

JEFFERIES GROUP INC /DE/

Form 10-K

February 29, 2008

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K**

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934.**

**For the fiscal year ended December 31, 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  
(State or other jurisdiction of  
incorporation or organization)**

**95-4719745  
(I.R.S. Employer  
Identification No.)**

**520 Madison Avenue, 12<sup>th</sup> Floor  
New York, New York  
(Address of principal executive offices)**

**10022  
(Zip Code)**

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

**Securities registered pursuant to Section 12(b) of the Act:**

Title of each class:

Name of each exchange on which registered:

**Common Stock, \$.0001 par value**

**New York Stock Exchange**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes ☐ No ☒

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K. ☒

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

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐  
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. \$3,038,203,420 as of June 29, 2007.

Indicate the number of shares outstanding of the registrant's class of common stock, as of the latest practicable date. 125,870,368 shares as of the close of business February 5, 2008.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Information from the Registrant's Definitive Proxy Statement with respect to the 2008 Annual Meeting of Stockholders to be held on May 19, 2008 to be filed with the SEC is incorporated by reference into Part III of this Form 10-K.

#### **LOCATION OF EXHIBIT INDEX**

The index of exhibits is contained in Part IV herein on page 97.

**JEFFERIES GROUP, INC.**  
**2007 FORM 10-K ANNUAL REPORT**  
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**PART I**

**Item 1. Business.**

**Introduction**

Jefferies Group, Inc. and its subsidiaries ( we or us ) operate as a full-service global investment bank and institutional securities firm serving dynamic companies and their investors. We offer these companies capital markets, merger and acquisition, restructuring and other financial advisory services, and provide investors fundamental research and trade execution in equity, equity-linked, high yield and investment grade fixed income securities, as well as commodities and derivatives. We also provide asset management services and products to institutions and other investors.

Our principal operating subsidiary, Jefferies & Company, Inc. ( Jefferies ), was founded in 1962. Since 2000, we have pursued a strategy of continuing growth and diversification, whereby we have sought to increase our market share in each of the markets we serve and the products and services we offer, while at the same time expanding the breadth of our activities in an effort to mitigate the cyclical nature of the financial markets in which we operate. Our growth plan has been achieved through internal growth supported by the ongoing addition of experienced personnel in targeted areas, as well as the acquisition from time to time of complementary businesses. More recently, we have increased our global focus on serving companies and investors in Europe, the Middle East, Latin America and Asia.

As of December 31, 2007, we had 2,568 employees. We maintain offices throughout the world and have our executive offices located at 520 Madison Avenue, New York, New York 10022. Our telephone number is (212) 284-2550 and our Internet address is [www.jefferies.com](http://www.jefferies.com).

We make available free of charge on our Internet website the following documents and reports, including amendments (the reports are made available as soon as reasonably practicable after such materials are filed with or furnished to the SEC pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934):

Code of Ethics;

Reportable waivers, if any, from our Code of Ethics by our executive officers;

Board of Directors Corporate Governance Guidelines;

Charter of the Audit Committee of the Board of Directors;

Charter of the Corporate Governance and Nominating Committee of the Board of Directors;

Charter of the Compensation Committee of the Board of Directors;

Annual reports on Form 10-K;

Quarterly reports on Form 10-Q;

Current reports on Form 8-K; and

Beneficial ownership reports on Forms 3, 4 and 5.

Shareholders may also obtain free of charge a printed copy of any of these documents or reports by sending a request to Investor Relations, Jefferies & Company, Inc., 520 Madison Avenue, 12th Floor, New York, NY 10022, by calling 203-708-5975 or by sending an email to [info@jefferies.com](mailto:info@jefferies.com).

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**Business Segments**

We currently operate in two business segments, Capital Markets and Asset Management. The Capital Markets reportable segment includes our securities trading, 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 research, sales, trading and origination effort for various fixed income, equity and advisory products and services. The Capital Markets segment comprises a number of interrelated divisions. The Asset Management segment is primarily comprised of operating activities related to our asset management businesses. 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 period's presentation. This change was made in order to reflect the manner in which these segments are currently managed.

Financial information regarding our reportable business segments as of December 31, 2007, December 31, 2006, and December 31, 2005 is set forth in note 19 of the Notes to Consolidated Financial Statements, titled "Segment Reporting" and is incorporated herein by reference.

**Our Businesses**

***Capital Markets***

Our Capital Markets activity includes our securities execution activities, including sales, trading and research in equity, equity derivatives, convertible, high yield and investment grade fixed income securities, and prime brokerage, and our investment banking activities which include capital markets transactions, mergers and acquisitions and other advisory transactions. In addition, our Capital Markets activities include securities lending and our proprietary trading activities as well as commodity-related trading. We are primarily focused on serving corporations and institutional investors.

**Investment Banking**

Our Investment Banking Division offers our clients, primarily growing and mid-sized companies, a full range of financial advisory services, as well as debt, equity, and convertible capital raising services.

***Underwriting***

**Equity and Equity-Linked Financing** We offer direct placements, private equity, private placements, initial public offerings, and follow-on offerings of equity and equity-linked convertible securities.

**Leveraged Finance** We offer a range of debt financing for growing and middle market companies and sponsors. We focus on structuring and distributing public and private debt in leveraged finance transactions, including leveraged buy-outs, acquisitions, growth capital financings, recapitalizations, and Chapter 11 exit financings. Our joint venture loan finance company, Jefferies Finance LLC, has the ability to commit capital for transactions that range between \$50 million and \$500 million.

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### ***Advisory Services***

**Mergers & Acquisitions** We advise buyers and sellers on sales, divestitures, acquisitions, mergers, tender offers, joint ventures, strategic alliances and takeover defenses. We can facilitate and finance acquisitions and recapitalizations on both buy-side and sell-side mandates. Our service to our clients includes leveraging our industry knowledge, extensive relationships, and capital markets and restructuring expertise.

**Restructuring & Recapitalization** We offer advisory services in connection with exchange offers, consent solicitations, capital raising, recapitalization, restructuring and distressed M&A activity. We provide advice and support in the structuring, valuation and placement of securities issued in recapitalizations and restructurings. We represent issuers, bondholders and creditors, as well as buyers and sellers of assets.

**Fund Placement** Helix Associates, our fund placement group, is a placement agent serving private equity fund sponsors and sophisticated investors throughout North America, Europe, the Middle East, Japan and Australia.

