

JEFFERIES GROUP INC /DE/

Form 10-Q

November 08, 2007

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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, 2007

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 1-14947

**JEFFERIES GROUP, INC.**

(Exact name of registrant as specified in its charter)

Delaware

95-4719745

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

520 Madison Avenue, 12<sup>th</sup> Floor, New York, New  
York

10022

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: (212) 284-2550

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is 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.

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 Exchange Act).

Yes  No

Indicate the number of shares outstanding of the registrant's class of common stock, as of the latest practicable date.  
125,571,015 shares as of the close of business November 5, 2007.

**JEFFERIES GROUP, INC. AND SUBSIDIARIES  
INDEX TO QUARTERLY REPORT ON FORM 10-Q  
SEPTEMBER 30, 2007**

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**PART I. FINANCIAL INFORMATION**  
**Item 1. Financial Statements**  
**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (UNAUDITED)**  
**(Dollars in thousands, except per share amounts)**

|  | September 30,<br>2007 | December 31,<br>2006 |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |
| Cash and cash equivalents  | \$ 521,339            | \$ 513,041           |
| Cash and securities segregated and on deposit for regulatory purposes or deposited with clearing and depository organizations        | 613,808               | 508,303              |
| Investments  | 163,167               | 125,533              |
| Investments in managed funds   | 322,450               | 372,869              |
| Securities borrowed  | 19,348,462            | 9,711,894            |
| Securities purchased under agreements to resell  | 1,135,511             | 226,176              |
| Receivable from brokers, dealers and clearing organizations  | 777,992               | 254,580              |
| Receivable from customers  | 751,017               | 663,552              |
| Financial instruments owned, including securities pledged to creditors of \$2,142,995 and \$1,481,098 in 2007 and 2006, respectively | 6,915,717             | 4,606,223            |
| Premises and equipment   | 122,490               | 91,375               |
| Goodwill   | 330,694               | 257,321              |
| Other assets   | 599,719               | 494,590              |
| <b>Total Assets</b>  | <b>\$ 31,602,366</b>  | <b>\$ 17,825,457</b> |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                       |                      |
| Bank loans and current portion of long-term debt   | \$ 399,806            | \$ 99,981            |
| Securities loaned  | 8,861,200             | 6,794,554            |
| Securities sold under agreements to repurchase   | 11,073,637            | 2,092,838            |
| Payable to brokers, dealers and clearing organizations   | 1,289,104             | 669,196              |
| Payable to customers   | 1,083,635             | 1,010,486            |
| Financial instruments sold, not yet purchased  | 4,077,429             | 3,600,869            |
| Accrued expenses and other liabilities   | 492,076               | 650,974              |
|  | 27,276,887            | 14,918,898           |
| Long-term debt   | 1,764,560             | 1,168,562            |
| Mandatorily redeemable convertible preferred stock   | 125,000               | 125,000              |
| Minority interest  | 605,167               | 31,910               |
| <b>Total Liabilities</b>   | <b>29,771,614</b>     | <b>16,244,370</b>    |
| <b>STOCKHOLDERS EQUITY</b>   |                       |                      |
| Common stock, \$.0001 par value. Authorized 500,000,000 shares; issued 154,178,478 shares in 2007 and 145,628,024 shares in 2006     | 15                    | 14                   |
| Additional paid-in capital   | 1,066,634             | 876,393              |
| Retained earnings  | 1,071,659             | 952,263              |
| Less:  |                       |                      |

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|  |               |               |
|--|---------------|---------------|
| Treasury stock, at cost, 28,521,310 shares in 2007 and 26,081,110 shares in 2006 | (320,222)     | (254,437)     |
| Accumulated other comprehensive gain:  |               |               |
| Currency translation adjustments   | 15,576        | 9,764         |
| Additional minimum pension liability   | (2,910)       | (2,910)       |
| Total accumulated other comprehensive gain                                       | 12,666        | 6,854         |
| Total stockholders' equity   | 1,830,752     | 1,581,087     |
| Total Liabilities and Stockholders' Equity                                       | \$ 31,602,366 | \$ 17,825,457 |

See accompanying unaudited notes to consolidated financial statements.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF EARNINGS (Unaudited)**  
(In thousands, except per share and ratio amounts)

|   | Three Months Ended |                   | Nine Months Ended |                   |
|---|--------------------|-------------------|-------------------|-------------------|
|   | Sept. 30,<br>2007  | Sept. 30,<br>2006 | Sept. 30,<br>2007 | Sept. 30,<br>2006 |
| Revenues:   |                    |                   |                   |                   |
| Commissions   | \$ 95,652          | \$ 67,953         | \$ 255,778        | \$ 208,589        |
| Principal transactions  | 47,325             | 98,984            | 320,804           | 353,088           |
| Investment banking  | 189,780            | 144,763           | 582,988           | 395,429           |
| Asset management fees and investment<br>income (loss) from managed funds                                      | (6,283)            | 16,783            | 29,586            | 80,132            |
| Interest  | 334,056            | 132,424           | 845,957           | 385,035           |
| Other   | 6,434              | 7,757             | 21,480            | 27,587            |
| Total revenues  | 666,964            | 468,664           | 2,056,593         | 1,449,860         |
| Interest expense  | 332,540            | 128,054           | 837,900           | 366,493           |
| Revenues, net of interest expense   | 334,424            | 340,610           | 1,218,693         | 1,083,367         |
| Non-interest expenses:  |                    |                   |                   |                   |
| Compensation and benefits   | 183,503            | 184,421           | 662,771           | 593,830           |
| Floor brokerage and clearing fees   | 19,155             | 15,496            | 50,264            | 46,363            |
| Technology and communications   | 26,120             | 21,490            | 71,980            | 59,863            |
| Occupancy and equipment rental  | 20,280             | 15,819            | 56,315            | 44,390            |
| Business development  | 13,791             | 12,653            | 38,980            | 36,057            |
| Other   | 16,254             | 14,394            | 51,178            | 48,405            |
| Total non-interest expenses   | 279,103            | 264,273           | 931,488           | 828,908           |
| Earnings before income taxes, minority<br>interest and cumulative effect of change in<br>accounting principle | 55,321             | 76,337            | 287,205           | 254,459           |
| Income taxes  | 21,608             | 29,734            | 107,312           | 99,523            |
| Earnings before minority interest and<br>cumulative effect of change in accounting<br>principle               | 33,713             | 46,603            | 179,893           | 154,936           |
| Minority interest in earnings (loss) of<br>consolidated subsidiaries  | (5,060)            | 663               | 11,026            | 6,575             |
| Earnings before cumulative effect of<br>change in accounting principle, net                                   | 38,773             | 45,940            | 168,867           | 148,361           |
| Cumulative effect of change in accounting<br>principle, net   | $\frac{3}{4}$      | $\frac{3}{4}$     | $\frac{3}{4}$     | 1,606             |

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|              |           |           |            |            |
|--------------|-----------|-----------|------------|------------|
| Net earnings | \$ 38,773 | \$ 45,940 | \$ 168,867 | \$ 149,967 |
|--------------|-----------|-----------|------------|------------|

Earnings per share:

Basic-

|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Earnings before cumulative effect of change in accounting principle, net | \$ 0.27 | \$ 0.34 | \$ 1.19 | \$ 1.12 |
|--|---------|---------|---------|---------|

|  |               |               |               |      |
|--|---------------|---------------|---------------|------|
| Cumulative effect of change in accounting principle, net | $\frac{3}{4}$ | $\frac{3}{4}$ | $\frac{3}{4}$ | 0.01 |
|--|---------------|---------------|---------------|------|

|              |         |         |         |         |
|--------------|---------|---------|---------|---------|
| Net earnings | \$ 0.27 | \$ 0.34 | \$ 1.19 | \$ 1.13 |
|--------------|---------|---------|---------|---------|

Diluted-

|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Earnings before cumulative effect of change in accounting principle, net | \$ 0.26 | \$ 0.32 | \$ 1.12 | \$ 1.03 |
|--|---------|---------|---------|---------|

|  |               |               |               |      |
|--|---------------|---------------|---------------|------|
| Cumulative effect of change in accounting principle, net | $\frac{3}{4}$ | $\frac{3}{4}$ | $\frac{3}{4}$ | 0.01 |
|--|---------------|---------------|---------------|------|

|              |         |         |         |         |
|--------------|---------|---------|---------|---------|
| Net earnings | \$ 0.26 | \$ 0.32 | \$ 1.12 | \$ 1.04 |
|--------------|---------|---------|---------|---------|

Weighted average shares:

|       |         |         |         |         |
|-------|---------|---------|---------|---------|
| Basic | 142,822 | 135,140 | 141,905 | 133,048 |
|-------|---------|---------|---------|---------|

|         |         |         |         |         |
|---------|---------|---------|---------|---------|
| Diluted | 155,480 | 148,908 | 153,911 | 146,502 |
|---------|---------|---------|---------|---------|

|                             |      |      |      |      |
|-----------------------------|------|------|------|------|
| Fixed charge coverage ratio | 2.6X | 4.0X | 4.2X | 4.5X |
|-----------------------------|------|------|------|------|

See accompanying unaudited notes to consolidated financial statements.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY (Unaudited)**  
**NINE MONTHS ENDED SEPTEMBER 30, 2007 AND YEAR ENDED DECEMBER 31, 2006**  
**(Dollars in thousands, except per share amounts)**

|   | <b>Nine<br/>Months<br/>Ended<br/>September<br/>30,<br/>2007</b> | <b>Year<br/>Ended<br/>December<br/>31,<br/>2006</b> |
|---|---|---|
| <b>Common stock, par value \$.0001 per share</b>        |   |   |
| Balance, beginning of year                              | \$ 14   | \$ 7  |
| Issued stock  | 1   | 7   |
| Balance, end of period                                  | \$ 15   | \$ 14   |
| <b>Additional paid in capital</b>                       |   |   |
| Balance, beginning of year                              | \$ 876,393  | \$ 709,447  |
| Benefit plan share activity (1)                         | 30,424  | 33,360  |
| Share-based amortization expense                        | 107,553   | 83,137  |
| Proceeds from exercise of stock options                 | 3,652   | 17,543  |
| Acquisitions and contingent consideration               | 10,349  |   |
| Tax benefits  | 38,263  | 32,906  |
| Balance, end of period                                  | \$ 1,066,634  | \$ 876,393  |
| <b>Retained earnings</b>                                |   |   |
| Balance, beginning of year, as previously reported      | \$ 952,263  | \$ 803,262  |
| Cumulative effect of adjustment from adoption of FIN 48 | (410)   |   |
| Net earnings  | 168,867   | 205,750   |
| Dividends   | (49,061)  | (56,749)  |
| Balance, end of period                                  | \$ 1,071,659  | \$ 952,263  |
| <b>Treasury stock, at cost</b>                          |   |   |
| Balance, beginning of year                              | \$ (254,437)  | \$ (220,703)  |
| Purchases   | (61,766)  | (23,972)  |
| Returns / forfeitures                                   | (4,019)   | (9,762)   |
| Balance, end of period                                  | \$ (320,222)  | \$ (254,437)  |
| <b>Accumulated other comprehensive income (loss)</b>    |   |   |
| Balance, beginning of year                              | \$ 6,854  | \$ (5,163)  |



|                                  |                     |                     |
|----------------------------------|---------------------|---------------------|
| Currency adjustment              | 5,812               | 8,802               |
| Pension adjustment               |                     | 3,215               |
| Balance, end of period           | \$ 12,666           | \$ 6,854            |
| <b>Total stockholders equity</b> | <b>\$ 1,830,752</b> | <b>\$ 1,581,087</b> |
| <b>Comprehensive income</b>      |                     |                     |
| Net earnings                     | \$ 168,867          | \$ 205,750          |
| Other comprehensive income       | 5,812               | 12,017              |
| Total comprehensive income       | \$ 174,679          | \$ 217,767          |

(1) Includes grants related to the Incentive Plan, Deferred Compensation Plan, and Director Plan.  
See accompanying unaudited notes to consolidated financial statements.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**  
**(Dollars in thousands)**

|   | Nine Months Ended |                   |
|---|-------------------|-------------------|
|   | Sept. 30,<br>2007 | Sept. 30,<br>2006 |
| Cash flows from operating activities:   |                   |                   |
| Net earnings  | \$ 168,867        | \$ 149,967        |
| Adjustments to reconcile net earnings to net cash used in operating activities:   |                   |                   |
| Cumulative effect of accounting change, net   | ¾                 | 1,606             |
| Depreciation and amortization   | 21,123            | 14,478            |
| Accruals related to various benefit plans, stock issuances, net of forfeitures  | 133,959           | 75,510            |
| (Increase) in cash and securities segregated and on deposit for regulatory purposes or deposited with clearing and depository organizations | (104,169)         | (138,744)         |
| (Increase) decrease in receivables:   |                   |                   |
| Securities borrowed   | (9,636,234)       | 115,658           |
| Brokers, dealers and clearing organizations   | (563,124)         | (137,169)         |
| Customers   | (87,043)          | (118,512)         |
| Increase in financial instruments owned   | (2,006,785)       | (2,277,946)       |
| Increase in investments   | (35,417)          | (19,196)          |
| Increase in investments in managed funds  | (8,274)           | (13,588)          |
| Increase in securities purchased under agreements to resell   | (909,335)         | ¾                 |
| Increase in other assets  | (111,017)         | (15,935)          |
| Increase (decrease) in operating payables:  |                   |                   |
| Securities loaned   | 2,100,026         | (537,375)         |
| Securities sold under agreements to repurchase  | 8,980,799         | 65,125            |
| Brokers, dealers and clearing organizations   | 695,432           | 213,445           |
| Customers   | 73,283            | 117,025           |
| Increase in financial instruments sold, not yet purchased   | 406,253           | 1,785,692         |
| (Decrease) increase in accrued expenses and other liabilities   | (176,154)         | 238,015           |
| Increase (decrease) in minority interest  | 11,026            | (5,227)           |
| Net cash used in operating activities   | (1,046,784)       | (487,171)         |
| Cash flows from investing activities:   |                   |                   |
| Decrease in short term bond funds   | ¾                 | 7,037             |
| Business acquisitions, net of cash received   | (33,446)          | ¾                 |
| Cash paid for contingent consideration  | (25,720)          | (19,944)          |
| Purchase of premises and equipment  | (50,393)          | (20,104)          |

|                                       |           |          |
|---------------------------------------|-----------|----------|
| Net cash used in investing activities | (109,559) | (33,011) |
|---------------------------------------|-----------|----------|

Continued on next page.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS CONTINUED (Unaudited)**  
**(Dollars in thousands)**

|  | Nine Months Ended |                   |
|--|-------------------|-------------------|
|  | Sept. 30,<br>2007 | Sept. 30,<br>2006 |
| Cash flows from financing activities   |                   |                   |
| Tax benefit from the issuance of stock based awards  | 38,263            | 17,681            |
| Proceeds from reorganization of high yield secondary market trading                              | 354,256           | ¾                 |
| Redemption of capital units related to our reorganization of high yield secondary market trading | (25,780)          | ¾                 |
| Repayment of long-term debt  | (100,000)         | ¾                 |
| Net proceeds from (payments on):   |                   |                   |
| Bank loans   | 399,806           | ¾                 |
| Issuance of senior notes   | 593,176           | 492,155           |
| Termination of interest rate swaps   | 8,452             |                   |
| Issuance of mandatorily redeemable convertible preferred stock                                   | ¾                 | 125,000           |
| Minority interest holders of consolidated subsidiaries related to asset management activities    | 3,586             | ¾                 |
| Repurchase of treasury stock   | (61,766)          | (16,638)          |
| Dividends  | (49,061)          | (40,948)          |
| Exercise of stock options, not including tax benefits  | 3,652             | 12,852            |
| <br>   |                   |                   |
| Net cash provided by financing activities  | 1,164,584         | 590,102           |
| <br>   |                   |                   |
| Effect of foreign currency translation on cash and cash equivalents                              | 57                | 656               |
| <br>   |                   |                   |
| Net increase in cash and cash equivalents  | 8,298             | 70,576            |
| <br>   |                   |                   |
| Cash and cash equivalents beginning of period  | 513,041           | 255,933           |
| <br>   |                   |                   |
| Cash and cash equivalents end of period  | \$ 521,339        | \$ 326,509        |
| <br>   |                   |                   |
| Supplemental disclosures of cash flow information:   |                   |                   |
| Cash paid during the period for:   |                   |                   |
| Interest   | \$ 828,671        | \$ 374,388        |
| Income taxes   | \$ 34,722         | \$ 140,472        |
| Non-cash proceeds from reorganization of high yield secondary market trading                     | \$ 230,169        | \$ ¾              |
| Putnam Acquisition:  |                   |                   |
| Fair value of assets acquired, including goodwill  | 14,664            | ¾                 |

|   |         |   |
|---|---------|---|
| Liabilities assumed                               | ¾       | ¾ |
| Stock issued                                      | ¾       | ¾ |
| Cash paid for acquisition                         | 14,664  | ¾ |
| LongAcre Acquisition:                             |         |   |
| Fair value of assets acquired, including goodwill | 32,828  | ¾ |
| Liabilities assumed                               | (6,150) | ¾ |
| Stock issued (311,831 shares)                     | (7,896) | ¾ |
| Cash paid for acquisition                         | 18,782  | ¾ |

See accompanying unaudited notes to consolidated financial statements.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**  
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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(Unaudited)**

**Note 1. Organization and Summary of Significant Accounting Policies****Organization**

The accompanying unaudited consolidated financial statements include the accounts of Jefferies Group, Inc. and all its subsidiaries (together, we or us), including Jefferies & Company, Inc. ( Jefferies ), Jefferies Execution Services, Inc. ( Jefferies Execution ), Jefferies International Limited, Jefferies Asset Management, LLC, Jefferies Financial Products, LLC and all other entities in which we have a controlling financial interest or are the primary beneficiary, including Jefferies High Yield Holdings, LLC ( JHYH ), Jefferies Special Opportunities Partners, LLC ( JSOP ) and Jefferies Employees Special Opportunities Partners, LLC ( JESOP ). The accompanying unaudited 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 accounting principles generally accepted in the U.S. for complete financial statements. All adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These unaudited consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2006.

**Reclassifications**

Starting in the third quarter of 2007, we include investments and investments in managed funds as a component of cash flows from operating activities rather than cash flows from investing activities and accordingly have reclassified the prior period to be consistent with the current presentation. We believe that a change in classification of a cash flow item represents a reclassification of information and not a change in accounting principle. The amounts involved are immaterial to the Consolidated Financial Statements. In addition, the change only affects the presentation within the Consolidated Statements of Cash Flows and does not impact the Consolidated Statements of Financial Condition or the Consolidated Statements of Earnings, debt balances or compliance with debt covenants.

Certain other reclassifications have been made to previously reported balances to conform to the current presentation.

