gains or losses on non-marketable investments, which vary from period to period.

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

**Execution and Clearing Segment Operating Results**

| (000 \$ omitted)                  | For the Three Months Ended September 30, |                 | For the Nine Months Ended September 30, |                   | Three Months                    | Nine Months                     |
|-----------------------------------|--|-----------------|---|-------------------|---------------------------------|---------------------------------|
|                                   | 2006                                     | 2005            | 2006                                    | 2005              | 2006 vs. 2005 Percentage Change | 2006 vs. 2005 Percentage Change |
| <b>Revenues:</b>                  |  |                 |   |                   |                                 |                                 |
| Commissions                       | \$ 8,342                                 | \$ 9,810        | 27,602                                  | 32,411            | (15.0)%                         | (14.8)%                         |
| Stock borrow interest             | 129                                      | 92              | 398                                     | 228               | 40.2                            | 74.6                            |
| Other interest                    | 246                                      | 120             | 786                                     | 307               | 105.0                           | 156.0                           |
| Net gain on NYX transaction       | 1,357                                    |                 | 12,793                                  |                   | 100.0                           | 100.0                           |
| Other                             | 33                                       | 13              | 133                                     | 76                | 153.8                           | 75.0                            |
| <b>Total segment revenues</b>     | <b>10,107</b>                            | <b>10,035</b>   | <b>41,712</b>                           | <b>33,022</b>     | <b>0.7</b>                      | <b>26.3</b>                     |
| Operating expenses                | 10,021                                   | 10,592          | 30,386                                  | 35,176            | (5.4)                           | (13.6)                          |
| <b>Income (loss) before taxes</b> | <b>\$ 86</b>                             | <b>\$ (557)</b> | <b>\$ 11,326</b>                        | <b>\$ (2,154)</b> | <b>115.4</b>                    | <b>625.8</b>                    |

Our Execution and Clearing segment's commissions revenue includes fees charged to customers for execution, clearance and direct-access floor brokerage activities.

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Net gain on the NYX transaction reflects the net gain associated with the exchange of the NYSE memberships owned in connection with our Execution and Clearing operations for restricted shares of NYX stock and cash on March 7, 2006, and the subsequent change in fair market value of such NYX stock.

Our Execution and Clearing segment's other revenues consist of interest income, proprietary trading net gains or losses and fees charged to customers for use of our proprietary front-end order execution system.

**Three Months Ended September 30, 2006 versus September 30, 2005**

Commissions revenue decreased primarily as a result of a discontinued relationship with a direct access customer. This was partially offset by an increase in commissions earned from institutional customers.

Net gain on NYX transaction is directly related to an increase in the fair value of our restricted shares of NYX stock during the third quarter of 2006.

**Nine Months Ended September 30, 2006 versus September 30, 2005**

Commissions revenue had an overall decrease due to discontinued business with a direct access customer. This was offset by increase in commissions earned by institutional trading.

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

**Other Segment Operating Results**

|                        | For the Three Months Ended September 30, |             | For the Nine Months Ended September 30, |             | Three Months                          | Nine Months                           |
|------------------------|--|-------------|---|-------------|---------------------------------------|---------------------------------------|
|                        | 2006                                     | 2005        | 2006                                    | 2005        | 2006 vs. 2005<br>Percentage<br>Change | 2006 vs. 2005<br>Percentage<br>Change |
| (000's omitted)        |  |             |   |             |                                       |                                       |
| Interest               | \$ 1,285                                 | \$ 885      | \$ 3,361                                | \$ 2,108    | 45.2%                                 | 59.4%                                 |
| Other                  | (22)                                     | 934         | 139                                     | 1,201       | (102.4)                               | (88.4)                                |
| Total segment revenues | 1,263                                    | 1,819       | 3,500                                   | 3,309       | (30.6)                                | 5.8                                   |
| Operating expenses     | 16,338                                   | 15,210      | 48,359                                  | 46,335      | 7.4                                   | 4.4                                   |
| Loss before taxes      | \$ (15,075)                              | \$ (13,391) | \$ (44,859)                             | \$ (43,026) | 12.6                                  | 4.3                                   |

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

**Three Months Ended September 30, 2006 versus September 30, 2005**

Interest revenues increased primarily as a result of increases in interest income on our short term investments, as a result of higher interest rates.

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Other revenue decreased primarily as a result of a decline in the gains related to our non-marketable investments.

**Nine Months Ended September 30, 2006 versus September 30, 2005**

Interest revenues increased primarily as a result of increases in interest income on our short term investments, as a result of higher interest rates.

Other revenue decreased primarily as a result of a decline in the gains related to our non-marketable investments.

For a discussion of operating expenses, see Our Operating Expenses below.

**Our Operating Expenses**

|  | <b>For the Three Months<br/>Ended September 30,</b> |               | <b>For the Nine Months<br/>Ended September 30,</b> |                | <b>Three months<br/>2006 vs. 2005</b> | <b>Nine months<br/>2006 vs. 2005</b> |
|--|---|---------------|--|----------------|---------------------------------------|--------------------------------------|
| <b>(000 s omitted)</b>                                 | <b>2006</b>   | <b>2005</b>   | <b>2006</b>  | <b>2005</b>    | <b>Percentage<br/>Change</b>          | <b>Percentage<br/>Change</b>         |
| <b>Expenses:</b>                                       |   |               |  |                |                                       |                                      |
| Employee compensation and related benefits             | \$ 20,098   | \$ 25,747     | \$ 63,621  | \$ 72,527      | (21.9)%                               | (12.3)%                              |
| Margin interest  | 50,830  | 10,152        | 119,623  | 18,959         | 400.7                                 | 531.0                                |
| Other interest   | 13,437  | 13,133        | 40,644   | 39,690         | 2.3                                   | 2.4                                  |
| Exchange, clearing and brokerage fees                  | 11,972  | 10,559        | 34,546   | 30,445         | 13.4                                  | 13.5                                 |
| Lease of exchange memberships and trading license fees | 1,340   | 1,008         | 3,651  | 3,003          | 32.9                                  | 21.6                                 |
| Depreciation and amortization of intangibles           | 3,195   | 3,008         | 9,255  | 9,100          | 6.2                                   | 1.7                                  |
| Other  | 10,815  | 9,374         | 31,903   | 30,579         | 15.4                                  | 4.3                                  |
| <b>Total expenses before taxes</b>                     | <b>111,687</b>                                      | <b>72,981</b> | <b>303,243</b>                                     | <b>204,303</b> | <b>53.0</b>                           | <b>48.4</b>                          |
| Provision for income taxes                             | \$ 5,924  | \$ 1,592      | \$ 74,224  | \$ 4,330       | 272.1                                 | 1614.2                               |