Our 539 investment banking professionals operate throughout the United States, Europe and Asia, and are organized into industry, product and geographic coverage groups. Industry coverage groups include Jefferies Quarterdeck for Aerospace and Defense, CleanTech, Jefferies Randall & Dewey for Energy, Gaming and Leisure, Healthcare, Industrial, Private Equity and Venture Capital Sponsors, Retail & Consumer, Jefferies Broadview for Technology, Oil Service & Infrastructure, Media and Communications and Putnam Lovell Investment Banking Business for Financial Services. The division has experienced substantial growth over the last six years both organically and through acquisitions.

### ***Equities***

Our Equities Division consists of equity research, sales and trading, electronic execution services, equity derivatives, securities lending and prime brokerage.

### ***Equity Sales and Trading***

Our equity research, sales and trading unit is one of the primary foundations of our platform. We have an over forty-year history in equity trading. Our equity sales representatives connect a network of institutional investors around the globe and provide execution with a focus on minimal market impact. We provide listed block trades, NASDAQ market making, bulletin board trading, capital markets/origination, risk arbitrage, statistical arbitrage, special situations, pair trades, relative value, and portfolio and electronic trading, as well as trading in American Depositary Receipts ( ADR ) and Ordinary Shares. Our clients include domestic and international investors such as investment advisors, banks, mutual funds, insurance companies, hedge funds, and pension and profit sharing plans. We have a small, but growing Private Client Services group that focuses on serving smaller institutions, family offices and high net worth individuals.

### ***Execution***

Through our Jefferies Execution subsidiary, we provide agency-only execution services for stocks and options listed on the NYSE, AMEX, and all other major exchanges, as well as OTC. In 2007, the firm traded over 33 billion shares utilizing its execution platform which includes floor brokerage, electronic connectivity, direct access and listed options trading. In addition, we offer quantitative and algorithmic trading solutions as well as access to liquidity in order to access the global markets. We leverage our portfolio management systems, analysis and benchmark auto-trading strategies to deliver our execution services to our institutional customers.

### ***Equity Research***

Encompassed within equity sales and trading is research and research sales. We provide long- and short-term investment ideas. Our analysts use a variety of quantitative and qualitative tools, integrating field analysis, proprietary channel checks and ongoing dialogue with the managements of the companies they cover.

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### ***Equity Derivatives***

We offer equity derivatives for investors seeking to manage risk and optimize returns within the equities market. Our professionals have expertise in listed and over-the-counter transactions and products. We focus on serving the diverse needs of our institutional, corporate and private client base across multiple product lines, offering listed options, ETFs and OTC options and swaps.

### ***Securities Lending***

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. In 2007 and 2006, we expanded our securities lending focus internationally, with additional professionals in London and New York. In addition to our securities lending activities, we are a participant in the U.S. and international repurchase agreement ( repo ) markets, providing secured financing for our clients in those regions.

### ***Prime Brokerage***

We offer prime brokerage services to hedge funds, money managers, and registered investment advisors.

### ***Fixed Income and Commodities***

Our Fixed Income and Commodities activities consist of our high yield secondary market activities, convertibles department, investment grade fixed income department, research and our commodity trading group.

### ***High Yield Secondary Market Activities***

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 ).



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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.

### ***Convertibles***

Our personnel in the U.S., London, Tokyo, and Zurich serve the geographically diverse global convertible markets. We offer sales, trading and analysis of U.S. domestic and international convertible bonds, convertible preferred shares, closed-end funds, warrants and structured products.

### ***Investment Grade Fixed Income***

We provide fixed income transaction execution for institutions acting as principal through a combination of sales and trading coverage, and a technology trading platform. The division trades corporate bonds, U.S. Treasury securities, U.S. government agency securities, mortgage-backed securities, municipal bonds and emerging markets debt.

### ***Fixed Income Research***

We have expanded our research platform over the last few years and provide long- and short-term investment ideas. Our analysts use a variety of quantitative and qualitative tools, integrating field analysis, proprietary channel checks and ongoing dialogue with the managements of the companies they cover.

### ***Commodities***

Our commodities group, Jefferies Financial Products, LLC ( JFP ), offers swaps, options and other derivatives typically linked to various commodity indexes and is a significant provider of liquidity in exchange-traded commodity index contracts. JFP provides financial products and commodity index knowledge to pension funds, mutual funds, sovereigns, foundations, endowments and other institutional investors seeking exposure to commodities as an asset class. In 2005, JFP worked with Reuters to modify the benchmark CRB Index, now renamed the Reuters Jefferies CRB Index. In addition, JFP offers proprietary commodity indexes, such as the Jefferies Commodity Performance Index, which are designed to outperform standard benchmark indexes.

### ***Asset Management***

We provide investment management services to various private investment funds. In the United States, investment management services are provided through Jefferies Asset Management, LLC ( JAM ) and Jefferies Capital Management, Inc. ( JCM ). Each of JAM and JCM is registered as an investment adviser with the SEC. Our private fund products consist of long-short equity and fixed income funds, including CLO s, that focus on specific strategies. These funds are not registered under federal or state securities laws, are made available only to certain sophisticated investors and are not offered or sold to the general public.

Our Asset Management business is primarily comprised of operating activities related to our private investment funds.

In Europe, we offer investment solutions for long-only strategies in global convertible bonds to pension funds, insurance companies and private banking clients in Switzerland, France and Germany.

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**Our Sources of Revenues**

***Commissions***

A substantial portion of our revenues is derived from customer commissions and commission equivalents. We charge fees for assisting our domestic and international clients with purchasing and selling equity, debt and convertible securities as well as ADRs, options, preferred stocks, financial futures and other similar products.

***Principal Transactions***

In the regular course of our business, we take securities positions as a market maker to facilitate customer transactions and for proprietary risk trading. Trading profits or losses and changes in market prices of our proprietary positions are also recorded as principal transactions revenues.

***Investment Banking***

Investment banking revenues are generated by fees from capital markets activities which include debt, equity, and convertible underwriting and placement services, and fees from financial advisory activities including M&A and restructuring services.

***Interest***

We derive a substantial portion of our interest revenues in connection with our securities borrowed / securities lending and repo activity. We also earn interest on our securities portfolio, on our operating and segregated balances, on our margin lending activity and on certain of our investments, including our investment in short-term bond funds.

**Competition**

As a global investment bank and securities firm, all aspects of our business are intensely competitive. We compete directly with numerous domestic and international competitors, including firms included on the AMEX Securities Broker/Dealer Index and with other brokers and dealers, investment banking firms, investment advisors, mutual funds, hedge funds and commercial banks. Many of our competitors have substantially greater capital and resources than we do and offer a broader range of financial products. In addition to competition from firms currently in the securities business, there has been increasing competition from others offering financial services. These developments and others have resulted, and may continue to result, in significant additional competition for us. We believe that the principal factors affecting competition involve market focus, reputation, the abilities of professional personnel, the relative price of the service and products being offered and the quality of service.