**Summary of Significant Accounting Policies****Principles of Consolidation**

Our policy is to consolidate all entities in which we own more than 50% of the outstanding voting stock and have control. In addition, in accordance with Financial Accounting Standards Board ( FASB ) Interpretation No. 46(R), *Consolidation of Variable Interest Entities* ( FIN 46(R) ), as revised, we consolidate entities which lack characteristics of an operating entity or business for which we are the primary beneficiary. Under FIN 46(R), the primary beneficiary is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests, direct or implied. In situations where we have significant influence but not control of an entity that does not qualify as a variable interest entity, we apply the equity method of accounting or fair value accounting. We also have formed nonconsolidated investment vehicles with third-party investors that are typically organized as limited partnerships. We act as general partner for these investment vehicles and have generally provided the third-party investors with termination or kick-out rights as defined by EITF 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*.

All material intercompany accounts and transactions are eliminated in consolidation.



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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(Unaudited)**

***Revenue Recognition Policies***

*Commissions.* All customer securities transactions are reported on the Consolidated Statement of Financial Condition on a settlement date basis with related income reported on a trade-date basis. Under clearing agreements, we clear trades for unaffiliated correspondent brokers and retain a portion of commissions as a fee for our services. Correspondent clearing revenues are included in other revenue. We permit institutional customers to allocate a portion of their gross commissions to pay for research products and other services provided by third parties. The amounts allocated for those purposes are commonly referred to as soft dollar arrangements. Soft dollar expenses amounted to \$11.1 million and \$7.2 million for the three month periods ended September 30, 2007 and 2006, respectively. Soft dollar expenses amounted to \$27.7 million and \$24.3 million for the nine month periods ended September 30, 2007 and 2006, respectively. We are accounting for the cost of these arrangements on an accrual basis. Our accounting for commission revenues includes the guidance contained in Emerging Issues Task Force ( EITF ) Issue No. 99-19, *Reporting Revenues Gross versus Net*, because we are not the primary obligor of such arrangements, and accordingly, expenses relating to soft dollars are netted against the commission revenues.

*Principal Transactions.* Financial instruments owned, securities pledged and financial instruments sold, but not yet purchased (all of which are recorded on a trade-date basis) and certain investments are carried at fair value, as appropriate, with unrealized gains and losses reflected in principal transactions in the Consolidated Statement of Earnings on a trade date basis.

*Investment Banking.* Underwriting revenues and fees from mergers and acquisitions, restructuring and other investment banking advisory assignments are recorded when the services related to the underlying transaction are completed under the terms of the assignment or engagement. Expenses associated with such transactions are deferred until reimbursed by the client, the related revenue is recognized or the engagement is otherwise concluded. Expenses are recorded net of client reimbursements. Revenues are presented net of related unreimbursed expenses. Unreimbursed expenses with no related revenues are included in business development in the Consolidated Statement of Earnings. Reimbursed expenses totaled approximately \$2.0 million and \$2.0 million for the three month periods ended September 30, 2007 and 2006, respectively, and totaled approximately \$7.8 million and \$8.7 million for the nine month periods ended September 30, 2007 and 2006, respectively.

*Asset Management Fees and Investment Income From Managed Funds.* Asset management fees and investment income from managed funds include revenues we receive from management, administrative and performance fees from funds managed by us, revenues from management and performance fees we receive from third-party managed funds, and investment income from our investments in these funds. We receive fees in connection with management and investment advisory services performed for various funds and managed accounts. These fees are based on the value of assets under management and may include performance fees based upon the performance of the funds. Management and administrative fees are generally recognized over the period that the related service is provided based upon the beginning or ending Net Asset Value of the relevant period. Generally, performance fees are earned when the return on assets under management exceeds certain benchmark returns, high-water marks, or other performance targets. Performance fees are accrued on a monthly basis and are not subject to adjustment once the measurement period ends (annually) and performance fees have been realized.

*Interest Revenue and Expense.* We recognize contractual interest on financial instruments owned and financial instruments sold, but not yet purchased, on an accrual basis as a component of interest revenue. Interest flows on derivative trading transactions and dividends are included as part of the mark-to-market valuation of these contracts in principal transactions in the Consolidated Statements of Earnings and are not recognized as a component of interest revenue or expense. We account for our short-term and long-term borrowings on an accrual basis with related interest recorded as interest expense. In addition, we recognize interest revenue related to our securities borrowed activities and interest expense related to our securities loaned activities. See accounting policies related to securities borrowed and securities loaned for further explanation.

***Cash Equivalents***



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Cash equivalents include highly liquid investments not held for resale with original maturities of three months or less.  
***Cash and Securities Segregated and on Deposit for Regulatory Purposes or Deposited With Clearing and Depository Organizations***

In accordance with Rule 15c3-3 of the Securities Exchange Act of 1934, Jefferies & Company, Inc., as a broker-dealer carrying client accounts, is subject to requirements related to maintaining cash or qualified securities in a segregated reserve account for the exclusive benefit of its clients. In addition, certain financial instruments used for initial and variation margin purposes with clearing and depository organizations are recorded in this caption.

***Foreign Currency Translation***

Assets and liabilities of foreign subsidiaries having non-U.S. dollar functional currencies are translated at exchange rates at the end of a period. Revenues and expenses are translated at average exchange rates during the period. The gains or losses resulting from translating foreign currency financial statements into U.S. dollars, net of hedging gains or losses and taxes, if any, are included in accumulated other comprehensive income, a component of stockholders equity. Gains or losses resulting from foreign currency transactions are included in the principal transactions in the Consolidated Statements of Earnings.

***Investments***

Investments include our strategic investment in Jefferies Finance, LLC, as well as, direct investments in limited liability companies and partnerships that make investments in private equity companies, strategic investments in financial service entities and other investments. With the adoption of FASB No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* ( FASB 159 ), we apply fair value accounting on investments that are risk-managed on a fair value basis. Factors considered in valuing investments at fair value include, without limitation, available market prices, reported net asset values, type of security, purchase price, purchases of the same or similar securities by other investors, marketability, restrictions on disposition, current financial position and operating results of the issuer and other pertinent information. For our strategic investment in Jefferies Finance, LLC we apply the equity method of accounting. Investment gains and losses are included in principal transactions in the Consolidated Statements of Earnings.

***Investments in Managed Funds***

Investments in managed funds includes our investments in non-consolidated funds managed by us and our investments in third-party managed funds in which we are entitled to a portion of the management and/or performance fees. Investments in managed funds are accounted for on the equity method.

***Receivable from, and Payable to, Customers***

Receivable from, and payable to, customers includes amounts receivable and payable on cash and margin transactions. Securities owned by customers and held as collateral for these receivables are not reflected in the accompanying consolidated financial statements. Receivable from officers and directors represents balances arising from their individual security transactions. These transactions are subject to the same regulations as customer transactions and are provided on substantially the same terms.

***Fair Value of Financial Instruments***

Substantially all of our financial instruments are carried at fair value or amounts approximating fair value. Assets, including cash and cash equivalents, securities borrowed or purchased under agreements to sell, and certain receivables, are carried at fair value or contracted amounts, which approximate fair value due to the short period to

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maturity. Similarly, liabilities, including bank loans, securities loaned or sold under agreements to repurchase and certain payables, are carried at amounts approximating fair value. Debt is carried at face value less unamortized discount. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the exit price). Financial instruments owned and financial instruments sold, not yet purchased, are valued at quoted market prices, if available. For financial instruments that do not have readily determinable fair values through quoted market prices, the determination of fair value is based upon consideration of available information, including types of financial instruments, current financial information, restrictions on dispositions, fair values of underlying financial instruments and quotations for similar instruments.

We have derivative financial instrument positions in exchange traded and over-the-counter option contracts, credit default swaps, foreign exchange forward contracts, index futures contracts, commodities swap and option contracts and commodities futures contracts, which are measured at fair value with gains and losses recognized in principal transactions. The gross contracted or notional amount of these contracts is not reflected in the Consolidated Statements of Financial Condition. We follow FIN No. 39, *Offsetting Amounts Related to Certain Contracts* ( FIN 39 ) and offset assets and liabilities in the Consolidated Statements of Financial Condition provided that the legal right of offset exists under a master netting agreement and that other requirements of FIN 39 are met. We also offset payables or receivables relating to the fair value of cash collateral received or paid associated with its derivative inventory, on a counterparty basis.

Prior to the adoption of FASB No. 157, *Fair Value Measurements* ( FASB 157 ), we followed Emerging Issues Task Force Statement No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* ( EITF 02-3 ). This guidance generally prohibited recognizing profit at the inception of a derivative contract unless the fair value of the derivative was obtained from a quoted market price in an active market or was otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique that incorporates observable market data. Subsequent to the transaction date, we recognized trading profits deferred at inception of the derivative transaction in the period in which the valuation of an instrument became observable. With the adoption of FASB 157, we are no longer applying the revenue recognition criteria of EITF 02-3. However, FASB 157 requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based on the best information available, which includes the transaction exit price.

***Securities Borrowed and Securities Loaned***

In connection with both trading and brokerage activities, we borrow securities to cover short sales and to complete transactions in which customers have failed to deliver securities by the required settlement date, and lend securities to other brokers and dealers for similar purposes. We have an active securities borrowed and lending matched book business in which we borrow securities from one party and lend them to another party. When we borrow securities, we generally provide cash to the lender as collateral, which is reflected in our Consolidated Statements of Financial Condition as securities borrowed. We earn interest revenues on this cash collateral. Similarly, when we lend securities to another party, that party provides cash to us as collateral, which is reflected in our Consolidated Statements of Financial Condition as securities loaned. We pay interest expense on the cash collateral received from the party borrowing the securities. A substantial portion of our interest revenues and interest expenses results from this matched book activity. The initial collateral advanced or received approximates or is greater than, the fair value of the securities borrowed or loaned. We monitor the fair value of the securities borrowed and loaned on a daily basis and request additional collateral or return excess collateral, as appropriate.

***Securities Purchased Under Agreements to Resell and Securities Sold Under Agreements to Repurchase***

Securities purchased under agreements to resell and securities sold under agreements to repurchase ( repos ) are treated as collateralized financing transactions and are recorded at their contracted repurchase amount.



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We monitor the fair value of the repos daily versus the related receivable or payable balances. Should the fair value of the repos decline or increase, additional collateral is requested or excess collateral is returned, as appropriate.

We carry repos on a net basis when permitted under the provisions of FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* ( FIN 41 ).

***Premises and Equipment***

Premises and equipment are depreciated using the straight-line method over the estimated useful lives of the related assets (generally three to ten years). Leasehold improvements are amortized using the straight-line method over the term of related leases or the estimated useful lives of the assets, whichever is shorter.

***Goodwill***

In accordance with FASB No. 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized; instead, it is reviewed, on at least an annual basis, for impairment. Goodwill is impaired when the carrying amount of the reporting unit exceeds the implied fair value of the reporting unit. While goodwill is no longer amortized, it is tested for impairment annually as of the third quarter or at the time of a triggering event requiring re-evaluation, if one were to occur. Goodwill was tested for impairment as of September 30, 2007 and based on this impairment test/analysis no reporting units were considered impaired.

***Income Taxes***

We file a consolidated U.S. Federal income tax return, which includes all of our qualifying subsidiaries. Amounts provided for income taxes are based on income reported for financial statement purposes and do not necessarily represent amounts currently payable. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred income taxes are provided for temporary differences in reporting certain items, principally deferred compensation, unrealized gains and losses on investments, and tax amortization on intangible assets. Tax credits are recorded as a reduction of income taxes when realized.

***Legal Reserves***

We recognize a liability for a contingency when it is probable that a liability has been incurred and when the amount of loss can be reasonably estimated. When a range of probable loss can be estimated, we accrue the most likely amount of such loss, and if such amount is not determinable, then we accrue the minimum of the range of probable loss.

We record reserves related to legal proceedings in accrued expenses and other liabilities. Such reserves are established and maintained in accordance with FASB No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss an Interpretation of FASB Statement No. 5*. The determination of these reserve amounts requires significant judgment on the part of management. Our management considers many factors including, but not limited to: the amount of the claim; the basis and validity of the claim; previous results in similar cases; and legal precedents and case law. Each legal proceeding is reviewed with counsel in each accounting period and the reserve is adjusted as deemed appropriate by management.

***Stock Based Compensation***

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Under FASB No. 123, *Accounting for Stock-Based Compensation*, we defined the service period (over which compensation cost should be recognized) to generally include the year prior to the grant and the subsequent vesting period. With the adoption of FASB 123R on January 1, 2006, our policy regarding the timing of expense recognition for non-retirement eligible employees changed to recognize compensation cost over the period from the service inception date, which is the grant date, through the date the employee is no longer required to provide service to earn the award.

In addition, with the adoption of FASB 123R on January 1, 2006, the awards granted to retirement eligible employees where the award does not contain future service requirements must be either expensed on the date of grant or, in certain circumstances, may be accrued in the periods prior to the grant date. Subsequent to the adoption of FASB 123R, we made certain changes to the terms of certain new grants which effectively eliminated accelerated expense recognition upon retirement and/or increased the retirement eligibility age and years of service from those generally provided for in prior grants. During the three month period ended September 30, 2007, we did not grant stock-based awards which require accelerated expense recognition upon retirement under FASB 123R. During the nine month period ended September 30, 2007, we granted stock-based awards with a fair value of \$9.2 million, which require accelerated expense recognition upon retirement under FASB 123R.

***Earnings per Common Share***

Basic earnings per share of common stock are computed by dividing net earnings by the average number of shares outstanding and certain other shares committed to be, but not yet issued. Basic earnings per share include restricted stock and RSUs for which no future service is required. Diluted earnings per share of common stock are computed by dividing net earnings plus dividends on mandatorily redeemable convertible preferred stock divided by the average number of shares outstanding of common stock and all dilutive common stock equivalents outstanding during the period. Diluted earnings per share include the dilutive effects of restricted stock and RSUs for which future service is required.

***Accounting and Regulatory Developments***

***FASB Interpretation No. 48.*** 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 derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The transition adjustment to beginning retained earnings was a reduction of approximately \$0.4 million.

***FASB No. 157.*** In September 2006, the FASB issued FASB No. 157, *Fair Value Measurements* ( FASB 157 ). FASB 157 clarifies that fair value is the amount that would be exchanged to sell an asset or transfer a liability, in an orderly transaction between market participants. FASB 157 reverses the consensus reached in EITF Issue No. 02-3 prohibiting the recognition of day one gain or loss on derivative contracts where we cannot verify all of the significant model inputs to observable market data and verify the model to market transactions. However, FASB 157 requires that a fair value measurement technique include an adjustment for risks inherent in a particular valuation technique (such as a pricing model) and/or the risks inherent in the inputs to the model, if market participants would also include such an adjustment. In addition, FASB 157 prohibits the recognition of block discounts for large holdings of unrestricted financial instruments where quoted prices are readily and regularly available in an active market. The provisions of FASB 157 are to be applied prospectively, except for changes in fair value measurements that result from the initial application of FASB 157 to existing derivative financial instruments measured under EITF Issue No. 02-3 and block discounts, which are to be recorded as an adjustment to opening retained earnings in the year of adoption. FASB 157 is effective for fiscal years beginning after November 15, 2007. We adopted FASB No. 157 as of the beginning of 2007. To determine the transition adjustment to opening retained earnings, we performed an analysis of existing derivative instruments measured under EITF Issue 02-3 and block discounts, and determined that there was no transition adjustment to opening retained earnings as of January 1, 2007.





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**FASB No. 158.** In September 2006, the FASB issued Statement No. 158, *Accounting for Uncertainty in Employers Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106, and 132(R)* ( FASB 158 ). FASB 158 improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This Statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer’s fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. On December 31, 2006, we adopted the recognition and disclosure provisions of FASB 158. FASB 158 required us to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of our benefit plan on our December 31, 2006 Consolidated Statement of Financial Condition, with a corresponding adjustment to accumulated other comprehensive income, net of tax. As a result of the pension plan being frozen, the projected benefit obligation was equal to the accumulated benefit obligation. Consequently, no additional adjustment to accumulated other comprehensive income was necessary.

**FASB No. 159.** In February 2007, the FASB issued FASB No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115* ( FASB 159 ). This standard permits an entity to measure financial instruments and certain other items at estimated fair value. Most of the provisions of FASB No. 159 are elective; however, the amendment to FASB No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities that own trading and available-for-sale securities. The fair value option created by FASB 159 permits an entity to measure eligible items at fair value as of specified election dates. The fair value option (a) may generally be applied instrument by instrument, (b) is irrevocable unless a new election date occurs, and (c) must be applied to the entire instrument and not to only a portion of the instrument. FASB 159 allows for a one-time election for existing positions upon adoption, with the transition adjustment recorded to opening retained earnings. FASB 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity (i) makes that choice in the first 120 days of that year, (ii) has not yet issued financial statements for any interim period of such year, and (iii) elects to apply the provisions of FASB 157. We adopted FASB 159 as of the beginning of 2007. We elected to apply the fair value option on loans and loan commitments made in connection with our investment banking activities ( loans and loan commitments ). Loans and loan commitments are included in financial instruments owned on the Consolidated Statement of Financial Condition. At the time of adoption, we did not have such loans and loan commitments outstanding, therefore there was no transition adjustment recorded to opening retained earnings. In addition, we elected to apply the fair value option on certain investments held by subsidiaries that are not registered broker-dealers as defined in the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*. These investments had been accounted for by us at fair value prior to the adoption of FASB 159; therefore, there was no transition adjustment recorded to opening retained earnings related to these investments. The fair value option was elected for loans and loan commitments and investments held by subsidiaries that are not registered broker-dealers because they are risk managed by us on a fair value basis.

**FSP FIN 39-1.** In April 2007, the FASB issued a Staff Position ( FSP ) FIN No. 39-1, *Amendment of FASB Interpretation No. 39*. FSP FIN No. 39-1 defines right of setoff and specifies what conditions must be met for a derivative contract to qualify for this right of setoff. It also addresses the applicability of a right of setoff to derivative instruments and clarifies the circumstances in which it is appropriate to offset amounts recognized for those instruments in the statement of financial position. In addition, this FSP permits offsetting of fair value amounts recognized for multiple derivative instruments executed with the same counterparty under a master netting

arrangement and fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from the same master netting arrangement as the derivative instruments. The provisions of this FSP are consistent with our current accounting practice. This interpretation is effective for

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fiscal years beginning after November 15, 2007, with early application permitted. The adoption of FSP FIN No. 39-1 will not have a material impact on our Consolidated Financial Statements.

**EITF Issue No. 06-11.** In June 2007, the FASB ratified the consensus reached by the Emerging Issues Task Force on Issue 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* ( EITF 06-11 ). EITF 06-11 requires that the tax benefit related to dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity classified nonvested equity shares, nonvested equity share units, and outstanding equity share options be recorded as an increase in additional paid-in capital. We currently account for this tax benefit as a reduction to income tax expense. EITF 06-11 is to be applied prospectively for tax benefits on dividends declared in fiscal years beginning after December 15, 2007. We intend to adopt EITF 06-11 in the first quarter of 2008. We are currently evaluating the impact of EITF 06-11 on our results of operations for the first quarter of 2008.