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

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Interest expense is attributable primarily to \$199.8 million aggregate principal amount of our outstanding 9.5% Senior Notes due 2009 and \$260.0 million aggregate principal amount of our outstanding 11.0% Senior Notes due 2012. The interest expense at our Specialist and Market-Making segment is primarily the result of inventory financing costs relating to positions taken in connection with our options, futures and ETFs specialist and market-making operations and interest on subordinated indebtedness that has been approved by the NYSE for inclusion in the net capital of our LaBranche & Co. LLC subsidiary. Customers' free credit balances and bank loans generate interest expense at our Execution and Clearing segment.

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

### **Three Months Ended September 30, 2006 versus September 30, 2005**

Employee compensation and related benefits decreased based primarily on reduced 2006 accruals for discretionary and incentive bonus compared to the prior year.

Margin interest expense increased for the three months ended September 30, 2006 from the same period in 2005 mainly due to the increase in margin interest in our options, futures and ETFs specialist and market-making activities as a result of higher margin interest rates, coupled with an increase in the size of our positions in these products. These positions have grown primarily in connection with our ETF specialist business and the underlying hedging activities to manage the trading risk associated with specialist obligations.

Exchange, clearing and brokerage fees increased primarily due to an increase in trading activity in our Specialist and Market-Making segment offset by a decrease in our Execution and Clearing segment based on the discontinued business with one of its customers.

In the NYSE/Archipelago merger, we exchanged our NYSE memberships and terminated our NYSE lease arrangements and purchased 95 trading licenses for \$49,290 per license. The quarterly expense for these trading licenses is approximately \$1.2 million.

### **Nine Months Ended September 30, 2006 versus September 30, 2005**

Employee compensation and related benefits decreased primarily as a result of a decrease in incentive compensation and headcount for our NYSE cash equity specialist employees. Partially offsetting this decrease were higher employee salaries and stock-based compensation for our structured products employees due to higher revenues and increases in trading and support personnel.

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Margin interest expense increased for the nine months ended September 30, 2006 from the same period in 2005 mainly due to the increase in margin interest in our options, futures and ETFs specialist and market-making activities as a result of higher margin interest rates, coupled with an increase in the size of our positions in these products. These positions have grown primarily in connection with the growth of our ETF specialist listings and the costs associated with the additional obligations, including providing seed capital.

Exchange, clearing and brokerage fees increased for the nine months ended September 30, 2006 as compared to the same period in 2005 due to increased trading activity at our Specialist and Market-Making segment. Contributing to this change was an increase in NYSE allocation fees, odd lot fees, and higher commissions as a result of increased structured products trading activity. Offsetting these increases was a decline at our Execution and Clearing segment of floor brokerage expenses relating to direct-access commissions.

As a result of the consummation of the NYSE/Archipelago merger, we exchanged our NYSE memberships and terminated our NYSE lease arrangements and originally purchased 95 trading licenses for \$49,290 per license. The quarterly expense for these trading licenses is approximately \$1.2 million.

## **Liquidity and Capital Resources**

Given the nature of our specialist and market-making and execution and clearing activities, certain line items on our balance sheet may fluctuate considerably from time to time. Our total assets at September 30, 2006 increased to \$4,551.6 million from \$3,664.9 million at December 31, 2005. Of the \$0.9 billion increase in the balance sheet, \$210.4 million was attributable to the exchange of our NYSE memberships in connection with the NYSE/Archipelago merger for approximately 3.1 million shares of NYX stock. The remainder was due to the increase in our inventory positions from December 31, 2005 as a result of the continued growth in our specialist and market-making business. Our short inventory similarly increased due to the growth in our ETFs, equities, options and futures positions. Our deferred tax liabilities increased \$76.5 million primarily from the unrealized gains on the tax-free exchange of NYSE memberships for NYX stock in the NYSE/Archipelago merger. Of our total assets at September 30, 2006, \$568.2 million consisted of cash and short-term investments, primarily in government obligations maturing within three months, cash and securities segregated under federal regulations and overnight repurchase agreements. Our total capital base, which consists of long term obligations (inclusive of subordinated debt, other than those related to contributed exchange memberships), certain other liabilities and total stockholders' equity, increased to \$1,371.1 million at September 30, 2006 from \$1,259.9 million at December 31, 2005. This change was mainly due to an increase in equity associated with higher additional paid-in capital and retained earnings, partially offset by a decrease in long term indebtedness.

To date, we have financed our operations primarily with retained earnings from operations and proceeds from our debt and equity offerings. Due to the nature of the securities business and our role as a specialist, market-maker and execution and clearing agent, the amount of our cash and short-term investments, as well as operating cash flow, may vary considerably from period to period due to a number of factors, including but not limited to the

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dollar value of our positions as principal, whether we are net buyers or sellers of securities, the dollar volume of executions by our customers and clearing house requirements. Certain regulatory requirements constrain the use of a portion of our liquid assets for financing, investing or operating activities. Similarly, the nature of our business lines, the capital necessary to maintain current operations and our current funding needs subject our cash and cash equivalents to different requirements and uses.