**Regulation**

The securities industry in the United States is subject to extensive regulation under both federal and state laws. The Securities and Exchange Commission is the federal agency responsible for the administration of federal securities laws. In addition, self-regulatory organizations, principally Financial Industry Regulatory Authority ( FINRA ), are actively involved in the regulation of broker-dealers. These self-regulatory organizations conduct periodic examinations of member broker-dealers in accordance with rules they have adopted and amended from time to time, subject to approval by the SEC. Securities firms are also subject to regulation by foreign regulatory bodies, state securities commissions and state attorneys general in those jurisdictions and states in which they do business.

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Broker-dealers are subject to regulations which cover all aspects of the securities business, including sales methods, trade practices among broker-dealers, use and safekeeping of customers' funds and securities, capital structure of securities firms, anti-money laundering, record-keeping and the conduct of directors, officers and employees. Additional legislation, changes in rules promulgated by the SEC and self-regulatory organizations, or changes in the interpretation or enforcement of existing laws and rules, may directly affect the mode of operation and profitability of broker-dealers. Broker-dealers that engage in commodities and futures transactions are also subject to regulation by the Commodity Futures Trading Commission ( CFTC ) and the National Futures Association ( NFA ). The SEC, self-regulatory organizations, state securities commissions, state attorneys general, the CFTC and the NFA may conduct administrative proceedings which can result in censure, fine, suspension, expulsion of a broker-dealer, its officers or employees, or revocation of broker-dealer licenses. The principal purpose of regulation and discipline of broker-dealers is the protection of customers and the securities markets, rather than protection of creditors and stockholders of broker-dealers.

As registered broker-dealers, Jefferies, JHYT and Jefferies Execution are required by law to belong to the Securities Investor Protection Corporation ( SIPC ). In the event of a member's insolvency, the SIPC fund provides protection for customer accounts up to \$500,000 per customer, with a limitation of \$100,000 on claims for cash balances. We carry an excess policy that provides additional protection for securities of up to \$24.5 million per customer with an aggregate limit of \$100 million.

*Net Capital Requirements.* U.S. registered broker-dealers doing business with the public are subject to the SEC's Uniform Net Capital Rule (the Rule ), which specifies minimum net capital requirements. Jefferies Group is not a registered broker-dealer and is therefore not subject to the Rule; however, its United States broker-dealer subsidiaries are registered and are subject to the Rule.

The Rule provides that a broker-dealer doing business with the public shall not permit its aggregate indebtedness to exceed 15 times its adjusted net capital (the basic method ) or, alternatively, that it not permit its adjusted net capital to be less than the greater of 2% of its aggregate debit balances (primarily receivables from customers and broker-dealers) or \$250,000 computed in accordance with such Rule (the alternative method ). Jefferies, Jefferies Execution and JHYT use the alternative method of calculation.

Compliance with applicable net capital rules could limit operations of Jefferies, such as underwriting and trading activities, that require the use of significant amounts of capital, and may also restrict loans, advances, dividends and other payments by Jefferies, Jefferies Execution, or JHYT to us.

As of December 31, 2007, Jefferies, Jefferies Execution and JHYT's net capital and excess net capital were as follows (in thousands of dollars):

|                     | Net Capital | Excess Net Capital |
|---------------------|-------------|--------------------|
| Jefferies           | \$505,080   | \$ 483,108         |
| Jefferies Execution | \$ 30,297   | \$ 30,047          |
| JHYT                | \$558,087   | \$ 557,837         |

*NYSE Regulations.* Our common stock is listed on the New York Stock Exchange ( NYSE ). As a listed company, we are required to comply with the NYSE's rules and regulations, including rules pertaining to corporate governance matters. As required by the NYSE on an annual basis, in 2007 our Chief Executive Officer, Richard Handler, certified to the NYSE that he was not aware of any violation by us of the NYSE's corporate governance listing standards.

*Regulation Outside the United States.* We are an active participant in the international fixed income and equity markets and also provide investment banking services outside of the United States. Many of our principal subsidiaries that participate in these markets and provide these services are subject to comprehensive regulations in the United States and elsewhere that include some form of capital adequacy rules, other customer protection rules and compliance with other applicable regulations. We provide investment services in and from the United Kingdom under the regulation of the Financial Services Authority ( FSA ).

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### **Business Risks**

As a global investment bank and securities firm, risk is an inherent part of our businesses. Capital markets, by their nature, are prone to uncertainty and subject participants to a variety of risks. We have developed policies and procedures designed to identify, measure and monitor each of the risks involved in our trading, brokerage and investment banking activities on a global basis. Our principal risks are market, credit, operational, legal and compliance, new business risks. Risk management is considered to be of paramount importance to our day-to-day operations. Consequently, we devote significant resources (including investments in personnel and technology) to the measurement, analysis and management of risk.

We seek to reduce risk through the diversification of our businesses, counterparties and activities. We accomplish this objective by monitoring the usage of capital to each of our businesses, establishing trading limits and setting credit limits for individual counterparties. We seek to achieve adequate returns from each of our businesses commensurate with the risks assumed. Nonetheless, the effectiveness of our policies and procedures for managing risk exposure can never be completely or accurately predicted or fully assured. For example, unexpectedly large or rapid movements or disruptions in one or more markets or other unforeseen developments can have an adverse effect on our results of operations and financial condition. The consequences of these developments can include losses due to adverse changes in inventory values, decreases in the liquidity of trading positions, higher volatility in our earnings, increases in our credit exposure to customers and counterparties and increases in general systemic risk. If any of our strategies used to hedge or otherwise mitigate exposures to the various types of risks described above are not effective, we could incur losses. Additionally, business continuity plans have been developed and are periodically tested for critical processes and systems, and controls have been implemented to provide oversight of the activities.

#### *Margin Risk*

Customers' transactions are executed on either a cash or margin basis. In a margin transaction, we extend credit to the customer, collateralized by securities and cash in the customer's account, for a portion of the purchase price, and receive income from interest charged on such extensions of credit. In permitting a customer to purchase securities on margin, we are subject to the risk that a market decline could reduce the value of its collateral below the amount of the customer's indebtedness and that the customer might otherwise be unable to repay the indebtedness.

In addition to monitoring the creditworthiness of our customers, we also consider the trading liquidity and volatility of the securities we accept as collateral for margin loans. Trading liquidity and volatility may be dependent, in part, upon the market in which the security is traded, the number of outstanding shares of the issuer, events affecting the issuer and/or securities markets in general, and whether or not there are any legal restrictions on the sale of the securities. Certain types of securities have historical trading patterns, which may assist us in making this evaluation. Historical trading patterns, however, may not be good indicators over relatively short time periods or in markets which are affected by unusual or unexpected developments. We consider all of these factors at the time we agree to extend credit to customers and continue to review extensions of credit on an ongoing basis.