**SOP No. 07-1.** In June 2007, the American Institute of Certified Public Accountants issued Statement of Position No. 07-1, *Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* ( SOP 07-1 ). SOP 07-1 clarifies the scope of when an entity may apply the provisions of the AICPA Audit and Accounting Guide Investment Companies ( the Guide ). SOP 07-1 also provides guidance for determining whether the specialized industry accounting principles of the Guide should be retained in the financial statements of a parent company of an investment company or an equity method investor in an investment company, and includes certain disclosure requirements. In October 2007 the FASB delayed the effective date of SOP 07-1 indefinitely primarily because of concerns over implementation issues arising from the interaction between SOP 07-1 and Statements 157 and 159 and because of the short implementation period between its issuance on June 11, 2007 and its effective date. A new effective date will be determined after the FASB addresses implementation issues and potential amendments. We are currently evaluating the impact of SOP 07-1 on our Consolidated Financial Statements.

**SAB 109.** On November 5, 2007, SEC Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value Through Earnings* ( SAB 109 ), was issued. SAB 109 provides the staff's views on the accounting for written loan commitments recorded at fair value under generally accepted accounting principles. To make the staff's views consistent with current authoritative accounting guidance, SAB 109 revises and rescinds portions of SAB 105, *Application of Accounting Principles to Loan Commitments*. Specifically, SAB 109 states that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. The provisions of SAB 109 are applicable to written loan commitments issued or modified beginning on January 1, 2008. We are currently evaluating the impact, if any, that SAB 109 may have on our Consolidated Financial Statements.

***Use of Estimates***

Our management has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these financial statements in conformity with U.S. generally accepted accounting principles. The most important of these estimates and assumptions relate to fair value measurements and compensation and benefits. Although these and other estimates and assumptions are based on the best available information, actual results could be materially different from these estimates.

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**Note 2. Asset Management Fees and Investment Income (Loss) From Managed Funds**

Period end assets under management by predominant asset strategy were as follows (in millions of dollars):

|   | September<br>30,<br>2007 | September<br>30,<br>2006 |
|---|--------------------------|--------------------------|
| Assets under management:                      |                          |                          |
| Fixed Income (1)                              | \$ 1,832                 | \$ 1,420                 |
| Equities                                      | 277                      | 517                      |
| Convertibles                                  | 2,802                    | 2,221                    |
|   | 4,911                    | 4,158                    |
| Assets under management by third parties (2): |                          |                          |
| Equities, Convertibles and Fixed Income       | 235                      | 260                      |
| Private Equity                                | 600                      | 600                      |
|   | 835                      | 860                      |
| Total   | \$ 5,746                 | \$ 5,018                 |

(1) With the reorganization of our high yield secondary market trading activities, we no longer include high yield assets as assets under management as of April 2, 2007. Prior period amounts include \$439 million in assets under management from our high yield funds.

(2) Third party managed funds in which we have a 50% or less interest in the entities that manage these assets or otherwise receive a portion of the management fees.

The following summarizes revenues from asset management fees and investment income (loss) from managed funds relating to funds managed by us and funds managed by third parties for the three and nine-month periods ended September 30, 2007 and 2006 (in thousands of dollars):

|  | Three Months Ended |                      | Nine Months Ended    |                      |
|--|--------------------|----------------------|----------------------|----------------------|
|  | Sept. 30,<br>2007  | Sept.<br>30,<br>2006 | Sept.<br>30,<br>2007 | Sept.<br>30,<br>2006 |
| Asset management fees:                             |                    |                      |                      |                      |
| Fixed Income (1)                                   | \$ 1,987           | \$ 3,868             | \$ 9,589             | \$ 19,978            |
| Equities   | 349                | (823)                | 3,494                | 11,060               |
| Convertibles                                       | 3,033              | 3,300                | 9,030                | 7,997                |
| Real Assets  | $\frac{3}{4}$      | $\frac{3}{4}$        | $\frac{3}{4}$        | 2,237                |
|  | 5,369              | 6,345                | 22,113               | 41,272               |
| Investment income (loss) from managed funds<br>(1) | (11,652)           | 10,438               | 7,473                | 38,860               |

|       |            |           |           |           |
|-------|------------|-----------|-----------|-----------|
| Total | \$ (6,283) | \$ 16,783 | \$ 29,586 | \$ 80,132 |
|-------|------------|-----------|-----------|-----------|

- (1) With the reorganization of our high yield secondary market trading activities, we no longer record asset management fees and investment income from managed funds related to these activities. For the three month and nine month period ending September 30, 2006 asset management fees and investment income from managed funds related to our high yield funds amounted to \$5.4 million and \$34.6 million, respectively.

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The following tables detail our average investment in managed funds, investment income from managed funds, investment income from managed funds – minority interest portion and net investment income from managed funds relating to funds managed by us and funds managed by third parties for the three months ended September 30, 2007 and 2006 (in millions of dollars):

**Three Months Ended September 30, 2007**

|                  | Average<br>Investment<br>(2) | Investment<br>Income<br>(Loss)<br>from<br>Managed<br>Funds | Investment<br>Income<br>from<br>Managed<br>Funds<br>Minority<br>Interest<br>Portion | Net<br>Investment<br>Income<br>(Loss)<br>from<br>Managed<br>Funds |
|------------------|------------------------------|--|---|---|
| Fixed Income (1) | \$ 220.3                     | \$ (10.3)  | \$ ¾  | \$ (10.3)   |
| Equities         | 174.1                        | (1.7)  | ¾   | (1.7)   |
| Convertibles     | 34.4                         | 0.3  | ¾   | 0.3   |
| Total            | \$ 428.8                     | \$ (11.7)  | \$ ¾  | \$ (11.7)   |

(1) Excludes high yield secondary market trading activities.

(2) Includes consolidated asset management entities of \$123.5 million.

**Three Months Ended September 30, 2006**

|              | Average<br>Investment<br>(1) | Investment<br>Income<br>from<br>Managed<br>Funds | Investment<br>Income<br>from<br>Managed<br>Funds<br>Minority<br>Interest<br>Portion | Net<br>Investment<br>Income<br>from<br>Managed<br>Funds |
|--------------|------------------------------|--|---|---|
| Fixed Income | \$ 217.0                     | \$ 8.1   | \$ 0.4  | \$ 7.7  |
| Equities     | 85.4                         | 2.3  | ¾   | 2.3   |
| Convertibles | 12.9                         | ¾  | ¾   | ¾   |
| Total        | \$ 315.3                     | \$ 10.4  | \$ 0.4  | \$ 10.0   |

(1) Includes consolidated asset management entities of \$77.0 million and non-consolidated high yield funds of \$54.4 million.



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The following tables detail our average investment in managed funds, investment income from managed funds, investment income from managed funds – minority interest portion and net investment income from managed funds relating to funds managed by us and funds managed by third parties for the nine months ended September 30, 2007 and 2006 (in millions of dollars):

**Nine Months Ended September 30, 2007**

|                  | Average<br>Investment<br>(2) | Investment<br>Income<br>from<br>Managed<br>Funds | Investment<br>Income<br>from<br>Managed<br>Funds<br>Minority<br>Interest<br>Portion | Net<br>Investment<br>Income<br>from<br>Managed<br>Funds |
|------------------|------------------------------|--|---|---|
| Fixed Income (1) | \$ 239.0                     | \$ 2.1   | \$ 0.4  | \$ 1.7  |
| Equities         | 168.2                        | 3.9  | 0.4   | 3.5   |
| Convertibles     | 34.0                         | 1.5  | $\frac{3}{4}$   | 1.5   |
| Total            | \$ 441.2                     | \$ 7.5   | \$ 0.8  | \$ 6.7  |

(1) Excludes high yield secondary market trading activities for the six month period ended September 30, 2007.

(2) Includes consolidated asset management entities of \$101.1 million.

**Nine Months Ended September 30, 2006**

|              | Average<br>Investment<br>(1) | Investment<br>Income<br>from<br>Managed<br>Funds | Investment<br>Income<br>from<br>Managed<br>Funds<br>Minority<br>Interest<br>Portion | Net<br>Investment<br>Income<br>from<br>Managed<br>Funds |
|--------------|------------------------------|--|---|---|
| Fixed Income | \$ 187.0                     | \$ 28.9  | \$ 6.3  | \$ 22.6   |
| Equities     | 77.8                         | 8.2  | $\frac{3}{4}$   | 8.2   |
| Convertibles | 12.7                         | 1.1  | $\frac{3}{4}$   | 1.1   |
| Real Assets  | 4.7                          | 0.7  | $\frac{3}{4}$   | 0.7   |
| Total        | \$ 282.2                     | \$ 38.9  | \$ 6.3  | \$ 32.6   |

(1) Includes consolidated asset management entities of \$40.9 million and non-consolidated high yield funds of \$51.3 million.





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**Note 3. Cash, Cash Equivalents, and Short-Term Investments**

We generally invest our excess cash in money market funds and other short-term investments. Cash equivalents include highly liquid investments not held for resale with original maturities of three months or less. The following are financial instruments that are cash and cash equivalents or are deemed by our management to be generally readily convertible into cash as of September 30, 2007 and December 31, 2006 (in thousands of dollars):

|                                    | September 30,<br>2007 | December 31,<br>2006 |
|------------------------------------|-----------------------|----------------------|
| Cash and cash equivalents:         |                       |                      |
| Cash in banks                      | \$ 223,528            | \$ 107,488           |
| Money market investments           | 297,811               | 405,553              |
| <br>                               |                       |                      |
| Total cash and cash equivalents    | 521,339               | 513,041              |
| Cash and securities segregated (1) | 613,808               | 508,303              |
| Other (2)                          | 2,251                 | 71,160               |
|                                    | <br>\$ 1,137,398      | <br>\$ 1,092,504     |

(1) In accordance with Rule 15c3-3 of the Securities Exchange Act of 1934, Jefferies, as a broker-dealer carrying client accounts, is subject to requirements related to maintaining cash or qualified securities in a segregated reserve account for the exclusive benefit of its clients.

(2) Items are financial instruments utilized in our overall cash management activities and are readily convertible to cash, marginable or accessible for liquidity purposes.

**Note 4. Financial Instruments**

The following is a summary of the fair value of major categories of financial instruments owned and financial instruments sold, not yet purchased, as of September 30, 2007 and December 31, 2006 (in thousands of dollars):

|  | September 30, 2007                |   | December 31, 2006                 |   |
|--|-----------------------------------|---|-----------------------------------|---|
|  | Financial<br>Instruments<br>Owned | Financial<br>Instruments<br>Sold,<br>Not Yet<br>Purchased | Financial<br>Instruments<br>Owned | Financial<br>Instruments<br>Sold,<br>Not Yet<br>Purchased |
| Corporate equity securities            | \$2,868,873                       | \$1,918,672   | \$1,737,174                       | \$1,835,046   |
| Corporate debt securities              | 2,517,960                         | 1,499,497   | 1,918,829                         | 1,185,400   |
| U.S. Government and agency obligations | 625,019                           | 313,214   | 592,374                           | 339,891   |
| Mortgage-backed securities (1)         | 48,305                            | ¾   | 85,040                            | ¾   |
| Asset-backed securities                | 4,325                             | ¾   | 28,009                            | ¾   |
| Loans and loan commitments             | 148,100                           | ¾   | ¾                                 | ¾   |
| Derivatives                            | 697,663                           | 345,738   | 234,646                           | 240,231   |
| Other                                  | 5,472                             | 308   | 10,151                            | 301   |
|  | <br>\$6,915,717                   | <br>\$4,077,429   | <br>\$4,606,223                   | <br>\$3,600,869   |

(1) Represents non-agency mortgage-backed securities. As of September 30, 2007, these securities had a rating of AA or higher.

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Financial instruments owned includes securities pledged to creditors. The following is a summary of the fair value of major categories of securities pledged to creditors as of September 30, 2007 and December 31, 2006 (in thousands of dollars):

|                             | September 30,<br>2007 | December 31,<br>2006 |
|-----------------------------|-----------------------|----------------------|
| Corporate equity securities | \$ 1,766,909          | \$ 1,068,498         |
| Corporate debt securities   | 376,086               | 412,600              |
|                             | \$ 2,142,995          | \$ 1,481,098         |

At September 30, 2007 and December 31, 2006, the approximate fair value of collateral received by us that may be sold or repledged by us was \$20.2 billion and \$9.8 billion, respectively. This collateral was received in connection with resale agreements and securities borrowings. At September 30, 2007 and December 31, 2006, a substantial portion of this collateral received by us had been sold or repledged.

FASB 157 establishes a fair value hierarchy to prioritize the inputs used in valuation techniques. The three broad levels to the fair value hierarchy of inputs are:

- Level 1: Inputs that reflect unadjusted quoted prices at the measurement date for identical assets or liabilities in active markets;
- Level 2: Inputs other than quoted prices included in Level 1 that are either directly or indirectly observable for the asset or liability at the measurement date;
- Level 3: Inputs that are unobservable at the measurement date.

The following is a summary of our financial assets and liabilities that are accounted for at fair value as of September 30, 2007 by level within the fair value hierarchy (in thousands of dollars):

|  | Level 1     | Level 2     | Level 3   | Counterparty<br>and Cash<br>Collateral<br>Netting | Total       |
|--|-------------|-------------|-----------|---|-------------|
| <b>Assets:</b>                                 |             |             |           |   |             |
| Financial instruments owned:                   |             |             |           |   |             |
| Securities                                     | \$2,717,556 | \$3,086,127 | \$266,271 | \$ ¾  | \$6,069,954 |
| Loans and loan commitments (1)                 | ¾           | ¾           | 148,100   | ¾   | 148,100     |
| Derivative instruments                         | 841,303     | 129,807     | ¾         | (273,447)   | 697,663     |
| Total financial instruments owned              | 3,558,859   | 3,215,934   | 414,371   | (273,447)   | 6,915,717   |
| Investments (2)                                | ¾           | ¾           | 105,550   | ¾   | 105,550     |
| <b>Liabilities:</b>                            |             |             |           |   |             |
| Financial instruments sold, not yet purchased: |             |             |           |   |             |
| Securities                                     | 2,180,301   | 1,529,313   | 22,077    | ¾   | 3,731,691   |
| Derivative instruments                         | 416,970     | 717,618     | ¾         | (788,850)   | 345,738     |

|  |           |           |        |           |           |
|--|-----------|-----------|--------|-----------|-----------|
| Total financial instruments sold,<br>not yet purchased | 2,597,271 | 2,246,931 | 22,077 | (788,850) | 4,077,429 |
|--|-----------|-----------|--------|-----------|-----------|

- (1) We elected the fair value option in accordance with FASB 159 for loans and loan commitments. The fair value of these loans approximates the contractual principal amounts. No gains or losses were recorded for the three and nine month periods ended September 30, 2007.
- (2) Our \$57.6 million strategic equity method investment in Jefferies Finance LLC as of September 30, 2007 is excluded from this table.

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The following is a summary of changes in fair value of our financial assets and liabilities that have been classified as Level 3 for the three and nine months ended September 30, 2007 (in thousands of dollars):

**Three Months Ended**

|   | Non-derivative | Non-derivative | Investments |
|---|----------------|----------------|-------------|
|   | instruments    | instruments    |             |
|   | Assets         | Liabilities    |             |
| Balance, June 30, 2007                              | \$ 252,695     | \$ 2,835       | \$ 92,923   |
| Total gains/ (losses) (realized and unrealized) (1) | 8,358          | 45             | 12,854      |
| Purchases, sales, settlements, and Issuances        | 170,659        | (803)          | (227)       |
| Net transfers in and/or out of Level 3              | (17,341)       | 20,000         | ¾           |
| Balance, September 30, 2007                         | \$ 414,371     | \$ 22,077      | \$ 105,550  |

Change in unrealized gains/ (losses) relating to instruments still held at September 30, 2007 (1)

|           |        |        |
|-----------|--------|--------|
| \$ 10,072 | \$ (5) | 12,854 |
|-----------|--------|--------|

(1) Realized and unrealized gains/ losses are reported in principal transactions in the Consolidated Statements of Earnings.

**Nine Months Ended**

|   | Non-derivative | Non-derivative | Investments |
|---|----------------|----------------|-------------|
|   | instruments    | instruments    |             |
|   | Assets         | Liabilities    |             |
| Balance, December 31, 2006                          | \$ 205,278     | \$ ¾           | \$ 97,289   |
| Total gains/ (losses) (realized and unrealized) (1) | 5,575          | 45             | 21,515      |
| Purchases, sales, settlements, and Issuances        | 220,292        | 515            | (13,254)    |
| Net transfers in and/or out of Level 3              | (16,774)       | 21,517         | ¾           |
| Balance, September 30, 2007                         | \$ 414,371     | \$ 22,077      | \$ 105,550  |

Change in unrealized gains/ (losses) relating to instruments still held at September 30, 2007 (1)

|             |        |           |
|-------------|--------|-----------|
| \$ (11,292) | \$ (5) | \$ 21,515 |
|-------------|--------|-----------|

(1)

Realized and unrealized gains/ losses are reported in principal transactions in the Consolidated Statements of Earnings.

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**Note 5. Short-Term Borrowings**

Bank loans represent short-term borrowings that are payable on demand and generally bear interest at a spread over the Fed Funds rate. We had no outstanding secured bank loans as of September 30, 2007 and December 31, 2006. Unsecured bank loans are typically overnight loans used to finance securities owned or clearing related balances. We had \$399.8 million and \$0 of outstanding unsecured bank loans as of September 30, 2007 and December 31, 2006, respectively. Average daily bank loans for the nine month period ended September 30, 2007 and year ended December 31, 2006 were \$237.3 million and \$12.4 million, respectively.

**Note 6. Long-Term Debt**

The following summarizes long-term debt outstanding at September 30, 2007 and December 31, 2006 (in thousands of dollars):

|  | September 30,<br>2007 | December 31,<br>2006 |
|--|-----------------------|----------------------|
| 7.75% Senior Notes, due 2012, net of unamortized discount of \$4,127 (2007)      | 329,237               | 328,003              |
| 5.875% Senior Notes, due 2014, net of unamortized discount of \$1,653 (2007)     | 248,347               | ¾                    |
| 5.5% Senior Notes, due 2016, net of unamortized discount of \$1,544 (2007)       | 348,456               | 348,320              |
| 6.45% Senior Debentures, due 2027, net of unamortized discount of \$3,790 (2007) | 346,210               | ¾                    |
| 6.25% Senior Debentures, due 2036, net of unamortized discount of \$7,690 (2007) | 492,310               | 492,239              |
|  | \$ 1,764,560          | \$ 1,168,562         |

We previously entered into a fair value hedge with no ineffectiveness using interest rate swaps in order to convert \$200 million aggregate principal amount of unsecured 7<sup>3</sup>/<sub>4</sub>% senior notes due March 15, 2012 into floating rates based upon LIBOR. During the third quarter of 2007 we terminated these interest rate swaps and received cash consideration less accrued interest of \$8.5 million. The \$8.5 million basis difference related to the fair value of the interest rate swaps at the time of the termination is being amortized as a reduction in interest expense of \$1.9 million per year over the remaining life of the notes through March 2012.