At September 30, 2006, our net cash capital (as defined below) was \$130.0 million. Fluctuations in net cash capital are common and are a function of variability in our total assets, balance sheet composition and total capital. We attempt to maintain cash capital sources in excess of the aggregate longer-term funding requirements (*i.e.* positive net cash capital). Over the previous twelve months, our net cash capital has averaged above \$100 million.

|                                       | (\$ millions)     |                   |
|---------------------------------------|-------------------|-------------------|
|                                       | 9/30/06           | 12/31/05          |
| <b>Cash Capital Available:</b>        |                   |                   |
| Stockholders equity                   | \$ 834.7          | \$ 733.5          |
| Subordinated debt                     | 6.4               | 9.4               |
| Long term debt > 1 year               | 459.8             | 481.4             |
| Other holding company liabilities     | 70.2              | 35.6              |
| <b>Total cash capital available</b>   | <b>\$ 1,371.1</b> | <b>\$ 1,259.9</b> |
| <b>Cash Capital Required:</b>         |                   |                   |
| Regulatory capital                    | \$ 328.2          | \$ 449.7          |
| Working capital                       | 217.3             | 119.1             |
| Illiquid assets/long-term investments | 690.2             | 582.2             |
| Subsidiary intercompany               | 5.4               | 2.0               |
| <b>Total Cash Capital Required</b>    | <b>\$ 1,241.1</b> | <b>\$ 1,153.0</b> |
| <b>Net Cash Capital</b>               | <b>\$ 130.0</b>   | <b>\$ 106.9</b>   |

Cash Capital Available is mainly comprised of stockholders equity, long term debt, subordinated debt and other liabilities of our parent holding company which, in the aggregate, constitute the currency used to purchase our assets and provide our working capital. This amount will principally be affected as debt matures or is refinanced and as earnings are retained or paid as dividends. Cash Capital Required mainly consists of the assets used in our businesses. Regulatory capital is defined as capital required by the SEC and applicable exchanges to be maintained by broker-dealers. It is principally comprised of cash, net equities, other investments and net receivables from other broker-dealers. Working capital constitutes liquid assets available to our subsidiaries in excess of the required regulatory capital. Illiquid assets and long term investments mainly are comprised of restricted NYX securities, exchange memberships, intangible assets, such as goodwill, tradename and stock listing rights, deposits, deferred taxes and non-marketable investments. Net Cash Capital is considered to be the excess of Cash Capital Available over Cash Capital Required, or free cash, which we can utilize to fund our business needs.

On July 25, 2006, the SEC approved a reduction of the minimum dollar regulatory capital for a specialist in cash equities and increased the requirement for a specialist in ETFs. On September 1, 2006, our LaBranche & Co. LLC NLA requirement was reduced by \$49.0 million, which also included pre September 1, 2006 excess NLA held by LaBranche & Co., LLC. Our NLA requirement will be reduced in three more installments on December 1, 2006,

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March 1, 2007 and June 1, 2007, with the aggregate NLA reduction expected to be approximately \$170.0 million to \$180.0 million, depending on our market share and on value at risk, or VAR calculation, although we cannot be certain of the eventual reduction amount.

We also monitor alternative funding measures in addition to our available net cash. The alternative funding measures are significant transactions and actions we could take in a short-term time frame to generate cash to meet debt maturities or other business needs. More precisely, as of September 30, 2006, we have identified the following alternative funding measures to support future debt maturity requirements:

Reduction of NLA requirements by the NYSE and SEC.

Disposition of net invested capital at certain subsidiaries.

Reduction of excess capital at LaBranche & Co LLC to only required net liquid assets (excess NLA dividend).

Sale of our NYX shares, subject to transfer restrictions to start expiring one third annually beginning March 7, 2007.

**Alternative Funding Measures as of September 30, 2006**

|   | <b>\$millions</b> |
|---|-------------------|
| Net cash capital  | \$ 130.0          |
| Investment in subsidiaries                                    | 146.2             |
| Estimated further reduction of NLA requirement                | 131.0             |
| NYX stock (1) (2)   | 132.1             |
| <b>Total cash available from alternative funding measures</b> | <b>\$ 539.3</b>   |

(1) Computed on an after-tax basis

(2) Based on the market price of NYX stock of \$74.75 per share on September 30, 2006

In addition to the alternative funding measures above, we monitor the maturity profile of our unsecured debt to minimize refinancing risk, we maintain relationships with debt investors and bank creditors. Strong relationships with a diverse base of creditors and debt investors are critical to our liquidity. We also maintain available sources of short-term funding that exceed actual utilization, thus allowing us to accommodate changes in investor appetite and credit capacity for our debt obligations.

With respect to the management of refinancing risk, the maturity profile of our long-term debt portfolio is monitored on an ongoing basis and structured in the context of two significant debt tranches with a significant spread of years between maturities (mid-term and long-term.) Thus, we have strategically negotiated debt terms due 2009 and 2012 for the significant debt tranches. In addition, the debt tranches have call provisions which allow pre-maturity retirements as early as 2007. The debt tranches have available maturities and calls

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over the six year period 2007 through 2012 to allow us maximum flexibility in satisfying the debt maturities with payments and/or sufficient time to refinance the long-term debt as required. The following chart profiles our long-term debt maturity as of September 30, 2006:

Our outstanding senior notes were issued pursuant to an indenture, which includes certain covenants that, among other things, limit our ability to make certain investments, engage in transactions with stockholders and affiliates, create liens on our assets and sell assets or engage in mergers and consolidations, except in accordance with certain specified conditions. In addition, our ability to take certain actions, including incurring additional indebtedness (other than certain permitted indebtedness), or making certain restricted payments (such as paying dividends, redeeming stock or repurchasing subordinated indebtedness prior to maturity), is limited if our consolidated fixed charge coverage ratio calculated on a trailing four-quarter basis is at or below a threshold of 2.00:1. The consolidated fixed charge coverage ratio reflects the ratio of (1) our consolidated earnings before interest, taxes, depreciation and amortization expenses, or EBITDA, and (2) the sum of our consolidated interest expense and a tax-effected multiple of any dividend payments that we might make with respect to preferred stock. As of September 30, 2006, our consolidated fixed charge coverage ratio was approximately 2.04:1.