The majority of our margin loans are made to United States citizens or to corporations which are domiciled in the United States. We may extend credit to investors or corporations who are citizens of foreign countries or who may reside outside the United States. We believe that should such foreign investors default upon their loans and should the collateral for those loans be insufficient to satisfy the investors' obligations, it may be more difficult to collect such investors' outstanding indebtedness than would be the case if investors were citizens or residents of the United States.

Although we attempt to minimize the risk associated with the extension of credit in margin accounts, there is no assurance that the assumptions on which we base our decisions will be correct or that we are in a position to predict factors or events which will have an adverse impact on any individual customer or issuer, or the securities markets in general.

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### *Underwriting Risk*

Investment banking activity involves both economic and regulatory risks. An underwriter may incur losses if it is unable to sell the securities it is committed to purchase or if it is forced to liquidate its commitments at less than the agreed upon purchase price. In addition, under the federal securities laws and other laws and court decisions with respect to underwriters' liability and limitations on indemnification of underwriters by issuers, an underwriter is subject to substantial potential liability for material misstatements or omissions in prospectuses and other communications with respect to underwritten offerings. Further, underwriting commitments constitute a charge against net capital and our underwriting commitments may be limited by the requirement that our broker-dealers must, at all times, be in compliance with the Uniform Net Capital Rule 15c3-1 of the Securities Exchange Act of 1934. We intend to continue to pursue opportunities for our corporate customers, which may require us to finance and/or underwrite the issuance of securities. Under circumstances where we are required to act as an underwriter or to take a position in the securities of our customers, we may assume greater risk than would normally be assumed in our normal trading activity.

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

#### **Factors Affecting Our Business**

The following 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. In addition to the factors mentioned in this report, we may also be affected by changes in general economic and business conditions, acts of war, terrorism and natural disasters.

#### *Changing conditions in financial markets and the economy could result in decreased revenues.*

Our net revenues are directly related to the number and size of the transactions in which we participate and therefore were adversely affected in the second half of 2007 by the equity and credit market turmoil, and may be further impacted by continued or further credit market dislocations or sustained market downturns. As an investment banking and securities firm, changes in the financial markets or economic conditions in the United States and elsewhere in the world could adversely affect our business in many ways, including the following:

A market downturn could lead to a decline in the volume of transactions executed for customers and, therefore, to a decline in the revenues we receive from commissions and spreads.

Unfavorable financial or economic conditions could likely reduce the number and size of transactions in which we provide underwriting, financial advisory and other services. Our investment banking revenues, in the form of financial advisory and underwriting or placement fees, are directly related to the number and size of the transactions in which we participate and could therefore be adversely affected by unfavorable financial or economic conditions. Adverse changes in the market could lead to a reduction in revenues from principal transactions and commissions. Adverse changes in the market could also lead to a reduction in revenues from asset management fees and investment income from managed funds and losses from managed funds. Continued increases in our asset management business, especially increases in the amount of our investments in managed funds, would make us more susceptible to adverse changes in the market. Even in the absence of a market downturn, below-market investment performance by our funds and portfolio managers could reduce asset management revenues and assets under management and result in reputational damage that might make it more difficult to attract new investors. Increases in interest rates or credit spreads, as well as limitations on the availability of credit, such as occurred in the second half of 2007, can affect our ability to borrow on a secured or unsecured basis, which may adversely affect our liquidity and results of operations.

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*Our principal trading and investments expose us to risk of loss.*

A considerable portion of our revenues is derived from trading in which we act as principal. Although a significant portion of our principal trading is riskless principal in nature, we may incur trading losses relating to the purchase, sale or short sale of high yield, international, convertible, and equity securities and futures and commodities for our own account and from other program or principal trading. Additionally, we have made substantial investments of our capital in debt securities, equity securities and commodities, including investments managed by us and investments managed by third parties. In any period, we may experience losses as a result of price declines, lack of trading volume, and illiquidity. From time to time, we may engage in a large block trade in a single security or maintain large position concentrations in a single security, securities of a single issuer, or securities of issuers engaged in a specific industry. In general, because our inventory is marked to market on a daily basis, any downward price movement in these securities could result in a reduction of our revenues and profits. In addition, we may engage in hedging transactions that if not successful, could result in losses.

*Increased competition may adversely affect our revenues and profitability.*

All aspects of our business are intensely competitive. We compete directly with numerous other brokers and dealers, investment banking firms and banks. In addition to competition from firms currently in the securities business, there has been increasing competition from others offering financial services, including automated trading and other services based on technological innovations. We believe that the principal factors affecting competition involve market focus, reputation, the abilities of professional personnel, the ability to execute the transaction, relative price of the service and products being offered and the quality of service. Increased competition or an adverse change in our competitive position could lead to a reduction of business and therefore a reduction of revenues and profits. Competition also extends to the hiring and retention of highly skilled employees. A competitor may be successful in hiring away an employee or group of employees, which may result in our losing business formerly serviced by such employee or employees. Competition can also raise our costs of hiring and retaining the key employees we need to effectively execute our business plan.

*Operational risks may disrupt our business, result in regulatory action against us or limit our growth.*

Our businesses are highly dependent on our ability to process, on a daily basis, a large number of transactions across numerous and diverse markets in many currencies, and the transactions we process have become increasingly complex. If any of our financial, accounting or other data processing systems do not operate properly or are disabled or if there are other shortcomings or failures in our internal processes, people or systems, we could suffer an impairment to our liquidity, financial loss, a disruption of our businesses, liability to clients, regulatory intervention or reputational damage. These systems may fail to operate properly or become disabled as a result of events that are wholly or partially beyond our control, including a disruption of electrical or communications services or our inability to occupy one or more of our buildings. The inability of our systems to accommodate an increasing volume of transactions could also constrain our ability to expand our businesses.

We also face the risk of operational failure or termination of any of the clearing agents, exchanges, clearing houses or other financial intermediaries we use to facilitate our securities transactions. Any such failure or termination could adversely affect our ability to effect transactions and manage our exposure to risk.

In addition, despite the contingency plans we have in place, our ability to conduct business may be adversely impacted by a disruption in the infrastructure that supports our businesses and the communities in which they are located. This may include a disruption involving electrical, communications, transportation or other services used by us or third parties with which we conduct business.

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Our operations rely on the secure processing, storage and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, our computer systems, software and networks may be vulnerable to unauthorized access, computer viruses or other malicious code, and other events that could have a security impact. If one or more of such events occur, this potentially could jeopardize our or our clients' or counterparties' confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our, our clients', our counterparties' or third parties' operations. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance maintained by us.