In January 2006, we sold in a registered public offering \$500 million aggregate principal amount of our unsecured 6.25% 30-year senior debentures due January 15, 2036.

In June 2007, we sold in a registered public offering \$600 million aggregate principal amount of our senior debt, consisting of \$250 million of 5.875% senior notes due June 8, 2014 and \$350 million of 6.45% senior debentures due June 8, 2027.

**Note 7. Mandatorily Redeemable Convertible Preferred Stock**

In February 2006, Massachusetts Mutual Life Insurance Company ( MassMutual ) purchased in a private placement \$125 million of our Series A convertible preferred stock. Our Series A convertible preferred stock has a 3.25% annual, cumulative cash dividend and is currently convertible into 4,074,300 shares of our common stock at an effective conversion price of approximately \$30.68 per share. The preferred stock is callable beginning in 2016 and will mature in 2036. As of September 30, 2007, 10,000,000 shares of preferred stock were authorized and 125,000 shares of preferred stock were issued and outstanding. The dividend is recorded as a component of interest expense as the



Series A convertible preferred stock is treated as debt for accounting purposes. The dividend is not deductible for tax purposes because the Series A convertible preferred stock is considered equity for tax purposes.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
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**Note 8. Income Taxes**

We adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), as of January 1, 2007. As a result of adoption, we recognized a \$0.4 million increase to reserves for uncertain tax positions. This increase was accounted for as an adjustment to the beginning balance of retained earnings on the Consolidated Statement of Financial Condition. As of September 30, 2007 and January 1, 2007, we had approximately \$4.2 million and \$3.3 million, respectively, of total gross unrecognized tax benefits. These totals also represent the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective income tax rate in any future periods.

We are subject to U.S. federal income tax as well as income tax in multiple state and foreign jurisdictions. We have concluded all U.S. federal income tax matters for the years through 2000. Substantially all material state and local, and foreign income tax matters have been concluded for the years through 1998. New York State and New York City income tax returns for the years 2001 through 2004 and 2000 through 2003, respectively, are currently under examination. The final outcome of these examinations is not yet determinable. However, management anticipates that adjustments to the unrecognized tax benefits, if any, will not result in a material change to the results of operations or financial condition.

We recognize interest accrued related to unrecognized tax benefits in interest expense. Penalties, if any, are recognized in other expenses. As of September 30, 2007 and January 1, 2007, we had accrued interest and penalties related to unrecognized tax benefits of approximately \$1.1 million and \$1.0 million, respectively.

**Note 9. Benefit Plans**

The following summarizes the net periodic pension cost for the three-month and nine-month periods ended September 30, 2007 and 2006 (in thousands of dollars):

|   | Three Months Ended   |                      | Nine Months Ended    |                      |
|---|----------------------|----------------------|----------------------|----------------------|
|   | Sept.<br>30,<br>2007 | Sept.<br>30,<br>2006 | Sept.<br>30,<br>2007 | Sept.<br>30,<br>2006 |
| Net pension cost included the following components: |                      |                      |                      |                      |
| Service cost (1)                                    | \$ 69                | \$ 137               | \$ 207               | \$ 137               |
| Interest cost on projected benefit obligation       | 599                  | 543                  | 1,779                | 1,818                |
| Expected return on plan assets                      | (833)                | (697)                | (2,089)              | (1,816)              |
| Amortization of prior service cost                  | ¾                    | ¾                    | ¾                    | ¾                    |
| Amortization of net loss                            | (141)                | 26                   | 141                  | 536                  |
| Net periodic pension cost                           | \$ (306)             | \$ 9                 | \$ 38                | \$ 675               |

(1) Service costs relates to administrative expenses incurred during the three and nine month periods.

We contributed \$2.0 million to our pension plan during the quarter ended September 30, 2007 and do not anticipate contributing more during the remainder of 2007. Effective December 31, 2005, benefits under the pension plan have been frozen. There are no incremental benefit accruals for service after December 31, 2005.

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**Note 10. Minority Interest**

Under FASB No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* ( FASB 150 ), certain minority interests in consolidated entities may meet the standard's definition of a mandatorily redeemable financial instrument and thus require reclassification as liabilities and remeasurement at the estimated amount of cash that would be due and payable to settle such minority interests under the applicable entity's organization agreement, assuming an orderly liquidation of the entity, net of estimated liquidation costs. Our consolidated financial statements include certain minority interests that meet the standard's definition of mandatorily redeemable financial instruments. These mandatorily redeemable minority interests represent interests held by third parties in Jefferies High Yield Holdings, LLC ( JHYH ). The mandatorily redeemable minority interests are entitled to a pro rata share of the profits of JHYH, as set forth in JHYH's organization agreements, and are scheduled to terminate in 2013, with an option to extend up to three additional one-year periods. The carrying amount of these mandatorily redeemable minority interests are approximately \$609.1 million at September 30, 2007, which represents the initial capital and the pro rata share of the profits of JHYH assigned to the holder of the mandatorily redeemable minority interests. A certain portion of these mandatorily redeemable minority interests represent investments from Jefferies Special Opportunities Partners ( JSOP ) and Jefferies Employees Special Opportunities Partners ( JESOP ), and are eliminated in consolidation. The carrying amount of these mandatorily redeemable minority interests eliminated in consolidation is approximately \$252.7 million at September 30, 2007, resulting in minority interest related to JHYH on a consolidated basis of approximately \$356.4 million at September 30, 2007.

Minority interest also includes the minority equity holders' proportionate share of the equity of JSOP and JESOP. At September 30, 2007, minority interest related to JSOP and JESOP was approximately \$211.6 million and \$27.3 million, respectively.

At September 30, 2007, we had other minority interests of approximately \$9.9 million primarily related to our start-up asset management funds.

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**Note 11. Earnings Per Share**

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the three-month and nine-month periods ended September 30, 2007 and 2006 (in thousands, except per share amounts):

|  | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | Sept. 30,<br>2007  | Sept. 30,<br>2006 | Sept. 30,<br>2007 | Sept. 30,<br>2006 |
| Earnings before cumulative effect of change in accounting principle, net | \$ 38,773          | \$ 45,940         | \$ 168,867        | \$ 148,361        |
| Cumulative effect of change in accounting principle, net                 | $\frac{3}{4}$      | $\frac{3}{4}$     | $\frac{3}{4}$     | 1,606             |
| Net earnings   | \$ 38,773          | \$ 45,940         | \$ 168,867        | \$ 149,967        |
| Add: Convertible preferred stock dividends                               | 1,016              | 1,016             | 3,048             | 2,528             |
| Net earnings for diluted earnings per share                              | \$ 39,789          | \$ 46,956         | \$ 171,915        | \$ 152,495        |
| Shares:  |                    |                   |                   |                   |
| Average shares used in basic computation                                 | 142,822            | 135,140           | 141,905           | 133,048           |
| Unvested restricted stock / restricted stock units                       | 8,351              | 8,542             | 7,462             | 8,771             |
| Stock options  | 236                | 1,184             | 480               | 1,341             |
| Convertible preferred stock  | 4,071              | 4,042             | 4,064             | 3,342             |
| Average shares used in diluted computation                               | 155,480            | 148,908           | 153,911           | 146,502           |
| Earnings per share:  |                    |                   |                   |                   |
| Basic-   |                    |                   |                   |                   |
| Earnings before cumulative effect of change in accounting principle, net | \$ 0.27            | \$ 0.34           | \$ 1.19           | \$ 1.12           |
| Cumulative effect of change in accounting principle, net                 | $\frac{3}{4}$      | $\frac{3}{4}$     | $\frac{3}{4}$     | 0.01              |
| Net earnings   | \$ 0.27            | \$ 0.34           | \$ 1.19           | \$ 1.13           |
| Diluted-   |                    |                   |                   |                   |
| Earnings before cumulative effect of change in accounting principle, net | \$ 0.26            | \$ 0.32           | \$ 1.12           | \$ 1.03           |
| Cumulative effect of change in accounting principle, net                 | $\frac{3}{4}$      | $\frac{3}{4}$     | $\frac{3}{4}$     | 0.01              |
| Net earnings   | \$ 0.26            | \$ 0.32           | \$ 1.12           | \$ 1.04           |



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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
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**Note 12. Derivative Financial Instruments**

***Off-Balance Sheet Risk***

We have contractual commitments arising in the ordinary course of business for securities loaned or purchased under agreements to sell, financial instruments sold but not yet purchased, repurchase agreements, future purchases and sales of foreign currencies, securities transactions on a when-issued basis, options contracts, futures index contracts, commodities futures contracts and underwriting. Each of these financial instruments and activities contains varying degrees of off-balance sheet risk whereby the fair values of the securities underlying the financial instruments may be in excess of, or less than, the contract amount. The settlement of these transactions is not expected to have a material effect upon our consolidated financial statements.

***Derivative Financial Instruments***

Our derivative activities are recorded at fair value in the Consolidated Statement of Financial Condition. Acting in a trading capacity, we may enter into derivative transactions to satisfy the needs of our clients and to manage our own exposure to market and credit risks resulting from our trading activities.

Derivatives are subject to various risks similar to other financial instruments, including market, credit and operational risk. In addition, we may be exposed to legal risks related to derivative activities. The risks of derivatives should not be viewed in isolation, but rather should be considered on an aggregate basis along with our other trading-related activities. We manage the risks associated with derivatives on an aggregate basis along with the risks associated with proprietary trading as part of our firmwide risk management policies.

We record trading derivative contracts at fair value with realized and unrealized gains and losses recognized in principal transactions in the Consolidated Statement of Earnings on a trade date basis and as a component of cash flows from operating activities in the Consolidated Statements of Cash Flows.

We previously entered into a fair value hedge with no ineffectiveness using interest rate swaps in order to convert \$200 million aggregate principal amount of unsecured 7<sup>3</sup>/<sub>4</sub>% senior notes due March 15, 2012 into floating rates based upon LIBOR. During the third quarter of 2007 we terminated these interest rate swaps and received cash consideration less accrued interest of \$8.5 million. The \$8.5 million basis difference related to the fair value of the interest rate swaps at the time of the termination is being amortized as a reduction in interest expense of \$1.9 million per year over the remaining life of the notes through March 2012.

The following table presents the fair value of derivatives at September 30, 2007 and December 31, 2006. The fair value of assets/liabilities related to derivative contracts at September 30, 2007 and December 31, 2006 represent our receivable/payable for derivative financial instruments, gross of related collateral received and pledged:

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| (in thousands)  | September 30, 2007 |                  | December 31, 2006 |                  |
|---|--------------------|------------------|-------------------|------------------|
|   | Assets             | Liabilities      | Assets            | Liabilities      |
| Derivative instruments included in financial instruments owned and financial instruments sold, not yet purchased: |                    |                  |                   |                  |
| Exchange traded futures   | \$397,196          | \$ 13,345        | \$ 19,724         | \$ 2,116         |
| Swaps (1)   | 5,337              | 490,642          | 173,821           | 20,251           |
| Option contracts (1)  | 289,303            | 350,788          | 152,361           | 238,115          |
| Forward contracts   | 10,127             | 10,666           | 820               | ¾                |
| <b>Total</b>  | <b>\$701,963</b>   | <b>\$865,441</b> | <b>\$346,726</b>  | <b>\$260,482</b> |
| Derivative instruments included in other assets:  |                    |                  |                   |                  |
| Interest rate swaps   |                    | ¾                | 7,690             | ¾                |

- (1) Option and swap contracts in the table above are gross of collateral received and/ or collateral pledged. Option and swap contracts are recorded net of collateral received and/ or collateral pledged on the Consolidated Statement of Financial Condition. As September 30, 2007, collateral received and collateral pledged were \$4.3 million and \$519.7 million, respectively. At December 31, 2006, collateral received and collateral pledged were \$112.1 million and \$20.3 million, respectively.

**Jefferies Financial Products**

Jefferies Financial Products, LLC ( JFP ), a wholly-owned subsidiary of ours, was formed as a limited liability company in November 2003. JFP is a market maker in commodity index products and a trader in commodities futures and options. JFP offers customers exposure to over-the-counter commodity indices and other commodity baskets in the form of fixed-for-floating swaps ( swaps ) and options, where the return is based on a specific commodity or basket of commodities (e.g., Jefferies Commodity Performance Index ( JCPI )). The primary end users in this market are creditworthy institutional investors, such as pension funds, mutual funds, foundations, endowments, and insurance companies. These investors generally seek exposure to commodities in order to diversify their existing stock and bond portfolios. Generally, JFP will enter into swaps whereby JFP receives a stream of fixed cash flows against paying the return of a given commodity or index plus a spread or fee ( fee ). The fee is meant to compensate JFP for the costs of replicating the commodity or index exposure in the underlying exchange traded futures markets. The floating return can be either the total return on the index (inclusive of implied collateral yield), or the excess return. JFP also enters into swap, forward and option transactions on foreign exchange, individual commodities and commodity indices. Generally, the swap and option contract tenors range from 1 month to 2 years, and in some transactions both parties may settle the changes in the mark-to-market value of the transaction on a monthly basis. Where appropriate, JFP utilizes various credit enhancements, including guarantees, collateral and margin agreements to mitigate the credit exposure relating to these swaps and options. JFP establishes credit limits based on, among other things, the creditworthiness of the counterparties, the transaction s size and tenor, and estimated potential exposure. In addition, swap and option transactions are generally documented under International Swaps and Derivatives Association Master Agreements. We believe that such agreements provide for legally enforceable set-off and close-out netting of exposures to specific counterparties. Under such agreements, in connection with an early termination of a transaction, JFP is permitted to set-off its receivables from a counterparty against its payables to the same counterparty arising out of all included transactions. As a result, the fair value represents the net sum of estimated fair values after the application of such netting. JFP has determined that the fair value of its swaps and options approximated \$(484.2) million and \$(77.2) million, respectively at September 30, 2007 and \$156.1 million and \$(125.4) million,

respectively at December 31, 2006.



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The following table sets forth the fair value of JFP's outstanding OTC positions and exchange-traded futures and options by remaining contractual maturity as of September 30, 2007:

| (in millions)           | 0 12<br>Months   | 1 5<br>Years    | 5 10<br>Years   | Total            |
|-------------------------|------------------|-----------------|-----------------|------------------|
| Swaps                   | \$(483.6)        | \$ (0.6)        | \$ ¾            | \$(484.2)        |
| Options                 | (6.5)            | (70.7)          | ¾               | (77.2)           |
| FX forwards             | (1.3)            | 0.5             | ¾               | (0.8)            |
| Exchange-traded futures | 168.5            | 228.3           | (0.1)           | 396.7            |
| <b>Total</b>            | <b>\$(322.9)</b> | <b>\$ 157.5</b> | <b>\$ (0.1)</b> | <b>\$(165.5)</b> |

In July 2004, JFP entered into a credit intermediation facility with an AA-rated European bank (the Bank). This facility allows JFP customers that require a counterparty with a high credit rating for commodity index transactions to transact with the Bank. The Bank simultaneously enters into a back-to-back transaction with JFP and receives a fee from JFP for providing credit support. Subject to the terms of the agreement between JFP and the Bank, JFP is generally responsible to the Bank for the performance of JFP's customers. We guarantee the performance of JFP to the Bank under the credit intermediation facility. JFP also provides commodity index pricing to the Bank's customers and JFP earns revenue from the Bank's hedging of its customer transactions with JFP.

At September 30, 2007 and December 31, 2006, the counterparty credit quality with respect to the fair value of commodities and foreign exchange futures, options and swap portfolios were as follows:

| (in millions)                           | <b>Fair Value</b>        |                         |
|---|--------------------------|-------------------------|
|   | September<br>30,<br>2007 | December<br>31,<br>2006 |
| Counterparty credit quality:            |                          |                         |
| A or higher                             | \$(564.0)                | \$ 37.5                 |
| Exchange-traded futures and options (1) | 398.5                    | 13.4                    |
| <b>Total</b>                            | <b>\$(165.5)</b>         | <b>\$ 50.9</b>          |

(1) Exchange-traded commodities and foreign exchange futures and options are not deemed to have significant credit exposures as the exchanges guarantee that every contract will be properly settled on a daily basis.

At September 30, 2007 and December 31, 2006 the counterparty breakdown by industry with respect to the fair value of JFP's commodities and foreign exchange futures, options and swap portfolio was as follows:

| (in millions)   | <b>Fair Value</b>        |                         |
|---|--------------------------|-------------------------|
|   | September<br>30,<br>2007 | December<br>31,<br>2006 |
| Foundations, trusts and endowments  | \$ (30.9)                | \$ (6.4)                |
| Financial services  | (235.6)                  | 4.7                     |
| Sovereign entity  | (5.2)                    | ¾                       |
| Collective investment vehicles (including pension plans, mutual funds and other institutional | (292.3)                  | 39.2                    |

|                 |           |         |
|-----------------|-----------|---------|
| counterparties) |           |         |
| Exchanges (1)   | 398.5     | 13.4    |
| Total           | \$(165.5) | \$ 50.9 |

(1) Exchange-traded commodities and foreign exchange futures and options are not deemed to have significant credit exposures as the exchanges guarantee that every contract will be properly settled on a daily basis.