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In addition, under the indenture governing our outstanding senior notes, even if our consolidated fixed charge coverage ratio is 2.00:1 or greater, we cannot make any such restricted payments if doing so will cause our cumulative restricted payments since May 18, 2004 to be greater than the sum of (A) 50.0% of our cumulative consolidated net income since July 1, 2004 (or, if such calculation is a loss, minus 100.0% of such loss) and (B) 100.0% of the net cash proceeds received from any issuance or sale of our capital stock since July 1, 2004 and certain other amounts. As of September 30, 2006 this calculation yields a restricted payment allowance of \$85.1 million. However, in the event this restriction were to limit us from making restricted payments in the future, we also would be entitled to make such payments up to an aggregate of \$15.0 million over the life of the indenture, as described above. Although we have not made any restricted payments since May 18, 2004, we cannot be sure if, when or to what extent the covenants in the indenture will prevent us from making restricted payments higher than \$15.0 million in the future. To the extent we repurchase any outstanding senior notes in connection with future corporate strategic initiatives, our fixed-term interest payments would be correspondingly reduced, and our fixed charge coverage ratio under the indenture would thereby increase.

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

In connection with the sale of our investment in Lava Trading Inc. ( Lava ) pursuant to an acquisition of Lava in August 2004, we received cash of approximately \$48.6 million, of which approximately \$9.6 million was held in escrow to secure our indemnification obligations as a stockholder of Lava. The full amount of this escrow was released to us on October 31, 2005. An additional \$640,960 was received by us on or before October 31, 2005 in connection with the settlement by Lava of tax and insurance claims. Under the terms of the indenture governing our outstanding senior notes, we were required, on or before the 361<sup>st</sup> day after the receipt of these funds to offer to purchase from all the holders of the senior notes, on a pro rata basis, an aggregate principal amount of such senior notes equal to 100.0% of the net cash proceeds (as defined in the indenture) which we did not use, within 360 days to repay certain of our secured indebtedness, to repay certain indebtedness of our subsidiaries, or acquire replacement assets (as defined in the indenture), plus accrued and unpaid interest up to, but not including, the payment date of such offer. In July 2005, we offered to purchase up to \$18.2 million aggregate principal amount of the senior notes due to the first \$39.0 million received in the initial Lava closing. However, on an after-tax basis, we received additional net cash proceeds (as defined in the indenture) of \$6,639,000 in connection with the Lava asset sale on October 31, 2005, and we did not use any portion of such net cash

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proceeds to repay any of our secured indebtedness or any indebtedness of our subsidiaries or to acquire replacement assets. Accordingly, on October 24, 2006, we commenced an offer to purchase senior notes in the aggregate principal amount of up to \$6.6 million. This proceeds offer is scheduled to expire on November 22, 2006, unless extended by us. In the event we receive tenders for the full \$6.6 million principal amount of senior notes, the total amount of funds required by us to purchase tendered senior notes, before accrued and unpaid interest, will be \$6.6 million. We intend to fund the purchase of any senior notes tendered in this offer with available cash on hand.

We have short-term debt outstanding in the aggregate principal amount of \$24.6 million consisting \$13.6 million of our 12.0% senior subordinated notes due 2007 (the 2007 Notes ) which accrue interest at the rate of 12% per annum until their maturity on March 2, 2007, and \$8.0 million consisting of eight separate note obligations, each in the principal amount of \$1.0 million, which mature in August 2007 and bear interest at an annual rate of 9.0%, and \$3.0 million of senior subordinated debt payable on June 3, 2007.

In October 2006, LaBranche & Co. LLC determined to allow its \$200.0 million committed credit agreement with a bank to expire at the end of its then-current term, which was October 17, 2006. In connection with the credit agreement, we paid an annual fee of 0.25% of the total committed line of credit. This facility was only allowed to be used to finance inventory requirements at LaBranche & Co. LLC. We did not renew this facility in light of our increased liquidity and in light of the reduction of our NLA requirements with the NYSE. It should be noted that since our IPO in 1999, we have never utilized this facility. In the event we would need additional cash to fund our inventory needs in an adverse situation, we believe we could obtain a loan on terms and using the same collateral we would have used under the credit agreement before it lapsed.

As of September 30, 2006, the subordinated indebtedness of LaBranche & Co. LLC aggregated \$6.4 million, excluding \$3.0 million classified as short term debt. This subordinated debt is comprised of senior subordinated notes and junior subordinated notes, which mature on various dates between December 2006 and June 2008 and bear interest at annual rates ranging from 7.7% to 10.0%. The senior subordinated notes were originally issued in the aggregate principal amount of \$15.0 million, and, in accordance with their terms, \$3.0 million in principal amount must be repaid on June 3 of each of 2004, 2005, 2006, 2007 and 2008. On June 3 of 2004, 2005 and 2006, LaBranche & Co. LLC repaid \$3.0 million principal amount of this senior subordinated indebtedness, plus accrued interest, thus leaving \$6.0 million principal amount of this senior subordinated indebtedness outstanding. LaBranche & Co. LLC may prepay, at a premium, all or any part of these remaining senior subordinated notes at any time, provided that the amount prepaid is not less than 5.0% of the aggregate principal amount of such senior subordinated notes then outstanding. The junior subordinated notes, which aggregate \$3.4 million principal amount, have an automatic rollover provision, which extends the maturity for an additional year, unless the lender provides at least seven months advance notice of its intention not to renew at maturity. LaBranche & Co. LLC is entitled to prepay with written consent from the NYSE the junior subordinated notes without penalty under the terms of the agreements relating thereto.

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As of September 30, 2006, we had a tax payable of \$2.6 million which is a pending tax liability assessed in April 2005.