*Asset management revenue is subject to variability based on market and economic factors and the amount of assets under management.*

Asset management revenue includes revenues we receive from management, administrative and performance fees from funds managed by us, revenues from asset management and performance fees we receive from third-party managed funds, and investment income from our investments in these funds. These revenues are dependent upon the amount of assets under management and the performance of the funds. If these funds do not perform as well as our asset management clients expect, our clients may withdraw their assets from these funds, which would reduce our revenues. Some of our revenues are derived from our own investments in these funds. We experience significant fluctuations in our quarterly operating results due to the nature of our asset management business and therefore may fail to meet revenue expectations. Even in the absence of a market downturn, below-market investment performance by our funds and portfolio managers could reduce asset management revenues and assets under management and result in reputational damage that might make it more difficult to attract new investors.

*We face numerous risks and uncertainties as we expand our business.*

We expect the growth of our business to come primarily from internal expansion and through acquisitions and strategic partnering. As we expand our business, there can be no assurance that our financial controls, the level and knowledge of our personnel, our operational abilities, our legal and compliance controls and our other corporate support systems will be adequate to manage our business and our growth. The ineffectiveness of any of these controls or systems could adversely affect our business and prospects. In addition, as we acquire new businesses, we face numerous risks and uncertainties integrating their controls and systems into ours, including financial controls, accounting and data processing systems, management controls and other operations. A failure to integrate these systems and controls, and even an inefficient integration of these systems and controls, could adversely affect our business and prospects.

*Our business depends on our ability to maintain adequate levels of personnel.*

We have made substantial increases in personnel. If a significant number of our key personnel leave, or if our business volume increases significantly over current volume, we could be compelled to hire additional personnel. At that time, there could be a shortage of qualified and, in some cases, licensed personnel whom we could hire. This could hinder our ability to expand or cause a backlog in our ability to conduct our business, including the handling of investment banking transactions and the processing of brokerage orders, all of which could harm our business, financial condition and operating results.

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*Extensive regulation of our business limits our activities, and, if we violate these regulations, we may be subject to significant penalties.*

The securities industry in the United States is subject to extensive regulation under both federal and state laws. The SEC is the federal agency responsible for the administration of federal securities laws. In addition, self-regulatory organizations, principally FINRA and the securities exchanges, are actively involved in the regulation of broker-dealers. Securities firms are also subject to regulation by regulatory bodies, state securities commissions and state attorneys general in those foreign jurisdictions and states in which they do business. Broker-dealers are subject to regulations which cover all aspects of the securities business, including sales methods, trade practices among broker-dealers, use and safekeeping of customers' funds and securities, capital structure of securities firms, anti-money laundering, record-keeping and the conduct of directors, officers and employees. Broker-dealers that engage in commodities and futures transactions are also subject to regulation by the CFTC and the NFA. The SEC, self-regulatory organizations, state securities commissions, state attorneys general, the CFTC and the NFA may conduct administrative proceedings which can result in censure, fine, suspension, expulsion of a broker-dealer or its officers or employees, or revocation of broker-dealer licenses. Additional legislation, changes in rules or changes in the interpretation or enforcement of existing laws and rules, may directly affect our mode of operation and our profitability. Continued efforts by market regulators to increase transparency and reduce the transaction costs for investors, such as decimalization and FINRA's Trade Reporting and Compliance Engine, or TRACE, has affected and could continue to affect our trading revenue.

*Our business is substantially dependent on our Chief Executive Officer.*

Our future success depends to a significant degree on the skills, experience and efforts of Richard Handler, our Chief Executive Officer. We do not have an employment agreement with Mr. Handler which provides for his continued employment. The loss of his services could compromise our ability to effectively operate our business. In addition, in the event that Mr. Handler ceases to actively manage the high yield fund, investors would have the right to withdraw from the fund. Although we have substantial key man life insurance covering Mr. Handler, the proceeds from the policy may not be sufficient to offset any loss in business.

*Legal liability may harm our business.*

Many aspects of our business involve substantial risks of liability, and in the normal course of business, we have been named as a defendant or co-defendant in lawsuits involving primarily claims for damages. The risks associated with potential legal liabilities often may be difficult to assess or quantify and their existence and magnitude often remain unknown for substantial periods of time. Private Client Services involves an aspect of the business that has historically had more risk of litigation than our institutional business. Additionally, the expansion of our business, including increases in the number and size of investment banking transactions and our expansion into new areas, imposes greater risks of liability. In addition, unauthorized or illegal acts of our employees could result in substantial liability to us. Substantial legal liability could have a material adverse financial effect or cause us significant reputational harm, which in turn could seriously harm our business and our prospects.

*Our business is subject to significant credit risk.*

In the normal course of our businesses, we are involved in the execution, settlement and financing of various customer and principal securities and derivative transactions. These activities are transacted on a cash, margin or delivery-versus-payment basis and are subject to the risk of counterparty or customer nonperformance. Although transactions are generally collateralized by the underlying security or other securities, we still face the risks associated with changes in the market value of the collateral through settlement date or during the time when margin is extended. We may also incur credit risk in our derivative transactions to the extent such transactions result in uncollateralized credit exposure to our counterparties.



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We seek to control the risk associated with these transactions by establishing and monitoring credit limits and by monitoring collateral and transaction levels daily. We may require counterparties to deposit additional collateral or return collateral pledged. In the case of aged securities failed to receive, we may, under industry regulations, purchase the underlying securities in the market and seek reimbursement for any losses from the counterparty.

*Derivative transactions may expose us to unexpected risk and potential losses.*

We are party to a large number of derivative transactions that require us to deliver to the counterparty the underlying security, loan or other obligation in order to receive payment. In a number of cases, we do not hold the underlying security, loan or other obligation and may have difficulty obtaining, or be unable to obtain, the underlying security, loan or other obligation through the physical settlement of other transactions. As a result, we are subject to the risk that we may not be able to obtain the security, loan or other obligation within the required contractual time frame for delivery, particularly if default rates increase as we have seen for the second half of 2007 and through the beginning of 2008. This could cause us to forfeit the payments due to us under these contracts or result in settlement delays with the attendant credit and operational risk as well as increased costs to the firm.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

Our executive offices and principal administrative offices are located at 520 Madison Avenue, New York, New York under an operating lease arrangement. We maintain offices throughout the world including New York, Stamford, Jersey City, London, Los Angeles, and Zurich. In addition, we maintain back-up facilities with redundant technologies in Dallas. We lease all of our office space which management believes is adequate for our business. For information concerning leasehold improvements and rental expense, see notes 1, 6 and 14 of the Notes to Consolidated Financial Statements.