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**Note 13. Other Comprehensive Gain (Loss)**

The following summarizes other comprehensive gain (loss) and accumulated other comprehensive gain (loss) at September 30, 2007 and for the three months then ended (in thousands of dollars):

|                                 | Currency<br>Translation<br>Adjustments | Minimum<br>Pension<br>Liability<br>Adjustment | Accumulated<br>Other<br>Comprehensive<br>Gain |
|---------------------------------|--|---|---|
| Beginning at June 30, 2007      | \$ 11,153                              | \$ (2,910)                                    | \$ 8,243                                      |
| Change in third quarter of 2007 | 4,423                                  | ¾   | 4,423   |
| Ending at September 30, 2007    | \$ 15,576                              | \$ (2,910)                                    | \$ 12,666                                     |

The following summarizes other comprehensive gain (loss) and accumulated other comprehensive gain (loss) at September 30, 2006 and for the three months then ended (in thousands of dollars):

|                                 | Currency<br>Translation<br>Adjustments | Minimum<br>Pension<br>Liability<br>Adjustment | Accumulated<br>Other<br>Comprehensive<br>(Loss) Gain |
|---------------------------------|--|---|--|
| Beginning at June 30, 2006      | \$ 6,502                               | \$ (6,125)                                    | \$ 377   |
| Change in third quarter of 2006 | (164)                                  | ¾   | (164)  |
| Ending at September 30, 2006    | \$ 6,338                               | \$ (6,125)                                    | \$ 213   |

Comprehensive income for the three months ended September 30, 2007 and 2006 was as follows (in thousands of dollars):

|                                 | September<br>30,<br>2007 | September<br>30,<br>2006 |
|---------------------------------|--------------------------|--------------------------|
| Net earnings                    | \$ 38,773                | \$ 45,940                |
| Other comprehensive gain (loss) | 4,423                    | (164)                    |
| Comprehensive income            | \$ 43,196                | \$ 45,776                |

The following summarizes other comprehensive gain (loss) and accumulated other comprehensive gain (loss) at September 30, 2007 and for the nine months then ended (in thousands of dollars):

|                                     | Currency<br>Translation<br>Adjustments | Minimum<br>Pension<br>Liability<br>Adjustment | Accumulated<br>Other<br>Comprehensive<br>Gain |
|-------------------------------------|--|---|---|
| Beginning at December 31, 2006      | \$ 9,764                               | \$ (2,910)                                    | \$ 6,854                                      |
| Change in first nine months of 2007 | 5,812                                  | ¾   | 5,812   |

|                              |           |            |           |
|------------------------------|-----------|------------|-----------|
| Ending at September 30, 2007 | \$ 15,576 | \$ (2,910) | \$ 12,666 |
|------------------------------|-----------|------------|-----------|

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The following summarizes other comprehensive gain (loss) and accumulated other comprehensive gain (loss) at September 30, 2006 and for the nine months then ended (in thousands of dollars):

|                                     | Currency<br>Translation<br>Adjustments | Minimum<br>Pension<br>Liability<br>Adjustment | Accumulated<br>Other<br>Comprehensive<br>(Loss) Gain |
|-------------------------------------|--|---|--|
| Beginning at December 31, 2005      | \$ 962                                 | \$ (6,125)                                    | \$ (5,163)   |
| Change in first nine months of 2006 | 5,376                                  | ¾   | 5,376  |
| Ending at September 30, 2006        | \$ 6,338                               | \$ (6,125)                                    | \$ 213   |

Comprehensive income for the nine months ended September 30, 2007 and 2006 was as follows (in thousands of dollars):

|                                 | September<br>30,<br>2007 | September<br>30,<br>2006 |
|---------------------------------|--------------------------|--------------------------|
| Net earnings                    | \$ 168,867               | \$ 149,967               |
| Other comprehensive gain (loss) | 5,812                    | 5,376                    |
| Comprehensive income            | \$ 174,679               | \$ 155,343               |

**Note 14. Net Capital Requirements**

As registered broker-dealers, Jefferies, Jefferies Execution and Jefferies High Yield Trading are subject to the Securities and Exchange Commission Uniform Net Capital Rule (Rule 15c3-1), which requires the maintenance of minimum net capital. Jefferies, Jefferies Execution and Jefferies High Yield Trading have elected to use the alternative method permitted by the Rule, which requires that they each maintain minimum net capital.

As of September 30, 2007, Jefferies, Jefferies Execution and Jefferies High Yield Trading's net capital and excess net capital were as follows (in thousands of dollars):

|                              | Net Capital | Excess Net<br>Capital |
|------------------------------|-------------|-----------------------|
| Jefferies                    | \$ 431,661  | \$ 409,404            |
| Jefferies Execution          | \$ 24,473   | \$ 24,223             |
| Jefferies High Yield Trading | \$ 555,033  | \$ 554,783            |

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**Note 15. Commitments, Contingencies and Guarantees**

The following table summarizes other commitments and guarantees at September 30, 2007:

|                           | Notional<br>/<br>Maximum<br>Payout | 2007    | Maturity Date         |                     |                     |                      |
|---------------------------|------------------------------------|---------|-----------------------|---------------------|---------------------|----------------------|
|                           |                                    |         | 2008                  | 2009<br>and<br>2010 | 2011<br>and<br>2012 | 2013<br>and<br>Later |
|                           |                                    |         |                       |                     |                     |                      |
|                           |                                    |         | (Dollars in Millions) |                     |                     |                      |
| Standby letters of credit | \$258.5                            | \$128.7 | \$129.8               |                     |                     |                      |
| Bank credit               | \$ 60.4                            |         | \$ 20.0               |                     | \$ 36.0             | \$ 4.4               |
| Equity commitments        | \$511.5                            |         |                       |                     | \$ 1.3              | \$510.2              |
| Derivative contracts      | \$609.5                            | \$579.5 | \$ 20.0               |                     | \$ 10.0             |                      |

**Standby Letters of Credit.** In the normal course of business, we had letters of credit outstanding aggregating \$258.5 million at September 30, 2007, mostly to satisfy various collateral requirements in lieu of depositing cash or securities. These letters of credit have a current carrying amount of \$0. As of September 30, 2007, there were no draw downs on these letters of credit.

**Bank Credit.** As of September 30, 2007, we had outstanding guarantees of \$56.0 million relating to bank credit obligations (\$38.4 million of which is undrawn) of associated investment vehicles in which we have an interest. Also, we have provided a guarantee to a third-party bank in connection with the bank's extension of 500 million Japanese yen (approximately \$4.4 million) to Jefferies (Japan) Limited.

**Equity Commitments.** On October 7, 2004, we entered into an agreement with Babson Capital and MassMutual to form Jefferies Finance LLC, a joint venture entity created for the purpose of offering senior loans to middle market and growth companies. In February 2006, we and MassMutual reached an agreement to double our equity commitments to Jefferies Finance LLC. With an incremental \$125 million from each partner, the new total committed equity capitalization of Jefferies Finance LLC is \$500 million. Loans are originated primarily through the investment banking efforts of Jefferies & Company, Inc. with Babson Capital providing primary credit analytics and portfolio management services. As of September 30, 2007, we have funded \$55.0 million of our aggregate \$250.0 million commitment leaving \$195.0 million unfunded.

As of September 30, 2007, we have an aggregate commitment to invest in Babson-Jefferies Loan Opportunity CLO, Ltd. of approximately \$25.0 million.

As of September 30, 2007, we have an aggregate commitment to invest in Jefferies Capital Partners IV L.P. and its related parallel fund of approximately \$30.0 million.

As of September 30, 2007, we have funded approximately \$350.0 million of our aggregate commitment in JHYH leaving approximately \$250.0 million unfunded (see note 20 of the Notes to Consolidated Financial Statements for more information related to our commitment to invest in JHYH).

As of September 30, 2007, we had other equity commitments to invest up to \$11.5 million in various other investments.

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**Derivative Contracts.** In accordance with FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45), we disclose certain derivative contracts meeting the FIN 45 definition of a guarantee. Such derivative contracts include credit default swaps (whereby a default or significant change in the credit quality of the underlying financial instrument may obligate us to make a payment) and written equity put options. At September 30, 2007, the maximum payout value of derivative contracts deemed to meet the FIN 45 definition of a guarantee was approximately \$609.5 million. For purposes of determining maximum payout, notional values are used; however, we believe the fair value of these contracts is a more relevant measure of these obligations because we believe the notional amounts greatly overstate our expected payout. At September 30, 2007, the fair value of such derivative contracts approximated \$9.7 million. In addition, the derivative contracts deemed to meet the FIN 45 definition of a guarantee are before consideration of hedging transactions. We substantially mitigate our risk on these contracts through hedges, such as other derivative contracts and/or cash instruments. We manage risk associated with derivative guarantees consistent with our risk management policies.

**High Yield Loan Commitments.** From time to time we make commitments to extend credit to investment-banking clients in loan syndication and acquisition-finance transactions. These commitments and any related drawdowns of these facilities typically have fixed maturity dates and are contingent on certain representations, warranties and contractual conditions applicable to the borrower. We define high yield (non-investment grade) as debt securities or loan commitments to companies rated BB+ or lower or equivalent ratings by recognized credit rating agencies, as well as non-rated securities or loans that, in management's opinion, are non-investment grade. We did not have any commitments outstanding to non-investment grade borrowers as of September 30, 2007.

**Jefferies Financial Products, LLC.** In July 2004, JFP entered into a credit intermediation facility with an AA-rated European bank (the Bank). This facility allows JFP customers that require a counterparty with a high credit rating for commodity index transactions to transact with the Bank. The Bank simultaneously enters into a back-to-back transaction with JFP and receives a fee from JFP for providing credit support. Subject to the terms of the agreement between JFP and the Bank, JFP is responsible to the Bank for the performance of JFP's customers. We guarantee the performance of JFP to the Bank under the credit intermediation facility. JFP will also provide commodity index pricing to the Bank's customers and JFP will earn revenue from the Bank's hedging of its customer transactions with JFP. Also, we guarantee the performance of JFP to its trading counterparties and various banks and other entities, which provide clearing and credit services to JFP.

**Other Guarantees.** In the normal course of business we provide guarantees to securities clearinghouses and exchanges. These guarantees generally are required under the standard membership agreements, such that members are required to guarantee the performance of other members. To mitigate these performance risks, the exchanges and clearinghouses often require members to post collateral. Our obligations under such guarantees could exceed the collateral amounts posted; however, the potential for us to be required to make payments under such guarantees is deemed remote. Also, we have guaranteed obligations of Jefferies International Limited (JIL) to various banks which provide clearing and credit services to JIL and to counterparties of JIL.

**Note 16. Segment Reporting**

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Beginning in the second quarter of 2007, our international convertible bond funds are included within the results of the Asset Management segment. Previously, operations from our international convertible bond funds were included in the Capital Markets segment. Prior period disclosures have been adjusted to conform to the current quarter's presentation. The above change was made in order to reflect the manner in which these segments are currently managed.

The Capital Markets reportable segment includes our traditional securities brokerage, including the results of our recently reorganized high yield secondary market trading activities and investment banking activities. The Capital Markets reportable segment is managed as a single operating segment that provides the sales, trading and origination effort for various fixed income, equity and advisory products and services. The Capital Markets segment comprises many divisions, with interactions among each. In addition, we choose to voluntarily disclose the Asset Management segment even though it is currently an immaterial non-reportable segment as defined by FASB 131, *Disclosures about Segments of an Enterprise and Related Information*.

Our reportable business segment information is prepared using the following methodologies:

Net revenues and expenses directly associated with each reportable business segment are included in determining earnings before taxes.

Net revenues and expenses not directly associated with specific reportable business segments are allocated based on the most relevant measures applicable, including each reportable business segment's net revenues, headcount and other factors.

Reportable business segment assets include an allocation of indirect corporate assets that have been fully allocated to our reportable business segments, generally based on each reportable business segment's capital utilization.



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Our net revenues, expenses, income before income taxes and total assets by segment are summarized below (amounts in millions):

|   | <b>Capital<br/>Markets</b> | <b>Asset<br/>Management</b> | <b>Total</b> |
|---|----------------------------|-----------------------------|--------------|
| <b>Three months ended September 30, 2007</b>  |                            |                             |              |
| Net revenues  | \$ 342.0                   | \$ (7.6)                    | \$ 334.4     |
| Expenses  | 274.5                      | 4.6                         | 279.1        |
| Earnings before income taxes, minority interest and cumulative effect of change in accounting principle | \$ 67.5                    | \$ (12.2)                   | \$ 55.3      |
| <b>Nine months ended September 30, 2007</b>   |                            |                             |              |
| Net revenues  | \$ 1,193.0                 | \$ 25.7                     | \$ 1,218.7   |
| Expenses  | 905.2                      | 26.3                        | 931.5        |
| Earnings before income taxes, minority interest and cumulative effect of change in accounting principle | \$ 287.8                   | \$ (0.6)                    | \$ 287.2     |
| Segment assets  | \$31,306.3                 | \$ 296.1                    | \$31,602.4   |
| <b>Three months ended September 30, 2006</b>  |                            |                             |              |
| Net revenues  | \$ 330.4                   | \$ 10.2                     | \$ 340.6     |
| Expenses  | 249.9                      | 14.4                        | 264.3        |
| Earnings before income taxes, minority interest and cumulative effect of change in accounting principle | \$ 80.5                    | \$ (4.2)                    | \$ 76.3      |
| <b>Nine months ended September 30, 2006</b>   |                            |                             |              |
| Net revenues  | \$ 1,041.9                 | \$ 41.5                     | \$ 1,083.4   |
| Expenses  | 785.4                      | 43.5                        | 828.9        |
| Earnings before income taxes, minority interest and cumulative effect of change in accounting principle | \$ 256.5                   | \$ (2.0)                    | \$ 254.5     |
| Segment assets  | \$15,270.7                 | \$ 214.0                    | \$15,484.7   |

**Note 17. Goodwill**

We acquired LongAcre Partners Limited in May 2007. The LongAcre Partners Limited acquisition contained a five-year contingency for additional consideration to the selling owners, based on future revenues.

We acquired Putnam Lovell Investment banking business ( Putnam ) in July 2007. The purchase price of the Putnam acquisition was \$14.7 million in cash and the acquisition did not contain any contingencies related to additional consideration.

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The following is a summary of goodwill activity for the period ended September 30, 2007 (in thousands of dollars):

|                                       | Nine<br>Months<br>Ended<br>Sept. 30,<br>2007 |
|---------------------------------------|--|
| Balance, at December 31, 2006         | \$ 257,321                                   |
| Add: Acquisition(s)                   | 44,244                                       |
| Add: Accrued contingent consideration | 29,129                                       |
| Balance, at September 30, 2007        | \$ 330,694                                   |

The acquisitions of LongAcre Partners Limited, Helix Associates, Randall & Dewey, and Quarterdeck Investment Partners, LLC all contained a five-year contingency for additional consideration to the selling owners, based on future revenues. This additional consideration is paid in cash annually. There is no contractual dollar limit to the potential of additional consideration. During the quarter ended June 30, 2007, the Broadview International LLC contingency for additional consideration was modified and all remaining contingencies have been accrued for as of June 30, 2007. During the nine month period ended September 30, 2007, we paid approximately \$25.7 million in cash related to contingent consideration that had been earned during the current nine month period or prior periods.

None of the acquisitions listed above were considered material based on the small percentage each represents of our total assets, equity, revenues and net earnings.

**Note 18. Quarterly Dividends**

The only restrictions on our present ability to pay dividends on our common stock are the dividend preference terms of our Series A convertible preferred stock and the governing provisions of the Delaware General Corporation Law.

Dividends per Common Share (declared and paid):

|      | 1 <sup>st</sup><br>Quarter | 2 <sup>nd</sup><br>Quarter | 3 <sup>rd</sup><br>Quarter |
|------|----------------------------|----------------------------|----------------------------|
| 2007 | \$ 0.125                   | \$ 0.125                   | \$ 0.125                   |
| 2006 | \$ 0.075                   | \$ 0.125                   | \$ 0.125                   |

On April 18, 2006, we declared a 2-for-1 stock split of all outstanding shares of common stock. The stock split was paid May 15, 2006 to stockholders of record as of April 28, 2006 and was effected as a stock dividend of one share of common stock for each one share outstanding on the record date. We also announced an increase to our quarterly dividend to \$0.125 per post-split share, which at the time represented a 67% increase from the previous dividend of \$0.075 per post split share.

**Note 19. Variable Interest Entities ( VIEs )***Jefferies High Yield Holdings*

Under the provisions of FIN 46(R) we determined that Jefferies High Yield Holdings ( JHYH ) and Jefferies Employees Special Opportunities Partners ( JESOP ) meet the definition of a VIE. We are the primary beneficiary of JHYH, and we and our employees (related parties) are the primary beneficiaries of JESOP. Therefore, we consolidate both JHYH and JESOP.

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*Managed CLO s*

We also own significant variable interests in various managed CLO s and for which we are not the primary beneficiary and therefore do not consolidate these entities. In aggregate, these variable interest entities have assets approximating \$1.4 billion as of September 30, 2007. Our exposure to loss is limited to our capital contributions. The carrying value of our aggregate investment in these variable interest entities is \$18.7 million at September 30, 2007 and is included in Investments in Managed Funds on our Consolidated Statements of Financial Condition.

*Third Party Managed Warehouse/Special Purpose Entity*

We own a significant variable interest in Babson-Jefferies Loan Opportunity CLO, Ltd., a third party managed warehouse/special purpose entity, in which we have a 33% direct economic interest for which we are not the primary beneficiary and therefore do not consolidate this entity. This variable interest entity has assets of approximately \$357.8 million as of September 30, 2007. Our exposure to loss is limited to our capital contributions. The carrying value of our investment in this variable interest entity is \$27.5 million at September 30, 2007 and is included in Financial Instruments Owned on our Consolidated Statements of Financial Condition.

**Note 20. High Yield Secondary Market Trading**

In January 2000, we created three broker-dealer entities that employed a trading and investment strategy substantially similar to that historically employed by our High Yield division. Two of these entities, the Jefferies Partners Opportunity Fund and the Jefferies Partners Opportunity Fund II, were principally capitalized with equity contributions from institutional and high net worth investors. The third fund, Jefferies Employees Opportunity Fund (and collectively with the two Jefferies Partners Opportunity Funds, referred to as the High Yield Funds ), was principally capitalized with equity investments from our employees and was therefore consolidated into our consolidated financial statements. The High Yield division and each of the funds shared gains or losses on trading and investment activities of the High Yield division on the basis of a pre-established sharing arrangement related to the amount of capital each had committed.

On April 2, 2007 we reorganized Jefferies High Yield Trading, LLC ( JHYT ) to conduct the secondary market trading activities previously performed by the High Yield division of Jefferies and the High Yield Funds. The activities of JHYT are overseen by Richard Handler, our Chief Executive Officer, and the same long-standing team previously responsible for these trading activities. JHYT is a registered broker-dealer engaged in the secondary sales and trading of high yield securities and special situation securities, including bank debt, post-reorganization equity, public and private equity, equity derivatives, credit default swaps and other financial instruments. JHYT makes markets in high yield and distressed securities and provides research coverage on these types of securities. JHYT is a wholly-owned subsidiary of Jefferies High Yield Holdings, LLC ( JHYH ).

We and Leucadia National Corporation ( Leucadia ) expect to increase our respective investments in JHYH to \$600 million each over time. We and Leucadia each have the right to nominate two of a total of four directors to JHYH s board of directors, and each respectively own 50% of the voting securities of JHYH. JHYH provides the opportunity for additional capital investments over time from third party investors through two funds managed by us, Jefferies Special Opportunities Fund ( JSOP ) and Jefferies Employees Special Opportunities Fund ( JESOP ). The term of the arrangement is for six years, with an option to extend.

Under the provisions of FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, we determined that JHYH meets the definition of a variable interest entity. We are the primary beneficiary and consolidate JHYH. Assets of JHYH were \$1.3 billion as of September 30, 2007. JHYH s net revenue and formula-determined non-interest expenses for the three month period ended September 30, 2007 amounted to \$0.0 million and \$8.8 million, respectively. JHYH s net revenue and formula-determined non-interest expenses for the six month period ended September 30, 2007 (April 2, 2007 to September 30, 2007) amounted to \$41.0 million and \$19.7 million, respectively. These formula-determined non-interest expenses do not necessarily reflect the actual expenses of operating JHYH.

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**Note 21. Stock Based Compensation**

***Incentive Plans***

We sponsor the following share based employee incentive plans:

We have an Incentive Compensation Plan ( Incentive Plan ) which allows awards in the form of incentive stock options (within the meaning of Section 422 of the Internal Revenue Code), nonqualified stock options, stock appreciation rights, restricted stock, unrestricted stock, performance awards, dividend equivalents or other stock based awards. The plan imposes a limit on the number of shares of our common stock that may be subject to awards. An award relating to shares may be granted if the aggregate number of shares subject to then-outstanding awards plus the number of shares subject to the award being granted do not exceed 30% of the number of shares issued and outstanding immediately prior to the grant.