Our Other liabilities of \$16.9 million reflected on the accompanying 2006 consolidated statement of financial condition are comprised primarily of tax contingencies pursuant to SFAS 5. Our tax and legal contingencies are considered long term, as there is no present obligation to pay such liabilities in the foreseeable future.

On May 26, 2006, we entered into a lease agreement for 48,000 square feet of office space at 33 Whitehall Street, New York, New York, which expires on February 28, 2017. Our approximate annual rent for this space will be \$1.6 million.

*Regulated Subsidiaries*

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

Quantitative and Qualitative Disclosures about Market Risk ), we balance our responsibility as specialist, market-maker and broker-dealer with our overall capital resources. These requirements may restrict our ability to make use of cash and other liquid assets for corporate actions, such as repaying our debt, repurchasing stock or making acquisitions.

As a broker-dealer, LaBranche & Co. LLC is subject to regulatory requirements intended to ensure the general financial soundness and liquidity of broker-dealers and requiring the maintenance of minimum levels of net capital, as defined in SEC Rule 15c3-1. LaBranche & Co. LLC is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. NYSE Rule 326(c) also prohibits a broker-dealer from repaying subordinated borrowings, paying cash dividends, making loans to any parent, affiliates or employees or otherwise entering into transactions which would result in a reduction of its total net capital to less than 150.0% of its required minimum capital. Moreover, broker-dealers are required to notify the SEC prior to repaying subordinated borrowings, paying dividends and making loans to any parent, affiliates or employees, or otherwise entering into transactions which, if executed, would result in a reduction of 30.0% or more of their excess net capital (net capital less minimum requirement). The SEC has the ability to prohibit or restrict such transactions if the result is deemed detrimental to the financial integrity of the broker-dealer. As of September 30, 2006, LaBranche & Co. LLC's net capital, as defined, was \$415.6 million, which exceeded the minimum requirements by \$414.2 million.

The NYSE generally requires its specialist firms to maintain a minimum dollar regulatory capital amount in order to establish that they can meet, with their own net liquid assets, their position requirement. As of September 30, 2006, LaBranche & Co. LLC's minimum required dollar amount of net liquid assets, as defined, was \$313.8 million. LaBranche & Co. LLC's actual net liquid assets, as defined, were \$412.2 million as of September 30, 2006. On September 1, 2006, our LaBranche & Co. LLC NLA requirement was reduced by \$49.0 million, which also included pre September 1, 2006 excess NLA held by LaBranche & Co., LLC. Our NLA requirement will be reduced in three more installments on December 1, 2006, March 1, 2007 and June 1, 2007, with the aggregate NLA reduction expected to be approximately \$170.0 million to \$180.0 million, although we cannot be certain of the eventual reduction amount. The final reduction in LaBranche & Co. LLC's net liquid assets requirement will allow funds no longer needed for net liquid assets purposes to be used for other corporate purposes.

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The AMEX generally requires its equities specialist firms to maintain a cash or liquid asset position of the greater of (a) \$1.0 million or (b) an amount sufficient to assume a position of sixty trading units of each security in which the specialist is registered. As of September 30, 2006, LaBranche & Co. LLC satisfied the AMEX equities specialist liquid asset requirements.

As a registered broker-dealer and member firm of the NYSE, LFSI also is subject to SEC Rule 15c3-1, as adopted and administered by the NYSE and the SEC. Under the alternative method permitted by the rule, the minimum required net capital of LFSI as of September 30, 2006 was equal to the greater of \$1.5 million or 2.0% of aggregate debit items, as defined. As of September 30, 2006, LFSI's net capital, as defined, was \$19.8 million, which exceeded its minimum net capital requirement by \$18.3 million.

As a clearing broker-dealer, LFSI is subject to SEC Rule 15c3-3, as adopted and administered by the SEC. As of October 2, 2006, to comply with its September 30, 2006 requirement, cash and U.S. Treasury Bills in the amount of \$2.6 million were segregated in a special reserve account for the exclusive benefit of customers, thus exceeding actual requirements by \$2.1 million. In addition, the Proprietary Accounts of Introducing Brokers ( PAIB ) calculation is computed in order for correspondent firms to classify their assets held by LFSI as allowable assets in the correspondents' net capital calculation. As of October 2, 2006, to comply with LFSI's September 30, 2006 requirement, cash and U.S. Treasury Bills in the amount of \$5.5 million were segregated in a special reserve account for the exclusive benefit of customers, thus exceeding actual requirements by \$1.0 million.

As a registered broker-dealer and AMEX member firm, LSP is subject to SEC Rule 15c3-1, as adopted and administered by the AMEX and the SEC. LSP is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. As of September 30, 2006, LSP's net capital, as defined, was \$64.5 million, which exceeded its minimum net capital requirement by \$64.0 million.

As a specialist and member of the NYSE, LSPS is subject to the provisions of SEC Rule 15c3-1, as adopted and administered by the SEC and NYSE. LSPS is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. As of September 30, 2006, LSPS' net capital, as defined under SEC Rule 15c3-1, was \$20.0 million, which exceeded the minimum requirement by \$19.8 million. As of September 30, 2006, LSPS' NYSE minimum required dollar amount of net liquid assets, as defined, was \$12.5 million. LSPS' actual NLA, as defined, were \$19.8 million. Prior to September 30, 2006 LSPS was not required to perform a net liquid assets calculation because LaBranche & Co. LLC's actual NLA exceed the combined net liquid assets requirement of LaBranche & Co. LLC and LSPS.

LSPD is an NASD member firm which we acquired in April 2006. It is subject to the provisions of SEC Rule 15c3-1, as adopted and administered by the SEC and NYSE. LSPD is required to maintain minimum net capital, as defined, equivalent to the greater of \$100,000 or  $\frac{1}{15}$  of aggregate indebtedness, as defined. As of September 30, 2006, LSPD's net capital, as defined, was \$3.0 million, which exceeded the minimum requirements by more than \$2.9 million.