**Item 3. Legal Proceedings.**

Many aspects of our business involve substantial risks of legal 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 judicial and 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 could be material for a particular period.

**Item 4. Submission of Matters to a Vote of Security Holders.**

None.

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

Our common stock trades on the NYSE under the symbol JEF. On April 18, 2006, we declared a 2-for-1 split of all outstanding shares of our common stock, payable May 15, 2006 to stockholders of record as of April 28, 2006. The stock split was effected as a stock dividend of one share for each one share outstanding on the record date. All prior period share, share price and per share information has been restated to retroactively reflect the effect of the 2-for-1 stock split.

The following table sets forth for the periods indicated the range of high and low sales prices per share of our common stock as reported by the NYSE, adjusted for the 2-for-1 stock split as appropriate.

|                | <b>High</b> | <b>Low</b> |
|----------------|-------------|------------|
| <b>2007</b>    |             |            |
| Fourth Quarter | \$29.67     | \$22.15    |
| Third Quarter  | 30.98       | 22.40      |
| Second Quarter | 33.80       | 25.92      |
| First Quarter  | 30.42       | 23.90      |
| <b>2006</b>    |             |            |
| Fourth Quarter | \$31.76     | \$26.41    |
| Third Quarter  | 30.50       | 21.45      |
| Second Quarter | 34.80       | 24.73      |
| First Quarter  | 29.58       | 22.38      |

There were approximately 900 holders of record of our common stock at February 7, 2008.

In 1988, we instituted a policy of paying regular quarterly cash 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.

In the second quarter of 2006, we announced a 67% increase in our quarterly dividend to \$0.125 per share.

Dividends per share of common stock (declared and paid):

|      | <b>First<br/>Quarter</b> | <b>Second<br/>Quarter</b> | <b>Third<br/>Quarter</b> | <b>Fourth<br/>Quarter</b> |
|------|--------------------------|---------------------------|--------------------------|---------------------------|
| 2007 | \$0.125                  | \$0.125                   | \$0.125                  | \$0.125                   |
| 2006 | \$0.075                  | \$0.125                   | \$0.125                  | \$0.125                   |
|      | 14                       |                           |                          |                           |

**Table of Contents****Issuer Purchases of Equity Securities**

| Period                         | (a) Total<br>Number of<br>Shares<br>Purchased (1) | (b)<br>Average<br>Price Paid<br>per Share | (c) Total<br>Number of<br>Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or<br>Programs (2)(3) | (d) Maximum<br>Number of<br>Shares that May<br>Yet Be<br>Purchased Under<br>the<br>Plans or Programs |
|--------------------------------|---------------------------------------------------|-------------------------------------------|------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------|
| October 1 - October 31, 2007   | 1,753,435                                         | 24.90                                     | 1,704,700                                                                                                        | 2,752,578                                                                                            |
| November 1 - November 30, 2007 | 1,739,490                                         | 23.56                                     | 1,671,200                                                                                                        | 1,081,378                                                                                            |
| December 1 - December 31, 2007 | 58,419                                            | 24.01                                     | <sup>3</sup> / <sub>4</sub>                                                                                      | 1,081,378                                                                                            |
| Total                          | 3,551,344                                         | 24.23                                     | 3,375,900                                                                                                        |                                                                                                      |

(1) We repurchased an aggregate of 175,444 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.

(3) On January 23, 2008, we issued a press release announcing the authorization by our Board of Directors to repurchase, from time to time, up to an additional 15,000,000 shares of our common stock

**Shareholder Return Performance Presentation**

Set forth below is a line graph comparing the yearly change in the cumulative total shareholder return on our common stock, after consideration of all relevant stock splits during the period, against the cumulative total return of the Financial Service Analytics Brokerage ( FSA Composite ) and Standard & Poor's 500 Indices for the period of five fiscal years, commencing January 1, 2003 (based on prices at December 31, 2002), and ending December 31, 2007 (normalized so that the value of our common stock and each index was \$100 on December 31, 2002).

|                      | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|----------------------|------|------|------|------|------|------|
| Jefferies Group Inc. | 100  | 159  | 195  | 221  | 268  | 235  |
| FSA Composite        | 100  | 144  | 156  | 188  | 247  | 200  |
| S&P 500              | 100  | 129  | 143  | 150  | 173  | 183  |

**Table of Contents****Item 6. Selected Financial Data.**

The selected data presented below as of and for each of the years in the five-year period ended December 31, 2007, are derived from the Consolidated Financial Statements of Jefferies Group, Inc. and its subsidiaries. The data should be read in connection with the Consolidated Financial Statements including the related notes contained on pages 43 through 95. On July 14, 2003, we declared a 2-for-1 split of all outstanding shares of common stock, payable August 15, 2003 to stockholders of record as of July 31, 2003. On April 18, 2006, we declared a 2-for-1 split of all outstanding shares of common stock, payable May 15, 2006 to stockholders of record as of April 28, 2006. The stock splits were effected as a stock dividend of one share for each one share outstanding on the record date. All share, share price and per share information has been restated to retroactively reflect the effect of the two-for-one stock splits. Certain reclassifications have been made to the prior period amounts to conform to the current period's presentation.