*Restricted Stock/Restricted Stock Units.* The Incentive Plan allows for grants of restricted stock awards, whereby employees are granted restricted shares of common stock subject to forfeiture until the requisite service has been provided. Grants of restricted stock are generally subject to annual ratable vesting over a five year period (i.e., 20% of the number of shares granted vests each year for a five year award) with provisions related to retirement eligibility. In addition, vested shares are subject to transferability restrictions that lapse at the end of the award term. With certain exceptions, the employee must remain with us for a period of years after the date of grant to receive the full number of shares granted. The Incentive Plan also allows for grants of restricted stock units. Restricted stock units give a participant the right to receive fully vested shares at the end of a specified deferral period. Restricted stock units are generally subject to forfeiture conditions similar to those of our restricted stock awards. One advantage of restricted stock units, as compared to restricted stock, is that the period during which the award is deferred as to settlement can be extended past the date the award becomes non-forfeitable, allowing a participant to hold an interest tied to common stock on a tax deferred basis. Prior to settlement, restricted stock units carry no voting or dividend rights associated with the stock ownership, but dividend equivalents are paid or accrued.

*Director Plan.* We also have a Directors Stock Compensation Plan ( Directors Plan ) which provides for an annual grant to each non-employee director of \$100,000 of restricted stock or deferred shares. These grants are made automatically on the date directors are elected or reelected at our annual shareholders meeting. These grants vest three years after the date of grant and are expensed over the vesting period.

Additionally, the Directors Plan permits each non-employee director to elect to be paid annual retainer fees, meeting fees and fees for service as chairman of a Board committee in the form of cash, deferred cash or deferred shares. If deferred cash is elected, interest is credited to such deferred cash at the prime interest rate in effect at the date of each annual meeting of stockholders. If deferred shares are elected, dividend equivalents equal to dividends declared and paid on our common stock are credited to a Director s account and reinvested as additional deferred shares.

*Employee Stock Purchase Plan.* We also have an Employee Stock Purchase Plan ( ESPP ). All regular full-time employees and employees who work part-time over 20 hours per week are eligible for the ESPP. Annual employee contributions are limited to \$21,250, are voluntary and are made via payroll deduction. The employee contributions are used to purchase our common stock. The stock price used is 95% of the closing price of our common stock on the last day of the applicable session (monthly).

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**(Unaudited)**

*Deferred Compensation Plan.* We also have a Deferred Compensation Plan which was established in 2001. In 2006, 2005, and 2004, employees with annual compensation of \$200,000 or more were eligible to defer compensation and to invest at a 10% discount in deferred shares of our stock ( DCP deferred shares ), stock options (prior to 2004) and other alternatives on a pre-tax basis through the plan. The compensation deferred by our employees is expensed in the period earned. In addition, the compensation cost related to the discount on the DCP deferred shares provided by the plan was \$157,000 and \$327,000, for the three-month period ended September 30, 2007 and 2006, respectively, and \$1,372,000 and \$1,261,000, for the nine-month period ended September 30, 2007 and 2006, respectively.

*Profit Sharing Plan.* We have a profit sharing plan, covering substantially all employees, which includes a salary reduction feature designed to qualify under Section 401(k) of the Internal Revenue Code. The compensation cost related to this plan was \$1,760,000 and \$741,000, for the three-month period ended September 30, 2007 and 2006, respectively, and \$7,658,000 and \$3,189,000, for the nine-month period ended September 30, 2007 and 2006, respectively.

***Adoption of FASB 123R***

We adopted the fair value recognition provisions for share based awards pursuant to FASB 123R effective January 1, 2006. See Note 1 Summary of Significant Accounting Policies for a further discussion. The following disclosures are also being provided pursuant to the requirements of FASB 123R.

Prior to the adoption of FASB 123R, we presented all tax benefits resulting from share based compensation as cash flows from operating activities in the consolidated statements of cash flows. FASB 123R requires cash flows resulting from tax deductions in excess of the grant-date fair value of share based awards to be included in cash flows from financing activities. Accordingly, we reflected the excess tax benefit of \$38.3 million and \$17.7 million related to share based compensation in cash flows from financing activities in the first nine months of 2007 and 2006, respectively.

In accordance with FASB 123R, the fair value of share based awards is estimated on the date of grant based on the market price of our stock less the impact of selling restrictions subsequent to vesting, if any, and is amortized as additional compensation expense on a straight-line basis over the related requisite service periods, which are generally five years. As of September 30, 2007, there was \$312.2 million of total unrecognized compensation cost related to nonvested share based awards, which is expected to be recognized over a remaining weighted-average vesting period of approximately 3.5 years. The unrecognized compensation cost related to nonvested share based awards was recorded as unearned compensation in stockholders equity at December 31, 2005 and was a reduction to stockholders equity. As part of the adoption of FASB 123R, the unrecognized compensation cost related to nonvested share based awards granted prior to January 1, 2006 is included as a component of additional paid-in capital.

The total compensation cost of share based awards was \$34.7 million and \$21.8 million for the three month periods ended September 30, 2007 and 2006, respectively, and \$109.0 million and \$65.0 million for the nine month periods ended September 30, 2007 and 2006, respectively.

We have historically and generally expect to issue new shares of common stock when satisfying our issuance obligations pursuant to share based awards, as opposed to reissuing common stock from treasury.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(Unaudited)**

**Restricted Stock and Restricted Stock Units ( Share Based Awards )**

The following tables detail the activity of restricted stock and restricted stock units:

|                            | <b>Nine Months<br/>Ended<br/>September 30,<br/>2007</b> | <b>Weighted<br/>Average<br/>Grant<br/>Date Fair<br/>Value</b> |
|----------------------------|---|---|
|                            | (Shares in 000s)  |   |
| <b>Restricted stock</b>    |   |   |
| Balance, beginning of year | 4,336   | \$ 19.12  |
| Grants                     | 4,664   | \$ 28.57  |
| Forfeited                  | (382)   | \$ 25.19  |
| Vested                     | (1,644)   | \$ 19.91  |
| Balance, end of period     | 6,974   | \$ 25.26  |

|  | <b>Nine Months Ended<br/>September 30, 2007</b> |                                  | <b>Weighted<br/>Average Grant<br/>Date Fair Value</b> |                                  |
|--|---|----------------------------------|---|----------------------------------|
|  | (Shares in 000s)                                |                                  |   |                                  |
|  | Future<br>Service<br>Required                   | No Future<br>Service<br>Required | Future<br>Service<br>Required                         | No Future<br>Service<br>Required |
| <b>Restricted stock units</b>            |   |                                  |   |                                  |
| Balance, beginning of year               | 14,813  | 13,905                           | \$ 19.21  | \$ 7.26                          |
| Grants, includes dividends               | 3,675   | 320                              | (1) \$ 25.13  | \$ (1)                           |
| Deferral expiration                      |   | (1,791)                          | \$  | \$ 12.20                         |
| Forfeited                                | (400)   |                                  | \$ 20.81  | \$                               |
| Vested                                   | (3,071)   | 3,071                            | \$ 17.99  | \$ 17.99                         |
| Grants related to stock option exercises |   | 509                              | \$  | \$ 11.69                         |
| Balance, end of period                   | 15,017  | 16,014                           | \$ 21.01  | \$ 8.75                          |

(1) Represents dividend equivalents on restricted stock units declared during the nine month period ending September 30, 2007.

The compensation cost associated with restricted stock and restricted stock units amounted to \$34.5 million and \$21.0 million for the three-month period ended September 30, 2007 and 2006, respectively, and \$107.5 million and \$62.6 million for the nine-month period ended September 30, 2007 and 2006, respectively. The average fair value of the vested awards during the first nine months of 2007 was approximately \$28.15 per share.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(Unaudited)**

**Stock Options**

The fair value of all option grants for all of our plans are estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for all fixed option grants in 2004: dividend yield of 0.9%; expected volatility of 32.6%; risk-free interest rates of 3.0%; and expected lives of 4.8 years. There were no option grants in 2007 and 2006. A summary of the status of our stock options in all of our stock-based plans as of September 30, 2007 and changes during the nine-month period then ended is presented below:

| Dollars and shares in thousands, except per share data | <b>Options</b> | <b>Weighted-Average Exercise Price</b> |
|--|----------------|--|
| Outstanding, December 31, 2006                         | 1,688          | \$11.02                                |
| Granted  |                |  |
| Exercised  | (1,303)        | \$11.18                                |
| Canceled   |                |  |
| Outstanding, September 30, 2007                        | 385            | \$10.28                                |

The total intrinsic value of stock options exercised during the nine months ended September 30, 2007 and 2006 was \$6.2 million and \$29.5 million, respectively. Cash received from the exercise of stock options during the nine-months ended September 30, 2007 and 2006 totaled \$3.7 million and \$12.9 million, respectively, and the tax benefit realized from stock options exercised during the nine-months ended September 30, 2007 and 2006 was \$2.5 million and \$7.1 million, respectively.

The table below provides additional information related to stock options outstanding at September 30, 2007:

Dollars and shares in thousands, except per share data

| <b>September 30, 2007</b>                             | <b>Outstanding Net of Expected Forfeitures</b> | <b>Options Exercisable</b> |
|---|--|----------------------------|
| Number of options                                     | 385  | 385                        |
| Weighted-average exercise price                       | \$10.28  | \$10.28                    |
| Aggregate intrinsic value                             | \$6,757  | \$6,757                    |
| Weighted-average remaining contractual term, in years | 1.82   | 1.82                       |

At September 30, 2007, the intrinsic value of vested options was approximately \$6.8 million for which tax benefits expected to be recognized in equity upon exercise are approximately \$2.8 million.



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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(Unaudited)**

**Note 22. Subsequent Events**

As previously reported, on July 18, 2005, we entered into a Share and Membership Interest Purchase Agreement ( Purchase Agreement ) with Brian P. Friedman (one of our directors and Chairman, Executive Committee), James L. Luikart, a family partnership controlled by Mr. Friedman and the manager and general partner of Jefferies Capital Partners IV L.P. Jefferies Capital Partners IV L.P., together with its related parallel funds, is a private equity fund managed by a team led by Messrs. Friedman and Luikart.

The closing of the Purchase Agreement occurred on November 1, 2007. In connection with the closing, we and the other parties to the Purchase Agreement entered into Amendment No. 1 to the Share and Membership Interest Purchase Agreement dated as of November 1, 2007 (the Amendment ). In the Amendment, the parties (i) confirmed that the aggregate shares of our common stock issuable pursuant to the terms of the Purchase Agreement (after giving effect to the 2-for-1 stock split effected as a stock dividend on May 15, 2006) to Messrs. Friedman and Luikart were 1,040,000 and 260,000, respectively; (ii) agreed that in lieu of the adjustment required to be made to the shares of our common stock issuable under the Purchase Agreement (other than the adjustment giving effect to the 2-for-1 stock split effected as a stock dividend on May 15, 2006), we would pay to Messrs. Friedman and Luikart \$156,000 and \$39,000, respectively, and agreed that the partial clawback provisions contained in the Purchase Agreement would apply to these cash amounts; (iii) agreed to a funds flow schedule for the various capital commitment transfers required pursuant to the Purchase Agreement; and (iv) agreed on other non-material, technical changes to exhibits to the Purchase Agreement.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**Item 2. Management's Discussion and Analysis of Financial**  
**Condition and Results of Operations**

This report contains or incorporates by reference forward-looking statements within the meaning of the safe harbor provisions of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements include statements about our future and statements that are not historical facts. These forward-looking statements are usually preceded by the words believe, intend, may, will, or similar expressions. Forward-looking statements may contain expectations regarding revenues, earnings, operations and other financial projections, and may include statements of future performance, plans and objectives. Forward-looking statements also include statements pertaining to our strategies for future development of our business and products. Forward-looking statements represent only our belief regarding future events, many of which by their nature are inherently uncertain and outside of our control. It is possible that the actual results may differ, possibly materially, from the anticipated results indicated in these forward-looking statements. Information regarding important factors that could cause actual results to differ, perhaps materially, from those in our forward-looking statements is contained in this report and other documents we file. You should read and interpret any forward-looking statement together with these documents, including the following:

the description of our business and risk factors contained in our annual report on Form 10-K for the fiscal year ended December 31, 2006 and filed with the SEC on March 1, 2007;

the discussion of our analysis of financial condition and results of operations contained in this report under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations ;

the notes to the consolidated financial statements contained in this report; and

cautionary statements we make in our public documents, reports and announcements.

Any forward-looking statement speaks only as of the date on which that statement is made. We will not update any forward-looking statement to reflect events or circumstances that occur after the date on which the statement is made.

**Critical Accounting Policies**

The consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles, which require management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes. Actual results can and will differ from estimates. These differences could be material to the financial statements.

We believe our application of accounting policies and the estimates required therein are reasonable. These accounting policies and estimates are constantly re-evaluated, and adjustments are made when facts and circumstances dictate a change. Historically, we have found our application of accounting policies to be appropriate, and actual results have not differed materially from those determined using necessary estimates.

Our management believes our critical accounting policies (policies that are both material to the financial condition and results of operations and require management's most difficult, subjective or complex judgments) are our valuation of financial instruments and our use of estimates related to compensation and benefits during the year.

*Fair Value Measurements*

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**

Our financial instruments are primarily recorded at fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the exit price). The use of fair value to measure financial instruments is fundamental to our financial statements and is our most critical accounting policy. Unrealized gains or losses are generally recognized in principal transactions in our Consolidated Statement of Earnings. Financial instruments are valued at quoted market prices, if available. For financial instruments that do not have readily determinable fair values through quoted market prices, the determination of fair value is based upon consideration of available information, including types of financial instruments, current financial information, restrictions on dispositions, fair values of underlying financial instruments and quotations for similar instruments.

We adopted FASB 157 and FASB 159, as of the beginning of 2007. See notes 1 and 4 of the Notes to the Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further information on FASB 157 and FASB 159, including the impact of adoption.

Level III assets, as defined by FASB 157, increased to approximately 7.4% as of September 30, 2007 of total financial instruments owned and other investments measured at fair value, compared to approximately 5.1% in the trailing quarter. The increase in Level III assets resulted largely from the origination of \$148.1 million in bridge loans to investment-banking clients in acquisition-finance transactions.

*Compensation and Benefits*

The use of estimates is important in determining compensation and benefits expenses for interim and year end periods. A substantial portion of our compensation and benefits represents discretionary bonuses, which are fixed at year end. In addition to the level of net revenues, our overall compensation expense in any given year is influenced by prevailing labor markets, revenue mix and our use of equity-based compensation programs. We believe the most appropriate way to allocate estimated annual discretionary bonuses among interim periods is in proportion to projected net revenues earned. Consequently, we have generally accrued interim compensation and benefits based on annual targeted compensation ratios, taking into account the guidance contained in FASB 123R regarding the timing of expense recognition for non retirement-eligible and retirement-eligible employees.

**Reportable Business Segments**

The Capital Markets reportable segment includes our traditional securities brokerage, including the results of our recently reorganized high yield secondary market trading activities and investment banking activities. The Capital Markets reportable segment is managed as a single operating segment that provides the sales, trading and origination effort for various fixed income, equity and advisory products and services. The Capital Markets segment comprises many divisions, with interactions among each. In addition, we choose to voluntarily disclose the Asset Management segment even though it is currently an immaterial non-reportable segment as defined by FASB 131, *Disclosures about Segments of an Enterprise and Related Information*.

For presentation purposes, the remainder of Results of Operations is presented on a detailed product and expense basis rather than on a business segment basis because the Asset Management segment is immaterial as compared to the consolidated Results of Operations.

Our earnings are subject to wide fluctuations since many factors over which we have little or no control, particularly the overall volume of trading, the volatility and general level of market prices, and the number and size of investment banking transactions may significantly affect our operations.

**Revenues by Source**

**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES**

The following provides a breakdown of total revenues by source for the three-month period ended September 30, 2007 and 2006 (in thousands of dollars):

|   | Three Months Ended |                            |                    |                            |
|---|--------------------|----------------------------|--------------------|----------------------------|
|   | September 30, 2007 | September 30, 2006         | September 30, 2007 | September 30, 2006         |
|   | <u>Amount</u>      | <u>% of Total Revenues</u> | <u>Amount</u>      | <u>% of Total Revenues</u> |
| Equity  | \$ 140,296         | 21%                        | \$ 112,635         | 24%                        |
| Fixed income and commodities:                                       |                    |                            |                    |                            |
| Fixed income (excluding high yield) and commodities (1)             | 16,502             | 2                          | 50,871             | 11                         |
| High yield (2)  | (7,387)            | (1)                        | 11,188             | 2                          |
| Total   | 9,115              | 1                          | 62,059             | 13                         |
| Investment banking  | 189,780            | 29                         | 144,763            | 31                         |
| Asset management fees and investment income from managed funds (3): |                    |                            |                    |                            |
| Asset management fees   | 5,369              | 1                          | 6,345              | 2                          |
| Investment income (loss) from managed funds                         | (11,652)           | (2)                        | 10,438             | 2                          |
| Total   | (6,283)            | (1)                        | 16,783             | 4                          |
| Interest  | 334,056            | 50                         | 132,424            | 28                         |
| Total revenues  | \$ 666,964         | 100%                       | \$ 468,664         | 100%                       |

- (1) Fixed income and commodities revenue is primarily comprised of investment grade fixed income, convertible and commodities product revenue.
- (2) High yield revenue is comprised of revenue generated by our high yield secondary market trading activities during the third quarter of 2007 and revenue generated by our pari passu share of high yield revenue in the third quarter of 2006. Our economic share of the revenues from high yield secondary market trading was \$(3.7) million or 50% of the total high yield revenue for the third quarter ended September 30, 2007. For the prior year period we recorded our pari passu share of our high yield fixed income activities in this caption.
- (3) Prior period amounts include asset management revenue from high yield funds. Effective April 2, 2007, with the commencement of our reorganized high yield secondary market trading activities, we do not record asset management revenue associated with these activities.

**Consolidated Results of Operations***Revenues*

Revenues increased \$198.3 million, or 42%, to \$667.0 million, compared to \$468.7 million for the third quarter of 2006. The increase was primarily due to a \$45.0 million, or 31%, increase in investment banking revenues, a \$27.7 million, or 25%, increase in equity product revenues, and a \$201.6 million, or 152%, increase in interest revenues due to increased securities borrowing activities; partially offset by a \$34.4 million, or 68%, decrease in fixed income (excluding high yield) and commodities revenues, an \$18.6 million, or 166%, decrease in high yield revenues and a \$23.1 million, or 137%, decrease in asset management fees and investment income (loss) from managed funds.

*Equity Product Revenue*

Equity product revenue is comprised of equity (including principal transaction and commission revenue), correspondent clearing and prime brokerage, and execution product revenues. Equity product revenue was \$140.3 million, up 25% from the third quarter of 2006 primarily attributable to strong customer activity in cash equity products driven by volatility in the global equity markets offset by a decrease in block trading and derivative product revenue due to a difficult trading environment.