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

As evidenced by the foregoing requirements, our broker-dealer subsidiaries require a substantial amount of capital. In particular, LaBranche & Co. LLC's and LSPS' combined NLA requirement of \$326.3 million limits our ability to utilize a substantial portion of our liquid assets for other corporate purposes. Although a portion of the combined NLA requirement of \$326.3 million is met by LaBranche & Co. LLC's and LSPS' securities positions, pending trades and other assets associated with their equities, options, futures and ETF specialist activities, a substantial portion of LaBranche & Co. LLC's cash and cash equivalents as of September 30, 2006 was used to meet their aggregate NLA requirements.

*Cash Flows*

Our cash and cash equivalents during the nine month period ended September 30, 2006 increased \$54.6 million to \$481.9 million. The increase was the result of (a) \$68.1 million provided by our operating activities primarily from increases in payable to brokers and dealers, deferred taxes and financial instruments sold, but not yet purchased as well as a decrease in receivable from brokers and dealers partially offset by increases in our financial instruments owned, at fair value (b) \$10.6 million used in investing activities primarily attributable to capital expenditures and (c) \$2.9 million used in financing activities for the repayment of a portion of our subordinated debt.

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

**Credit Ratings**

Our outstanding senior notes were originally sold in private sales to institutional investors on May 18, 2004, and substantially all these senior notes were subsequently exchanged for substantially identical senior notes registered under the Securities Act of 1933, as amended, pursuant to the terms of our May 2004 debt refinancing. The senior subordinated notes that remain outstanding since our May 2004 debt refinancing, in the aggregate principal amount of \$13.6 million, are publicly held but are no longer rated. The following table sets forth the credit ratings on our registered outstanding senior notes as of September 30, 2006:

|                   | <b>Moody's<br/>Investors Service</b> | <b>Standard<br/>&amp; Poor's</b> |
|-------------------|--------------------------------------|----------------------------------|
| 2009 Senior Notes | Ba2                                  | B                                |
| 2012 Senior Notes | Ba2                                  | B                                |

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In August 2005, although Moody's Investor Services changed its credit rating of our outstanding senior notes from Ba1 to Ba2, it improved its outlook to stable due to our high quality balance sheet and improved liquidity. In September 2005, Standard & Poors also improved its outlook on our outstanding senior notes to stable, while affirming our B rating, due to our improved debt service and liquidity positions.

### **Off-Balance Sheet Arrangements**

We have no off-balance sheet arrangements that have a material current effect or that are reasonably likely to have a material future effect on our financial position or results of operations.

### **Contractual Obligations**

As of September 30, 2006 the Company has contractual commitments to purchase office equipment and leasehold improvements totaling approximately \$10.5 million of which payments of \$5.9 million were disbursed as of September 30, 2006.

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

Due to regulatory requirements that prescribe communication barriers between our broker-dealer subsidiaries, we employ different compliance risk management procedures at each such subsidiary. These risk processes are set forth below:

#### *Our Cash Equity Specialist Risk Management Process*

Because our equity specialist activities on the NYSE and AMEX expose our capital to significant risks, managing these risks is a constant priority for us. Our central role in the auction process helps us to manage risks by incorporating up-to-date market information in the management of our inventory, subject to our specialist obligations. We have developed a risk management process at our LaBranche & Co. LLC subsidiary that is designed to balance our ability to profit from our specialist activities with our exposure to potential losses. This risk management process includes participation by our corporate compliance committee, executive operating committee, floor management committee, post managers, floor captains and specialists. These parties' roles are as follows:

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

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

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*Floor Management Committee.* Our floor management committee is composed of eleven post managers, two floor managers and one swat-team manager. This committee is responsible for formulating and overseeing our overall risk management procedures and trading guidelines for each of our specialist stocks. In determining these procedures and guidelines, the floor management committee considers the recommendations of the floor captains. The post managers meet with their respective floor captains on a weekly basis to review and, if necessary, revise the risk management procedures and trading guidelines for particular specialist stocks. In addition, post managers and floor managers are always available on the trading floor to review and assist with any unusual trading situations reported by a floor captain, and the swat-team manager is available to assess and provide assistance on break-out, or intense, trading situations. Our floor management committee reports to our executive operating committee about each of these trading situations as they occur.

*Floor Captains.* We employ thirteen floor captains who monitor the activities of our cash equity specialists throughout the trading day from various positions at our trading posts. The floor captains observe trades and constantly review trading activities on a real-time basis. In addition, the floor captains are readily available to assist our specialists in determining when to deviate from procedures and guidelines in reacting to any unusual situations or market conditions. The floor captains report these unusual situations and any deviations from these procedures and guidelines to their respective post managers. Floor captains meet with each specialist at least once a week to evaluate each specialist's adherence to our risk management procedures and trading guidelines, as well as to review compliance reports generated by the compliance department in monitoring and reviewing specialist trading activities. Floor captains also meet to review risk procedures and guidelines and, if appropriate, make recommendations to the floor management committee.

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

*On-Floor Compliance Officer.* We also have an on-floor compliance officer that monitors the specialists' compliance with NYSE rules throughout the day on an ad hoc basis. The on-floor compliance officer reports his findings on general on-floor compliance initiatives on a daily basis to our equity specialist unit's Chief Compliance Officer and Chief Executive Officer and provides summary updates of these efforts to the Corporate Compliance Committee on a monthly basis. Many of our compliance and risk management activities flow from the efforts of our on-floor compliance initiative.

We believe that the enhancements we have made to our compliance procedures and guidelines in connection with the undertakings set forth in our March 2004 settlement with the SEC and NYSE and on a continuous basis as circumstances warrant have improved our risk management process.