|                                                                                                          | Year Ended December 31,                  |            |            |            |            |
|----------------------------------------------------------------------------------------------------------|------------------------------------------|------------|------------|------------|------------|
|                                                                                                          | 2007                                     | 2006       | 2005       | 2004       | 2003       |
|                                                                                                          | (In Thousands, Except Per Share Amounts) |            |            |            |            |
| <b>Earnings Statement Data</b>                                                                           |                                          |            |            |            |            |
| Revenues:                                                                                                |                                          |            |            |            |            |
| Commissions                                                                                              | \$ 355,601                               | \$ 280,681 | \$ 246,943 | \$ 258,838 | \$ 250,191 |
| Principal transactions                                                                                   | 390,374                                  | 468,002    | 349,489    | 358,213    | 301,299    |
| Investment banking                                                                                       | 750,192                                  | 540,596    | 495,014    | 352,804    | 229,608    |
| Asset management fees and investment income from managed funds                                           | 23,534                                   | 109,550    | 82,052     | 81,184     | 32,769     |
| Interest                                                                                                 | 1,174,883                                | 528,882    | 304,053    | 134,450    | 102,403    |
| Other                                                                                                    | 24,311                                   | 35,497     | 20,322     | 13,150     | 10,446     |
| Total revenues                                                                                           | 2,718,895                                | 1,963,208  | 1,497,873  | 1,198,639  | 926,716    |
| Interest expense                                                                                         | 1,150,805                                | 505,606    | 293,173    | 140,394    | 97,102     |
| Revenues, net of interest expense                                                                        | 1,568,090                                | 1,457,602  | 1,204,700  | 1,058,245  | 829,614    |
| Non-interest expenses:                                                                                   |                                          |            |            |            |            |
| Compensation and benefits                                                                                | 946,309                                  | 791,255    | 669,957    | 595,887    | 474,709    |
| Floor brokerage and clearing fees                                                                        | 71,851                                   | 62,564     | 46,644     | 52,922     | 48,217     |
| Technology and communications                                                                            | 103,763                                  | 80,840     | 67,666     | 64,555     | 58,581     |
| Occupancy and equipment rental                                                                           | 76,765                                   | 59,792     | 47,040     | 39,553     | 32,534     |
| Business development                                                                                     | 56,594                                   | 48,634     | 42,512     | 35,006     | 26,481     |
| Other                                                                                                    | 67,074                                   | 65,863     | 62,474     | 43,333     | 44,559     |
| Total non-interest expenses                                                                              | 1,322,356                                | 1,108,948  | 936,293    | 831,256    | 685,081    |
| Earnings before income taxes, minority interest, and cumulative effect of change in accounting principle | 245,734                                  | 348,654    | 268,407    | 226,989    | 144,533    |
| Income taxes                                                                                             | 93,178                                   | 137,541    | 104,089    | 83,955     | 52,851     |

|                                                                                           |               |               |               |               |               |
|-------------------------------------------------------------------------------------------|---------------|---------------|---------------|---------------|---------------|
| Earnings before minority interest and cumulative effect of change in accounting principle | 152,556       | 211,113       | 164,318       | 143,034       | 91,682        |
| Minority interest in earnings of consolidated subsidiaries, net                           | 7,891         | 6,969         | 6,875         | 11,668        | 7,631         |
| Earnings before cumulative effect of change in accounting principle, net                  | 144,665       | 204,144       | 157,443       | 131,366       | 84,051        |
| Cumulative effect of change in accounting principle, net                                  |               | 1,606         |               |               |               |
| Net earnings                                                                              | \$ 144,665    | \$ 205,750    | \$ 157,443    | \$ 131,366    | \$ 84,051     |
| Earnings per share of Common Stock:                                                       |               |               |               |               |               |
| Basic-                                                                                    |               |               |               |               |               |
| Earnings before cumulative effect of change in accounting principle, net                  | \$ 1.02       | \$ 1.53       | \$ 1.27       | \$ 1.14       | \$ 0.79       |
| Cumulative effect of change in accounting principle, net                                  |               | 0.01          |               |               |               |
| Net earnings                                                                              | \$ 1.02       | \$ 1.54       | \$ 1.27       | \$ 1.14       | \$ 0.79       |
| Diluted-                                                                                  |               |               |               |               |               |
| Earnings before cumulative effect of change in accounting principle, net                  | \$ 0.97       | \$ 1.41       | \$ 1.16       | \$ 1.03       | \$ 0.71       |
| Cumulative effect of change in accounting principle, net                                  |               | 0.01          |               |               |               |
| Net earnings                                                                              | \$ 0.97       | \$ 1.42       | \$ 1.16       | \$ 1.03       | \$ 0.71       |
| Weighted average shares of Common Stock:                                                  |               |               |               |               |               |
| Basic                                                                                     | 141,515       | 133,898       | 123,646       | 114,906       | 106,179       |
| Diluted                                                                                   | 153,807       | 147,531       | 135,569       | 127,815       | 118,531       |
| Cash dividends per common share                                                           | \$ 0.50       | \$ 0.42       | \$ 0.26       | \$ 0.18       | \$ 0.11       |
| <b>Selected Balance Sheet Data</b>                                                        |               |               |               |               |               |
| Total assets                                                                              | \$ 29,793,817 | \$ 17,825,457 | \$ 12,780,931 | \$ 13,824,628 | \$ 10,992,283 |
| Long-term debt                                                                            | \$ 1,764,067  | \$ 1,168,562  | \$ 779,873    | \$ 789,067    | \$ 443,148    |
| Mandatorily redeemable convertible preferred stock                                        | \$ 125,000    | \$ 125,000    |               |               |               |
| Total stockholders' equity                                                                | \$ 1,761,544  | \$ 1,581,087  | \$ 1,286,850  | \$ 1,039,133  | \$ 838,371    |
| Shares outstanding                                                                        | 124,453       | 119,547       | 116,220       | 114,578       | 113,404       |
| <b>Other Data (Unaudited)</b>                                                             |               |               |               |               |               |
|                                                                                           | \$ 14.15      | \$ 13.23      | \$ 11.07      | \$ 9.07       | \$ 7.40       |

Book value per share of  
Common Stock

|                                 |      |      |      |      |      |
|---------------------------------|------|------|------|------|------|
| Fixed charge coverage ratio (1) | 3.0X | 4.5X | 5.5X | 5.6X | 5.6X |
|---------------------------------|------|------|------|------|------|

(1) The ratio of earnings to fixed charges is computed by dividing (a) income from continuing operations before income taxes plus fixed charges by (b) fixed charges. Fixed charges consist of interest expense on all long-term indebtedness and the portion of operating lease rental expense that is representative of the interest factor (deemed to be one-third of operating lease rentals).

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### **Item 7. 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 contained in this report under the caption Business ;

the risk factors contained in this report under the caption Risk Factors ;

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 discussion of our risk management policies, procedures and methodologies contained in this report under the caption Risk Management included within 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, impairment of goodwill assessment and our use of estimates related to compensation and benefits during the year.

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### *Valuation of Financial Instruments*

**Definition of Fair Value** - 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 a critical accounting policy. Unrealized gains or losses are generally recognized in principal transactions in our Consolidated Statements 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. Certain financial instruments have bid and ask prices that can be observed in the marketplace. Bid prices reflect the highest price that we and others are willing to pay for an asset. Ask prices represent the lowest price that we and others are willing to accept for an asset. For financial instruments whose inputs are based on bid-ask prices, the Company does not require that fair value always be a predetermined point in the bid-ask range. Our policy is to allow for mid-market pricing and adjusting to the point within the bid-ask range that meets our best estimate of fair value. For offsetting positions in the same financial instrument, the same price within the bid-ask spread is used to measure both the long and short positions.