*Fixed Income and Commodities Revenue*

**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES**

Fixed income and commodities revenue is primarily comprised of high yield secondary market trading activities, investment grade fixed income, convertible and commodities product revenue. Fixed income and commodities revenue was \$9.1 million, down 85% over third quarter of 2006. The decrease was driven by an (1) extremely challenging and illiquid U.S. credit markets and (2) difficult trading conditions in a very volatile commodity market.

*Investment Banking Product Revenue*

|                 | Quarter Ended          |                | Percentage Change |
|-----------------|------------------------|----------------|-------------------|
|                 | Sept. 30, 2007         | Sept. 30, 2006 |                   |
|                 | (Dollars in Thousands) |                |                   |
| Capital markets | \$ 92,256              | \$ 57,816      | 60%               |
| Advisory        | 97,524                 | 86,947         | 12%               |
| Total           | \$ 189,780             | \$ 144,763     | 31%               |

Capital markets revenues, which consist primarily of debt, equity and convertible financing services, were \$92.3 million, an increase of 60% from the third quarter of 2006. The increase in capital markets revenues was driven by strong conditions for both equity and debt underwritings.

Revenues from advisory activities were \$97.5 million, an increase of 12% from the third quarter of 2006. The increase in advisory revenues was led by services rendered on assignments in the technology, energy, media (including our recently acquired LongAcre Partners media group), maritime and aerospace and defense sectors.

*Asset Management Fees and Investment Income(Loss) from Managed Funds*

Asset management revenue includes revenues from management, administrative and performance fees from funds managed by us, revenues from asset management and performance fees from third-party managed funds, and investment income (loss) from our investments in these funds. Asset management revenues were \$(6.3) million, down \$23.1 million over the third quarter of 2006. The decrease in asset management revenue was a result of (1) a strong prior period performance from our High Yield Funds, which are no longer included in asset management effective April 2, 2007, (2) weaker operating performances from our equity funds and (3) downward valuation adjustments on our investments in our managed CLOs.

*Changes in Assets under Management*

| In millions                  | Three Month Period Ending Sept. 30, 2007 | Three Month Period Ending Sept. 30, 2006 | Percent Change |
|------------------------------|--|--|----------------|
| Balance, beginning of period | \$5,491                                  | \$4,383                                  | 25%            |
| Net cash flow in (out)       | 227                                      | 562                                      |                |
| Net market appreciation      | 28                                       | 73                                       |                |
|                              | 255                                      | 635                                      |                |
| Balance, end of period       | \$5,746                                  | \$5,018                                  | 15%            |



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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**

The net cash inflow during the third quarter of 2007 is partially due to the commencement of the St. James River CLO, Ltd., an actively managed collateralized loan obligation consisting primarily of senior secured loans, offset by redemptions from our convertible bond asset funds.

*Net Interest*

Interest income increased \$201.6 million primarily as a result of increased stock borrowing, securities purchased under agreements to resell activities and increases in interest rates; and interest expense increased by \$204.5 million primarily as a result of increased stock lending and securities sold under agreements to repurchase activities, increases in interest rates and the issuance of our \$600 million of senior unsecured debentures in June 2007.

*Compensation and Benefits*

Compensation and benefits decreased \$0.9 million, or 1%, relatively consistent with the 2% decrease in net revenues. The ratio of compensation to net revenues was approximately 54.9% for the third quarter of 2007 as compared to 54.1% for the third quarter of 2006. Average employee headcount increased 12% from 2,212 during the third quarter of 2006 to 2,472 during the third quarter of 2007. The growth in headcount is primarily due to increased business activities and growth initiatives, both domestically and internationally.

*Non-Personnel Expenses*

Non-personnel expense was \$95.6 million for the third quarter of 2007 versus \$79.9 million for the third quarter of 2006 or 28.6% of net revenues for the third quarter of 2007 versus 23.4% of net revenues for the third quarter of 2006. The increase in non-personnel expenses is consistent with our increase in headcount combined with increased legal, compliance, technology and communications costs as well as increased occupancy related to the expansion of the London and New York offices.

*Earnings before Income Taxes, Minority Interest, and Cumulative Effect of Change in Accounting Principle, Net*

Earnings before income taxes, minority interest and cumulative effect of change in accounting principle, net, were down \$21.0 million, or 28%, to \$55.3 million, compared to \$76.3 million for the third quarter of 2006. The effective tax rates were approximately 39.1% for the third quarter of 2007 and 39.0% for the third quarter of 2006. Although the effective tax rate was relatively consistent as compared to the prior period, the effective tax rate was impacted by a reduction in JHYH's projected minority interest tax benefit, offset by a decrease in state and local income taxes and return to provision adjustments for amounts previously deemed non-deductible.

*Minority Interest*

Minority interest was \$(5.1) million compared to \$0.7 million for the third quarter of 2006. The decrease is primarily due to JHYH's third quarter of 2007 net loss before minority interest of \$(8.8) million.

*Earnings per Share*

Diluted net earnings per share were \$0.26 for the third quarter of 2007 on 155,480,000 shares compared to \$0.32 in the third quarter of 2006 on 148,908,000 shares. The diluted earnings per share calculation for the third quarter of 2007 includes an addition of \$1.0 million to net earnings for preferred dividends.

Basic net earnings per share were \$0.27 for the third quarter of 2007 on 142,822,000 shares compared to \$0.34 in the third quarter of 2006 on 135,140,000 shares.



**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES**

The following provides a breakdown of total revenues by source for the nine-month period ended September 30, 2007 and 2006 (in thousands of dollars):

|   | Nine Months Ended  |                 |                    |                 |
|---|--------------------|-----------------|--------------------|-----------------|
|   | September 30, 2007 | % of            | September 30, 2006 | % of            |
|   | <u>Amount</u>      | <u>Total</u>    | <u>Amount</u>      | <u>Total</u>    |
|   |                    | <u>Revenues</u> |                    | <u>Revenues</u> |
| Equity  | \$ 457,916         | 22%             | \$ 386,917         | 27%             |
| Fixed income and commodities:                                       |                    |                 |                    |                 |
| Fixed income (excluding high yield) and commodities (1)             | 103,073            | 5               | 132,206            | 9               |
| High yield (2)  | 37,073             | 2               | 70,141             | 5               |
| Total   | 140,146            | 7               | 202,347            | 14              |
| Investment banking  | 582,988            | 28              | 395,429            | 27              |
| Asset management fees and investment income from managed funds (3): |                    |                 |                    |                 |
| Asset management fees   | 22,114             | 1               | 41,272             | 3               |
| Investment income from managed funds                                | 7,472              | 1               | 38,860             | 2               |
| Total   | 29,586             | 2               | 80,132             | 5               |
| Interest  | 845,957            | 41              | 385,035            | 27              |
| Total revenues  | \$ 2,056,593       | 100%            | \$ 1,449,860       | 100%            |

- (1) Fixed income and commodities revenue is primarily comprised of investment grade fixed income, convertible and commodities product revenue.
- (2) High yield revenue is comprised of revenue generated by our high yield secondary market trading activities during the second and third quarter of 2007 and revenue generated by our pari passu share of high yield revenue during the first quarter of 2007 and the first nine months of 2006. For the prior year period we recorded 100% of the revenue related to our pari passu share of our high yield revenue.
- (3) Prior period amounts include asset management revenue from high yield funds. Effective April 2, 2007, with the commencement of our reorganized high yield secondary market trading activities, we do not record asset management revenue associated with these activities.

**Consolidated Results of Operations***Revenues*

Revenues increased \$606.7 million, or 42%, to \$2,056.6 million, compared to \$1,449.9 million for the first nine months of 2006. The increase was primarily due to a \$187.6 million, or 47%, increase in investment banking revenue, a \$71.0 million, or 18%, increase in equity product revenue, and a \$460.9 million, or 120%, increase in interest revenue due to increased securities borrowing activities; partially offset by a \$29.1 million, or 22%, decrease in fixed income (excluding high yield) and commodities, a \$33.1 million, or 47%, decrease in high yield revenues, and a \$50.5 million, or 63%, decrease in asset management fees and investment income from managed funds.

*Equity Product Revenue*

Equity product revenue is comprised of equity (including principal transaction and commission revenue), correspondent clearing and prime brokerage, and execution product revenues. Equity product revenue was \$457.9 million, up 18% from the first nine months of 2006 primarily attributable to increased proprietary and block

trading activities, as well as strong contributions from our cash equity revenue products.

**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES***Fixed Income and Commodities Revenue*

Fixed income and commodities revenue is primarily comprised of high yield secondary market trading activities, investment grade fixed income, convertible and commodities product revenue. Fixed income and commodities revenue was \$140.1 million, down 31% over the first nine months of 2006. The decrease was driven by a strong prior period performance in high yield secondary market trading, extremely challenging and illiquid U.S. credit markets and difficult trading conditions in a very volatile commodity market.

*Investment Banking Product Revenue*

|                 | Nine Months Ended      |                   | Percentage<br>Change |
|-----------------|------------------------|-------------------|----------------------|
|                 | Sept. 30,<br>2007      | Sept. 30,<br>2006 |                      |
|                 | (Dollars in Thousands) |                   |                      |
| Capital markets | \$ 318,191             | \$ 147,748        | 115%                 |
| Advisory        | 264,797                | 247,681           | 7%                   |
| Total           | \$ 582,988             | \$ 395,429        | 47%                  |

Capital markets revenues, which consists primarily of debt, equity and convertible financing services, were \$318.2 million, an increase of 115% from the first nine months of 2006. The increase in capital markets revenues was led by a strong performance in debt underwritings as well as the expansion of our investment banking activities outside the United States.

Revenues from advisory activities were \$264.8 million, an increase of 7% from the first nine months of 2006. The increase in advisory revenues was led by services rendered on assignments in the technology, industrial, energy, media and communications and aerospace and defense sectors.

*Asset Management Fees and Investment Income from Managed Funds*

Asset management revenue includes revenues from management, administrative and performance fees from funds managed by us, revenues from asset management and performance fees from third-party managed funds, and investment revenue from our investments in these funds. Asset management revenues were \$29.6 million, down \$50.5 million over the first nine months of 2006. The decrease in asset management revenue was a result of a strong prior period performance from our High Yield Funds, which are no longer included in asset management effective April 2, 2007 and weaker operating performances from our equity funds.

**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES***Changes in Assets under Management*

| <b>In millions</b>           | <b>Nine<br/>Month<br/>Period<br/>Ending<br/>Sept. 30,<br/>2007</b> | <b>Nine<br/>Month<br/>Period<br/>Ending<br/>Sept. 30,<br/>2006</b> | <b>Percent<br/>Change</b> |
|------------------------------|--|--|---------------------------|
| Balance, beginning of period | \$ 5,282   | \$ 4,031   | 31%                       |
| Net cash flow in             | 241  | 687  |                           |
| Net market appreciation      | 223  | 300  |                           |
|                              | 464  | 987  |                           |
| Balance, end of period       | \$ 5,746   | \$ 5,018   | 15%                       |

The increase in net cash inflow during the first nine months of 2007 is primarily due to the commencement of the Clear Lake CLO and St. James River CLO, Ltd., partially offset by the liquidation of our managed high yield funds due to the commencement of our reorganized high yield secondary market trading activities (which are no longer included in assets under management) and the liquidation of the Jefferies Paragon Fund in June 2007.

*Net Interest*

Interest income increased \$460.9 million primarily as a result of increased stock borrowing, securities purchased under agreements to resell activities and increases in interest rates, and interest expense increased by \$471.4 million primarily as a result of increased stock lending and securities sold under agreements to repurchase activities, increases in interest rates and the issuance of our \$600 million of senior unsecured debentures in June 2007.

*Compensation and Benefits*

Compensation and benefits increased \$68.9 million, or 12%, consistent with the 12% increase in net revenues. The ratio of compensation to net revenues was approximately 54.4% for the first nine months of 2007 as compared to 54.8% for the first nine months of 2006. Average employee headcount increased 12% from 2,107 during the first nine months of 2006 to 2,352 during the first nine months of 2007. The growth in headcount is primarily due to increased business activities and growth initiatives, both domestically and internationally.

*Non-Personnel Expenses*

Non-personnel expense was \$268.7 million for the first nine months of 2007 versus \$235.1 million for the first nine months of 2006 or 22.1% of net revenues for the first nine months of 2007 versus 21.7% of net revenues for the first nine months of 2006. The increase in non-personnel expenses is consistent with our revenue growth and primarily attributable to increased legal, compliance, technology and communications costs as well as increased occupancy related to the expansion of the London and New York offices.

*Earnings before Income Taxes, Minority Interest, and Cumulative Effect of Change in Accounting Principle, Net*

Earnings before income taxes, minority interest and cumulative effect of change in accounting principle, net, were up \$32.7 million, or 12.9%, to \$287.2 million, compared to \$254.5 million for the first nine months of 2006. The effective tax rates were approximately 37.4% for the first nine months of 2007 and 39.1% for the first nine months of 2006. The lower effective tax rate is due to the minority interest holdings in JHYH which are not taxed at the Jefferies level.

*Minority Interest*

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**

Minority interest was \$11.0 million compared to \$6.6 million for the first nine months of 2006. The increase is due to the commencement of JHYH. We now consolidate 100% of the operations of JHYH for financial reporting purposes beginning with the second quarter of 2007.

*Earnings per Share*

Diluted net earnings per share were \$1.12 for the first nine months of 2007 on 153,911,000 shares compared to \$1.04 in the first nine months of 2006 on 146,502,000 shares. The diluted earnings per share calculation for the first nine months of 2007 includes an addition of \$3.0 million to net earnings for preferred dividends.

Basic net earnings per share were \$1.19 for the first nine months of 2007 on 141,905,000 shares compared to \$1.13 in the first nine months of 2006 on 133,048,000 shares.

**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES****Liquidity, Financial Condition and Capital Resources**

Our Chief Financial Officer and Treasurer are responsible for developing and implementing our liquidity, funding and capital management strategies. These policies are determined by the nature of our day to day business operations, business growth possibilities, regulatory obligations, and liquidity requirements.

Our actual level of capital, total assets, and financial leverage are a function of a number of factors, including, asset composition, business initiatives, regulatory requirements and cost availability of both long term and short term funding. We have historically maintained a highly liquid balance sheet, with a substantial portion of our total assets consisting of cash, highly liquid marketable securities and short-term receivables, arising principally from traditional securities brokerage activity. The highly liquid nature of these assets provides us with flexibility in financing and managing our business.

**Liquidity**

The following are financial instruments that are cash and cash equivalents or are deemed by management to be generally readily convertible into cash, marginable or accessible for liquidity purposes within a relatively short period of time (in thousands of dollars):

|                                    | September 30,<br>2007 | December 31,<br>2006 |
|------------------------------------|-----------------------|----------------------|
| Cash and cash equivalents:         |                       |                      |
| Cash in banks                      | \$ 223,528            | \$ 107,488           |
| Money market investments           | 297,811               | 405,553              |
| <br>                               |                       |                      |
| Total cash and cash equivalents    | 521,339               | 513,041              |
| Cash and securities segregated (1) | 613,808               | 508,303              |
| Other (2)                          | 2,251                 | 71,160               |
|                                    | \$ 1,137,398          | \$ 1,092,504         |

(1) In accordance with Rule 15c3-3 of the Securities Exchange Act of 1934, Jefferies, as a broker-dealer carrying client accounts, is subject to requirements related to maintaining cash or qualified securities in a segregated reserve account for the exclusive benefit of its clients.

(2) Items are financial instruments utilized in our overall cash management activities and are readily convertible to cash in normal market conditions.

Bank loans represent short-term borrowings that are payable on demand and generally bear interest at a spread over the fed funds rate. We had no outstanding secured bank loans as of September 30, 2007 and December 31, 2006. Unsecured bank loans are typically overnight loans used to finance financial instruments owned or clearing related balances. We had \$399.8 million and \$0 of outstanding unsecured bank loans as of September 30, 2007 and December 31, 2006, respectively. Average daily bank loans for the nine-months ended September 30, 2007 and year ended December 31, 2006 were \$237.3 million and \$12.4 million, respectively.

A substantial portion of our assets are liquid, consisting of cash or assets readily convertible into cash. The majority of securities positions (both long and short) in our trading accounts are readily marketable and actively traded. In addition, receivables from brokers and dealers are primarily current open transactions or securities borrowed transactions, which are typically settled or closed out within a few days. Receivable from customers includes margin balances and amounts due on transactions in the process of settlement. Most of our receivables are secured by marketable securities.



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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**

Our assets are funded by equity capital, senior debt, mandatorily redeemable convertible preferred stock, securities loaned, customer free credit balances, bank loans and other payables. Bank loans represent temporary (usually overnight) secured and unsecured short-term borrowings, which are generally payable on demand. We have arrangements with banks for unsecured financing of up to \$877.0 million. Secured bank loans are collateralized by a combination of customer, non-customer and firm securities. We have always been able to obtain necessary short-term borrowings in the past and believe that we will continue to be able to do so in the future. Additionally, we have \$258.5 million in letters of credit outstanding as of September 30, 2007, which are used in the normal course of business mostly to satisfy various collateral requirements in lieu of depositing cash or securities.

**Excess Liquidity**

Our policy is to maintain excess liquidity to cover all expected cash outflows for one year in a stressed liquidity environment. Liquid resources consist of unrestricted cash and unencumbered assets that are readily convertible into cash on a secured basis on short notice. Certain investments are also readily convertible to cash. In addition, we have \$877.0 million of unsecured, uncommitted lines of credit with various banks.

Management believes these resources provide sufficient excess liquidity to cover all expected cash outflows for one year during a stressed liquidity environment. Expected cash outflows include:

The payment of interest expense (including dividends on our mandatorily redeemable convertible preferred stock) on our long term debt;

The anticipated funding of outstanding investment commitments;

The anticipated fixed costs over the next 12 months;

Potential stock repurchases; and

Certain accrued expenses and other liabilities

**Analysis of Financial Condition and Capital Resources**

**Financial Condition**

As previously discussed, we have historically maintained a highly liquid balance sheet, with a substantial portion of our total assets consisting of cash, highly liquid marketable securities and short-term receivables, arising principally from traditional securities brokerage activity. Total assets increased \$13,776.9 million, or 77%, from \$17,825.5 million at December 31, 2006 to \$31,602.4 million at September 30, 2007 primarily due to increased repo activity. Our financial instruments owned, including securities pledged to creditors, increased \$2,309.5 million, while our financial instruments sold, not yet purchased increased \$476.6 million. Our securities borrowed and securities purchased under agreements to resell increased \$10,545.9 million, while our securities loaned and securities sold under agreements to repurchase increased \$11,047.4 million.

Level III assets, as defined by FASB 157, increased to approximately 7.4% as of September 30, 2007 of total financial instruments owned and other investments measured at fair value, compared to approximately 5.1% in the trailing quarter. The increase in Level III assets resulted largely from the origination of \$148.1 million in bridge loans to investment-banking clients in acquisition-finance transactions.