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Our equity specialist operations on the AMEX are conducted by six equity specialists. We have one post manager on the AMEX who monitors the trading activities of the AMEX equity specialists by observing trades and reviewing positions on a real-time basis. As a member of the floor management committee, the post manager regularly communicates with other members of the floor management committee regarding any deviations from our AMEX procedures and guidelines set by our executive operating committee. We also have an on-floor compliance officer that monitors the specialists' compliance with AMEX rules throughout the day on an ad hoc basis. The on-floor compliance officer reports his findings and on general on-floor compliance initiatives on a daily basis to our equity specialist unit's Chief Compliance Officer and Chief Executive Officer and provides summary updates of these efforts to the Corporate Compliance Committee on a monthly basis. Many of our compliance and risk management activities flow from the efforts of our on-floor compliance initiative.

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

### *Equity Market Risk*

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

A high concentration of equity specialists' principal trading revenue generally is generated from their ten and twenty-five most profitable NYSE specialist stocks. The percentage of our equity specialist trading revenue generated from our ten most profitable specialist stocks has increased from 15.5% to 19.4% of net principal trading revenue in the third quarter of 2005 and 2006, respectively. The percentage of our equity specialist trading revenue generated from our twenty-five most profitable specialist stocks has increased from 29.5% to 34.4% of net principal trading revenue in the third quarter of 2005 and 2006, respectively. The adverse trading conditions in the third quarter of 2006 resulted in a decline in overall net principal trading revenue. This resulted in the ten and twenty-five most profitable equity stocks becoming a larger percentage of equity specialist revenue. Revenue from the ten most profitable stocks was \$5.5 million and \$5.0 million for the third quarters of 2005 and 2006, respectively. Revenue from the twenty-five most profitable stocks was \$10.3 million and \$8.9 million for the third quarters of 2005 and 2006, respectively. We are not overly reliant on a particular group of specialist stocks, as the composition of our ten and twenty-five most profitable specialist stocks changes frequently.



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

*Our Options, Futures and ETFs Specialist and Market-Making Risk Management Process*

As specialists in options, ETFs and futures, we have a responsibility to maintain a fair and orderly market, and trade securities as principal out of both obligation and inclination. Our options, ETFs, futures, U.S. Government obligations and foreign currency specialist trading exposes us to certain risks, such as price and interest rate fluctuations, volatility risk, credit risk, foreign currency movements and changes in the liquidity of markets.

Additionally, as a market-maker in options, ETFs and futures, we also trade as principal out of inclination. In our market-making function, we bring immediacy and liquidity to the markets when we choose to participate. Our market-making activities expose us to certain risks, including, but not limited to, price fluctuations and volatility.

Certain members of management, including our Chief Risk Officer, who oversee our options, futures and ETFs specialist and market making activities are responsible for managing these risks. These individuals utilize a third-party software application to monitor specialist and market-making positions on a real-time basis. By monitoring actual and theoretical profit and loss, volatility and other standard risk measures, these individuals seek to insure that our traders operate within the parameters set by management. Our traders purchase and sell futures, options, the stocks underlying certain positions, U.S. Government securities and foreign currencies in an attempt to hedge market and foreign currency risk. Furthermore, our aggregate risk in connection with our options, futures and ETFs trading is under constant evaluation by certain members of management and our traders, and all significant trading strategies and positions are closely monitored. Our options, futures and ETF trading is executed on national and foreign exchanges. These trades clear through the Options Clearing Corporation, the National Securities Clearing Corporation or the applicable exchange clearing organization, thereby reducing potential credit risk.

The following chart illustrates how specified movements in the underlying securities prices of the options, futures and ETF s in our specialist and market-making portfolios would have impacted profits and losses:

| (000 s omitted)         | Profit or (Loss) if the underlying securities move: |             |         |           |           |
|-------------------------|---|-------------|---------|-----------|-----------|
|                         | -15.0%  | -5.0%       | 0%      | +5.0%     | +15.0%    |
| <b>Portfolio as of:</b> |   |             |         |           |           |
| March 31, 2006          | \$ (13,803)   | \$ 5,760    | \$ (25) | \$ 1,734  | \$ 512    |
| June 30, 2006           | \$ (31,187)   | \$ (17,747) | \$ (50) | \$ 23,486 | \$ 55,548 |
| September 30, 2006      | \$ 8,256  | \$ 4,089    | \$ 17   | \$ 114    | \$ (801)  |

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The modeling of the risk characteristics of our trading positions involves a number of assumptions and approximations. While management believes that these assumptions and approximations are reasonable, there is no standard methodology for estimating this risk, and different methodologies would produce materially different estimates. The zero percent change column represents the profit or loss our options, futures and ETFs specialist operations would experience on a daily basis if the relevant market remained unchanged.

*Foreign Currency Risk*

In connection with the trading of U.S.-registered shares of foreign issuers in connection with our cash equity specialist operations, we are exposed to varying degrees of foreign currency risk. The pricing of these securities is based on the value of the ordinary securities as denominated in their local currencies. Thus, a change in a foreign currency rate relative to the U.S. dollar will result in a change in the value of U.S.-registered shares in which we are the specialist.

Our ETF specialist and market-makers trade international ETFs that are denominated and settled in U.S. dollars, but the pricing of these ETFs is also affected by changes in the relevant foreign currency rates. We, therefore, hold various foreign currencies in order to lessen the risks posed by changing foreign currency rates. In addition, LSP trades derivatives denominated in foreign currencies, which creates exposure to foreign currency risk.

The following chart illustrates how the specified movements in foreign currencies relative to the U.S. dollar to which our specialist and market-making activities are exposed would have impacted our profits and losses:

| (000 s omitted)         | Profit or (Loss) if the foreign currencies<br>relative to the U.S. dollar move: |            |          |          |
|-------------------------|---|------------|----------|----------|
|                         | -15.0%  | -5.0%      | +5.0%    | +15.0%   |
| <b>Portfolio as of:</b> |   |            |          |          |
| March 31, 2006          | \$ (2,412)  | \$ (804)   | \$ 804   | \$ 2,412 |
| June 30, 2006           | \$ (500)  | \$ (167)   | \$ 167   | \$ 500   |
| September 30, 2006      | \$ (3,816)  | \$ (1,272) | \$ 1,272 | \$ 3,816 |

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

*Execution and Clearing Risk Management Process*

In connection with our specialist and market-making activities, we are engaged in various securities trading and lending activities and assume positions in stocks, rights, options, ETFs, U.S. Government securities, futures and foreign currencies for which we are exposed to credit risk associated with the nonperformance of counterparties in fulfilling their contractual

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obligations pursuant to these securities transactions. We are also exposed to market risk associated with the sale of securities not yet purchased, which can be directly impacted by volatile trading on the NYSE, AMEX and other exchanges. Additionally, in the event of nonperformance and unfavorable market price movements, we may be required to purchase or sell financial instruments at a loss.