**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES**

The following table sets forth book value, pro forma book value, tangible book value and pro forma tangible book value per share (dollars in thousands, except per share data):

|   | September 30, 2007 | December 31, 2006 |
|---|--------------------|-------------------|
| Stockholders equity   | \$ 1,830,752       | \$ 1,581,087      |
| Less: Goodwill  | (330,694)          | (257,321)         |
| Tangible stockholders equity  | \$ 1,500,058       | \$ 1,323,766      |
| Stockholders equity   | \$ 1,830,752       | \$ 1,581,087      |
| Add: Projected tax benefit on vested portion of restricted stock          | 134,039            | 130,700           |
| Pro forma stockholders equity   | \$ 1,964,791       | \$ 1,711,787      |
| Tangible stockholders equity  | \$ 1,500,058       | \$ 1,323,766      |
| Add: Projected tax benefit on vested portion of restricted stock          | 134,039            | 130,700           |
| Pro forma tangible stockholders equity                                    | \$ 1,634,097       | \$ 1,454,466      |
| Shares outstanding  | 125,657,168        | 119,546,914       |
| Add: Shares not issued, to the extent of related expense amortization     | 22,433,471         | 24,139,907        |
| Less: Shares issued, to the extent related expense has not been amortized | (4,442,655)        | (1,813,423)       |
| Adjusted shares outstanding   | 143,647,984        | 141,873,398       |
| Book value per share (1)  | \$ 14.57           | \$ 13.23          |
| Pro forma book value per share (2)  | \$ 13.68           | \$ 12.07          |
| Tangible book value per share (3)   | \$ 11.94           | \$ 11.07          |
| Pro forma tangible book value per share (4)                               | \$ 11.38           | \$ 10.25          |

(1) Book value per share equals stockholders equity divided by common shares outstanding.

(2) Pro forma book value per share equals stockholders equity plus the projected deferred tax benefit on the amortized portion of restricted stock and RSUs divided by common shares outstanding adjusted for shares not yet issued to the extent of the related expense amortization and shares issued to the extent the related expense has not been amortized.

- (3) Tangible book value per share equals tangible stockholders' equity divided by common shares outstanding.
- (4) Pro forma tangible book value per share equals tangible stockholders' equity plus the projected deferred tax benefit on the amortized portion of restricted stock and RSUs divided by common shares outstanding adjusted for shares not yet issued to the extent of the related expense amortization and shares issued to the extent the related expense has not been amortized.

Tangible stockholders' equity, pro forma book value per share, tangible book value per share and pro forma tangible book value per share are non-GAAP financial measures. A non-GAAP financial measure is a numerical measure of financial performance that includes adjustments to the most directly comparable measure calculated and presented in accordance with GAAP, or for which there is no specific GAAP guidance. We calculate tangible stockholders' equity as stockholders' equity less intangible assets. We calculate pro forma book value per share as stockholders' equity plus the projected deferred tax benefit on the vested portion of restricted stock and RSUs divided by common shares outstanding adjusted for shares not yet issued to the extent of the related expense amortization and shares issued to the extent the related expense has not been amortized. We calculate tangible book value per share by dividing tangible stockholders' equity by common stock outstanding. We calculate pro forma tangible book value per share by dividing tangible stockholders' equity plus the projected deferred tax benefit on the vested portion of restricted stock and RSUs by common shares outstanding adjusted for shares not yet issued to the extent of the related expense amortization and shares issued to the extent the related expense has not been amortized. We consider these ratios as meaningful measurements of our financial condition and believe they provide investors with additional metrics to comparatively assess the fair value of our stock.

**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES****Capital Resources**

We had total long term capital of \$3.7 billion and \$2.9 billion as of September 30, 2007 and December 31, 2006, respectively, resulting in a long-term debt to total capital ratio of 47% and 41%, respectively. Our total capital base as of September 30, 2007 and December 31, 2006 was as follows (in thousands):

|   | September 30,<br>2007 | December 31,<br>2006 |
|---|-----------------------|----------------------|
| Long-Term Debt  | \$ 1,764,560          | \$ 1,168,562         |
| Mandatorily Redeemable Convertible Preferred<br>Stock | 125,000               | 125,000              |
| Total Stockholders' Equity                            | 1,830,752             | 1,581,087            |
| Total Capital   | \$ 3,720,312          | \$ 2,874,649         |

Our ability to support increases in total assets is largely a function of our ability to obtain short term secured and unsecured funding, primarily through securities lending, and through our \$877.0 million of uncommitted unsecured bank lines. Our ability is further enhanced by the cash proceeds from the \$500 million senior unsecured bonds and \$125 million in series A preferred stock, both issued in the first quarter of 2006; as well as cash proceeds from our \$600 million senior unsecured debt issuance in June 2007.

At September 30, 2007, our senior long-term debt, net of unamortized discount, consisted of contractual principal payments (adjusted for amortization) of \$492.3 million, \$346.2 million, \$348.5 million, \$248.3 million and \$329.2 million due in 2036, 2027, 2016, 2014 and 2012, respectively.

We rely upon our cash holdings and external sources to finance a significant portion of our day-to-day operations. Access to these external sources, as well as the cost of that financing, is dependent upon various factors, including our debt ratings. Our current debt ratings are dependent upon many factors, including operating results, operating margins, earnings trend and volatility, balance sheet composition, liquidity and liquidity management, our capital structure, our overall risk management, business diversification and our market share and competitive position in the markets in which we operate.

Our long term debt ratings are as follows:

|                            | Rating |
|----------------------------|--------|
| Moody's Investors Services | Baa1   |
| Standard and Poor's        | BBB+   |
| Fitch Ratings              | BBB+   |

**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES***Net Capital*

Jefferies, Jefferies Execution and Jefferies High Yield Trading are subject to the net capital requirements of the SEC and other regulators, which are designed to measure the general financial soundness and liquidity of broker-dealers. Jefferies, Jefferies Execution and Jefferies High Yield Trading use the alternative method of calculation.

As of September 30, 2007, Jefferies, Jefferies Execution and Jefferies High Yield Trading's net capital and excess net capital were as follows (in thousands of dollars):

|                              | <u>Net Capital</u> | <u>Excess Net Capital</u> |
|------------------------------|--------------------|---------------------------|
| Jefferies                    | \$ 431,661         | \$ 409,404                |
| Jefferies Execution          | \$ 24,473          | \$ 24,223                 |
| Jefferies High Yield Trading | \$ 555,033         | \$ 554,783                |

*Guarantees*

As of September 30, 2007, we had outstanding guarantees of \$20.0 million relating to an undrawn bank credit obligation of an associated investment fund in which we have an interest. In addition, we guarantee up to an aggregate of approximately \$36.0 million in bank loans committed to an employee parallel fund of Jefferies Capital Partners IV L.P. ( Fund IV ).

We have guaranteed the performance of JIL and JFP to their trading counterparties and various banks and other entities, which provide clearing and credit services to JIL and JFP. Also, we have provided a guarantee to a third-party bank in connection with the bank's extension of 500 million Japanese yen (approximately \$4.4 million) to Jefferies (Japan) Limited. In addition, as of September 30, 2007, we had commitments to invest up to \$511.5 million in various investments, including \$195.0 million in Jefferies Finance LLC, \$25.0 million in Babson-Jefferies Loan Opportunity CLO, \$30.0 million in Fund IV, \$250.0 million in JHYH and \$11.5 million in other investments.

*Leverage Ratios*

The following table presents total assets, adjusted assets, and net adjusted assets with the resulting leverage ratios as of September 30, 2007 and December 31, 2006. With respect to leverage ratio, we believe that net adjusted leverage is the most relevant measure, given the low-risk, collateralized nature of our securities borrowed and segregated cash assets.

|                                 | September 30, 2007 | December 31, 2006 |
|---------------------------------|--------------------|-------------------|
| Total assets                    | \$ 31,602,366      | \$ 17,825,457     |
| Adjusted assets (1)             | 30,988,558         | 17,317,154        |
| Net adjusted assets (2)         | 11,640,096         | 7,605,260         |
| Leverage ratio (3)              | 17.3               | 11.3              |
| Adjusted leverage ratio (4)     | 16.9               | 11.0              |
| Net adjusted leverage ratio (5) | 6.4                | 4.8               |

(1) Adjusted assets are total assets less cash and securities segregated.

(2) Net adjusted assets are adjusted assets, less securities borrowed.

(3) Leverage ratio equals total assets divided by stockholders' equity.

(4) Adjusted leverage ratio equals adjusted assets divided by stockholders' equity.

(5) Net adjusted leverage ratio equals net adjusted assets divided by stockholders' equity.

**Table of Contents****JEFFERIES GROUP, INC. AND SUBSIDIARIES****Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We use a number of quantitative tools to manage our exposure to market risk. These tools include:  
inventory position and exposure limits, on a gross and net basis;

scenario analyses, stress tests and other analytical tools that measure the potential effects on our trading net revenues of various market events, including, but not limited to, a large widening of credit spreads, a substantial decline in equities markets and significant moves in selected emerging markets; and

risk limits based on a summary measure of risk exposure referred to as Value-at-Risk ( VaR ).

**Value-at Risk**

In general, Value-at-Risk (VaR) measures potential loss of trading revenues at a given confidence level over a specified time horizon. We calculate VaR over a one day holding period measured at a 95% confidence level which implies the potential loss of daily trading revenue is expected to be at least as large as the VaR amount on one out of every twenty trading days.

VaR is one measurement of potential loss in trading revenues that may result from adverse market movements over a specified period of time with a selected likelihood of occurrence. As with all measures of VaR, our estimate has substantial limitations due to our reliance on historical performance, which is not necessarily a predictor of the future. Consequently, this VaR estimate is only one of a number of tools we use in our daily risk management activities.

The VaR numbers below are shown separately for interest rate, equity, currency and commodity products, as well as for our overall trading positions, excluding corporate investments in asset management positions, using a historical simulation approach. The aggregated VaR presented here is less than the sum of the individual components (i.e., interest rate risk, foreign exchange rate risk, equity risk and commodity price risk) due to the benefit of diversification among the risk categories. Diversification benefit equals the difference between aggregated VaR and the sum of VaRs for the four risk categories. The following table illustrates the VaR for each component of market risk.

**Daily VaR (1)**  
**(in millions)**  
**Value-at-Risk in trading portfolios**

| Risk Categories            | 9/30/07   | VaR at    |           | Average VaR Three Months Ended |           |           |
|----------------------------|-----------|-----------|-----------|--------------------------------|-----------|-----------|
|                            |           | 6/30/07   | 12/31/06  | 9/30/07                        | 6/30/07   | 12/31/06  |
| Interest Rates             | \$ 1.48   | \$ 1.71   | \$ 1.39   | \$ 1.78                        | \$ 1.69   | \$ 1.07   |
| Equity Prices              | \$ 10.37  | \$ 8.95   | \$ 6.37   | \$ 8.34                        | \$ 7.84   | \$ 5.44   |
| Currency Rates             | \$ 0.46   | \$ 0.45   | \$ 0.34   | \$ 0.47                        | \$ 0.29   | \$ 0.34   |
| Commodity Prices           | \$ 1.20   | \$ 1.59   | \$ 0.80   | \$ 1.29                        | \$ 1.18   | \$ 1.41   |
| Diversification Effect (2) | \$ (3.39) | \$ (3.60) | \$ (3.36) | \$ (4.03)                      | \$ (2.92) | \$ (3.18) |
| Firmwide                   | \$ 10.12  | \$ 9.10   | \$ 5.54   | \$ 7.85                        | \$ 8.08   | \$ 5.08   |

(1) VaR is the potential loss in value of our trading positions due to adverse market movements over a defined time horizon with a specific confidence level. For the VaR numbers reported above, a one-day time horizon and 95% confidence level were used.

(2) Equals the difference between firmwide VaR and the sum of the VaRs by risk categories. This effect is due to the market categories not being perfectly correlated.



Table of Contents**JEFFERIES GROUP, INC. AND SUBSIDIARIES****Daily VaR (1)****(in millions)****Value-At-Risk Highs and Lows for Three Months Ended**

| <b>Risk Categories</b> | <b>09/30/07</b> |            | <b>06/30/07</b> |            | <b>12/31/06</b> |            |
|------------------------|-----------------|------------|-----------------|------------|-----------------|------------|
|                        | <b>High</b>     | <b>Low</b> | <b>High</b>     | <b>Low</b> | <b>High</b>     | <b>Low</b> |
| Interest Rates         | \$ 2.24         | \$ 1.37    | \$ 2.18         | \$ 1.41    | \$ 1.50         | \$ 0.45    |
| Equity Prices          | \$ 12.40        | \$ 6.59    | \$ 10.34        | \$ 4.94    | \$ 6.45         | \$ 4.22    |
| Currency Rates         | \$ 0.54         | \$ 0.30    | \$ 0.55         | \$ 0.13    | \$ 0.48         | \$ 0.24    |
| Commodity Prices       | \$ 2.36         | \$ 0.78    | \$ 2.03         | \$ 0.40    | \$ 3.22         | \$ 0.61    |
| <br>                   |                 |            |                 |            |                 |            |
| Firmwide               | \$ 11.35        | \$ 5.95    | \$ 11.36        | \$ 5.31    | \$ 5.85         | \$ 4.27    |

(1) VaR is the potential loss in value of our trading positions due to adverse market movements over a defined time horizon with a specific confidence level. For the VaR numbers reported above, a one-day time horizon and 95% confidence level were used.

Average VaR of \$7.85 million during the third quarter of 2007 decreased from the \$8.08 million average during the second quarter of 2007 due mainly to an increase in the diversification effect.

The following table presents our daily VaR over the last four quarters:

**Daily VaR Trend**

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**

**VaR Back-Testing**

The comparison of daily actual revenue fluctuations with the daily VaR estimate is the primary method used to test the efficacy of the VaR model. Back testing is performed at various levels of the trading portfolio, from the holding company level down to specific business lines. A back-testing exception occurs when the daily loss exceeds the daily VaR estimate. Results of the process at the aggregate level demonstrated ten outliers when comparing the 95% one-day VaR with the back-testing profit and loss in the third quarter of 2007. The outliers were driven predominately by exceptionally high market volatility realized during the quarter. A 95% confidence one-day VaR model usually should not have more than twelve (1 out of 20 days) back-testing exceptions on an annual basis. Back-testing profit and loss is a subset of actual trading revenue and includes only the profit and loss effects relevant to the VaR model, excluding fees, commissions and certain provisions. We compare the trading revenue with VaR for back-testing purposes because VaR assesses only the potential change in position value due to overnight movements in financial market variables such as prices, interest rates and volatilities under normal market conditions. The graph below illustrates the relationship between daily back-testing trading profit and loss and daily VaR for us in the third quarter of 2007.

VaR is a model that predicts the future risk based on historical data. We could incur losses greater than the reported VaR because the historical market prices and rates changes may not be an accurate measure of future market events and conditions. In addition, the VaR model measures the risk of a current static position over a one-day horizon and might not predict the future position. When comparing our VaR numbers to those of other firms, it is important to remember that different methodologies could produce significantly different results.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**

**Daily Trading Net Revenue**

**(\$ in millions)**

Trading revenue used in the histogram below entitled "Third Quarter 2007 vs. Third Quarter 2006 Distribution of Daily Trading Revenue" is the actual daily trading revenue which is excluding fees, commissions and certain provisions. The histogram below shows the distribution of daily trading revenue for substantially all of our trading activities.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**

**Item 4. Controls and Procedures**

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2007. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of September 30, 2007 are functioning effectively to provide reasonable assurance that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding disclosure. A controls system cannot provide absolute assurance, however, that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

No change in our internal control over financial reporting occurred during the quarter ended September 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

Many aspects of our business involve substantial risks of liability. In the normal course of business, we have been named as defendants or co-defendants in lawsuits involving primarily claims for damages. We are also involved in a number of regulatory matters arising out of the conduct of our business. Our management, based on currently available information, does not believe that any matter will have a material adverse effect on our financial condition, although, depending on our results for a particular period, an adverse determination or settlements could be material for a particular period.

**Item 1A. Risk Factors**

Information regarding our risk factors appears in Part I, Item 1A. of our annual report on Form 10-K for the fiscal year ended December 31, 2006 filed with the SEC on March 1, 2007. These risk factors describe some of the assumptions, risks, uncertainties and other factors that could adversely affect our business or that could otherwise result in changes that differ materially from our expectations. There have been no material changes from the risk factors previously disclosed in our annual report on Form 10-K.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

*Issuer Purchases of Equity Securities*

| Period      |                       | (a) Total<br>Number of<br>Shares<br>Purchased<br>(1) | (b)<br>Average<br>Price<br>Paid<br>per Share | (c) Total Number<br>of<br>Shares Purchased<br>as<br>Part of Publicly<br>Announced Plans<br>or<br>Programs | (d) Maximum Number<br>of<br>Shares that May Yet<br>Be<br>Purchased Under the<br>Plans or Programs (2) |
|-------------|-----------------------|--|--|---|---|
| July 1      | July 31, 2007         | 543,292  | 27.02  | 475,000   | 5,019,793   |
| August 1    | August 31, 2007       | 526,407  | 25.58  | 525,000   | 4,494,793   |
| September 1 | September 30,<br>2007 | 40,305   | 22.29  | 37,515  | 4,457,278   |
| Total       |                       | 1,110,004  | 26.17  | 1,037,515   |   |

(1) We repurchased an aggregate of 72,489 shares other than as part of a publicly announced plan or program. We repurchased these securities in connection with our stock compensation plans which allow participants to use shares to pay the exercise price of options exercised and to use shares to satisfy tax liabilities arising from the exercise of options or the vesting of restricted stock. The number above does not include unvested shares forfeited back to us pursuant to the terms of our stock compensation plans.

(2) On July 26, 2005, we issued a press release announcing the authorization by our Board of Directors to repurchase, from time to time, up to an aggregate of 3,000,000 shares of our common stock. After giving effect to the 2-for-1 stock split effected as a stock dividend on May 15, 2006, this authorization increased to 6,000,000 shares.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**  
**Item 6. Exhibits**

**Exhibits**

- 3.1 Amended and Restated Certificate of Incorporation of Jefferies Group, Inc. is incorporated herein by reference to Exhibit 3 of the Registrant's Form 8-K filed on May 26, 2004.
- 3.2 Registrant's Certificate of Designations of 3.25% Series A Cumulative Convertible Preferred Stock is incorporated herein by reference to Exhibit 3.1 of the Registrant's Form 8-K filed on February 21, 2006.
- 3.3 By-Laws of Jefferies Group, Inc are incorporated herein by reference to Exhibit 3.2 of Registrant's Form 10-K filed on March 28, 2003.
- 31.1\* Rule 13a-14(a)/15d-14(a) Certification by the Chief Financial Officer.
- 31.2\* Rule 13a-14(a)/15d-14(a) Certification by the Chief Executive Officer.
- 32\* Rule 13a-14(b)/15d-14(b) and Section 1350 of Title 18 U.S.C. Certification by the Chief Executive Officer and Chief Financial Officer.

\* Filed herewith.

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**SIGNATURE**

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.

**JEFFERIES GROUP, INC.**  
(Registrant)

Date: November 8,  
2007

By: /s/ Joseph A. Schenk

Joseph A. Schenk  
Chief Financial Officer  
(duly authorized officer)

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