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

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

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

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

We systematically monitor our open transaction risk in connection with our execution and clearing activities, starting when the transaction occurs and continuing until the designated settlement date. Transactions that remain unsettled after settlement date are scrutinized and necessary action to reduce risk that is taken. Credit risk that could result from contra brokers defaulting is minimized since much of the settlement risk for transactions with brokers is essentially transferred to the National Stock Clearing Corporation. The credit risk associated with institutional and direct access clearing customers is minimized since these customers have been qualified by the Depository Trust Company ( DTC ) or the DTC participants or have met the prime broker qualification standards at other brokerage firms. Before conducting business with a prospective customer, senior management that oversees our execution and clearing operations, in conjunction with the related compliance department, reviews the prospective customer's experience in the securities industry, financial condition and personal background, including a background check with a risk reporting agency. For retail customers and professional investors, we seek to control the risks associated with customer activities by requiring customers to maintain margin collateral in compliance with various regulatory and internal guidelines. We monitor margin levels daily pursuant to such guidelines and require customers to deposit additional collateral or reduce positions when necessary.

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### *Operational Risk*

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

our aggregate long and short positions;

the various positions of each of our trading professionals;

our overall position in a particular stock; and

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

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

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

### *Legal and Regulatory Risk*

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

Our registered broker-dealer subsidiaries are subject to certain regulatory requirements intended to insure their general financial soundness and liquidity. These broker-dealers are subject to SEC Rules 15c3-1, 15c3-3 and other requirements adopted and administered by both the NYSE and AMEX.

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

**Item 4. Controls and Procedures**

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

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

There have been no material new developments in our legal proceedings since our Form 10-Q for the second quarter of 2006 (the Second Quarter 10-Q ), which updated the legal proceedings disclosed in the 2005 10-K and our Form 10-Q for the first quarter of 2006 (the First Quarter 10-Q ), except as follows:

**Brown.** The history of this litigation is reported in our Form 10-K for the year ended December 31, 2004 filed on March 16, 2005 and Form 10-Q for the quarter ended March 31, 2005 filed on May 10, 2005. On September 7, 2006, Florence Brown filed a motion for leave to file an amended shareholder derivative complaint alleging that her demand was wrongfully refused and asserting the same claims previously asserted in the action filed on November 6, 2003.

**Henik.** On August 28, 2006, Diane Henik made a demand, alleging breaches of fiduciary duties by our directors and certain executive officers and demanding that the Board commence a civil action against certain past or present directors and officers to recover for the benefit of the Company the amount of damages sustained by the Company as a result of their breaches of fiduciary duties and all bonuses, restricted stock, stock option, and other incentive compensation recoverable pursuant to Section 304 of the Sarbanes-Oxley Act of 2002 and/or Delaware law. The letter further states that [i]f within a reasonable period of time after receipt of this letter the Board has not commenced an action as demanded herein, Ms. Henik will commence a shareholder derivative action on behalf of the Company seeking appropriate relief. On October 19, 2006, our Board of Directors determined to refuse the demand.

**EEOC/Servidio Litigation.** On August 11, 2006, we and our LaBranche & Co. LLC subsidiary entered into a settlement of the EEOC/Servidio actions in exchange for the payment of an immaterial sum.

We believe that the claims asserted against us by the plaintiffs in the pending proceedings described in the 2005 10-K, the First Quarter 10-Q, the Second Quarter 10-Q and above are without merit, and we deny all allegations of wrongdoing. There can be no assurance, however, as to the outcome or timing of the resolution of these proceedings. Therefore, we are unable to estimate the amount or potential range of any loss that may arise out of these proceedings. The range of possible resolutions could include determinations and judgments against us or settlements that could require substantial payments by us that could have a material adverse effect on our financial condition, results of operations and cash flows.

In addition to the proceedings described in the 2005 10-K and above, we and our operating subsidiaries have been the target, from time to time, of various claims, lawsuits and regulatory inquiries in the ordinary course of our respective businesses. While the ultimate outcome of those claims and lawsuits which are currently pending cannot be predicted with certainty, we believe, based on our understanding of the facts of these proceedings, that their ultimate resolution will not, in the aggregate, have a material adverse effect on our financial condition, results of operations or cash flows.

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### **Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in the 2005 10-K, which could materially affect our business, financial condition or future results. There have been no material changes in the Risk Factors disclosed in the 2005 10-K. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

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

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

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**Item 6. Exhibits.**

- 31.1 Certification of George M.L. LaBranche, IV, Chairman, Chief Executive Officer and President, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Jeffrey A. McCutcheon, Senior Vice President and Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of George M.L. LaBranche, IV, Chairman, Chief Executive Officer and President, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, regarding the information contained in LaBranche & Co Inc. s Quarterly Report on Form 10-Q for the period ended September 30, 2006.
- 32.2 Certification of Jeffrey A. McCutcheon, Senior Vice President and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, regarding the information contained in LaBranche & Co Inc. s Quarterly Report on Form 10-Q for the period ended September 30, 2006.  
All other items of this report are inapplicable.



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

November 9, 2006

LABRANCHE & Co INC.

By: /s/ Jeffrey A. McCutcheon  
Name: Jeffrey A. McCutcheon  
Title: Senior Vice President and Chief  
Financial Officer

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EXHIBIT INDEX

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