**Fair Value Hierarchy** - We adopted FASB 157, *Fair Value Measurements* ( FASB 157 ), as of the beginning of 2007. FASB 157 defines fair value, establishes a framework for measuring fair value, establishes a fair value hierarchy based on the inputs used to measure fair value and enhances disclosure requirements for fair value measurements. FASB 157 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

- Level 1: Quoted prices are available in active markets for identical assets or liabilities as of the reported date. The type of financial instruments included in Level 1 are highly liquid cash instruments with quoted prices such as G-7 government, agency securities, listed equities and money market securities, as well as listed derivative instruments;
- Level 2: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these financial instruments include cash instruments for which quoted prices are available but traded less frequently, derivative instruments whose fair value have been derived using a model where inputs to the model are directly observable in the market, or can be derived principally from or corroborated by observable market data, and instruments that are fair valued using other financial instruments, the parameters of which can be directly observed. Instruments which are generally included in this category are corporate bonds, convertible bonds, municipal bonds and OTC derivatives;
- Level 3: Instruments that have little to no pricing observability as of the reported date. These financial instruments do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation. Instruments that are included in this category generally include certain illiquid equity securities, commercial loans and loan commitments, investments, distressed debt, as well as certain highly structured OTC derivative contracts.



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**Valuation Process for Financial Instruments** - The overall valuation process for financial instruments may include adjustments to valuations derived from pricing models. These adjustments may be made when, in management's judgment, either the size of the position in the financial instrument or other features of the financial instrument such as its complexity, or the market in which the financial instrument is traded (such as counterparty, credit, concentration or liquidity) require that an adjustment be made to the value derived from the pricing models. An adjustment may be made if a trade of a financial instrument is subject to sales restrictions that would result in a price less than the computed fair value measurement from a quoted market price. Additionally, an adjustment from the price derived from a model typically reflects management's judgment that other participants in the market for the financial instrument being measured at fair value would also consider such an adjustment in pricing that same financial instrument.

**Valuation Models Used to Determine Fair Value** - Non-derivative financial assets and liabilities presented at fair value and categorized as Level 3 are generally those that are based on an assessment of each underlying investment, incorporating valuations that consider the evaluation of financing and sale transactions with third parties, expected cash flows models, market-based information, including comparable company transactions, performance multiples and changes in market outlook, among other factors. Derivative financial instruments are generally those that are marked-to-model using relevant empirical data to estimate fair value. The models' inputs reflect assumptions that market participants would use in pricing the instrument in a current period transaction and outcomes from the models represent an exit price and expected future cash flows. Our valuation models are calibrated to the market on a frequent basis. The parameters and inputs are adjusted for assumptions about risk and current market conditions. Changes to inputs in valuation models are not changes to valuation methodologies; rather, the inputs are modified to reflect direct or indirect impacts on asset classes from changes in market conditions. Accordingly, results from valuation models in one period may not be indicative of future period measurements.

**Controls Over Valuation of Financial Instruments** Our Risk Management Department, independent of the trading function, plays an important role in asserting that our financial instruments are appropriately valued and that fair value measurements are reliable. This is particularly important where prices or valuations that require inputs are less observable. In the event that observable inputs are not available, the control processes are designed to assure that the valuation approach utilized is appropriate and consistently applied and that the assumptions are reasonable. These control processes include reviews of the pricing model's theoretical soundness and appropriateness by risk management personnel with relevant expertise who are independent from the trading desks. Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model.

### ***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 finalized 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. Our fourth quarter reflects the difference between the compensation and benefits we determine at year end and the accruals recorded through the end of the third quarter.

### ***Goodwill Impairment***

At least annually, we are required to assess whether goodwill has been impaired by comparing the estimated fair value, calculated based on earnings and book value multiples, of each business segment with its estimated net book value, by estimating the amount of stockholders' equity required to support each reporting unit. Periodically estimating the fair value of a reporting unit requires significant judgment and often involves the use of significant estimates and assumptions. These estimates and assumptions could have a significant effect on whether or not an



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impairment charge is recorded and the magnitude of such a charge. We completed our last impairment test on goodwill as of September 30, 2007, and no impairment was identified.

However, our Jefferies Execution subsidiary recorded a goodwill impairment charge of \$26 million during the fourth quarter of 2007. Jefferies Execution is a registered broker-dealer. Therefore, goodwill relating to the acquisition of Jefferies Execution in 2001, formerly Helfant Group, Inc., was pushed down from us to Jefferies Execution in accordance with Emerging Issues Task Force Issue No. D-97, *Push Down Accounting*.

We have two reporting units, Capital Markets and Asset Management, as defined by FASB 142, *Goodwill and Other Intangible Assets*. Jefferies Execution is not a reporting unit of ours and we have not recorded this \$26 million goodwill impairment charge to our Consolidated Financial Statements.

**Revenues by Source**

The Capital Markets reportable segment includes our securities trading, 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.

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The following provides a summary of revenues by source for the past three years:

|                                                                     | Year Ended December 31, |              |              |              |              |              |
|---------------------------------------------------------------------|-------------------------|--------------|--------------|--------------|--------------|--------------|
|                                                                     | 2007                    | % of         | 2006         | % of         | 2005         | % of         |
|                                                                     | Amount                  | Net Revenues | Amount       | Net Revenues | Amount       | Net Revenues |
|                                                                     | (Dollars in Thousands)  |              |              |              |              |              |
| Equity                                                              | \$ 597,164              | 38%          | \$ 538,891   | 37%          | \$ 438,080   | 36%          |
| Fixed income and commodities:                                       |                         |              |              |              |              |              |
| Fixed income (excluding high yield) and commodities (1)             | 139,274                 | 9            | 165,170      | 11           | 116,801      | 10           |
| High yield (2)                                                      | 33,848                  | 2            | 80,119       | 6            | 61,873       | 5            |
| Total                                                               | 173,122                 | 11           | 245,289      | 17           | 178,674      | 15           |
| Investment banking                                                  | 750,192                 | 48           | 540,596      | 37           | 495,014      | 41           |
| Asset management fees and investment income from managed funds (3): |                         |              |              |              |              |              |
| Asset management fees                                               | 28,533                  | 2            | 55,462       | 4            | 50,943       | 4            |
| Investment income (loss) from managed funds                         | (4,999)                 | (1)          | 54,088       | 4            | 31,109       | 3            |
| Total                                                               | 23,534                  | 1            | 109,550      | 8            | 82,052       | 7            |
| Interest                                                            | 1,174,883               | 75           | 528,882      | 36           | 304,053      | 25           |
| Total revenues                                                      | \$ 2,718,895            | 173%         | \$ 1,963,208 | 135%         | \$ 1,497,873 | 124%         |
| Interest expense                                                    | (1,150,805)             | (73)         | (505,606)    | (35)         | (293,173)    | (24)         |
| Net revenues                                                        | \$ 1,568,090            | 100%         | \$ 1,457,602 | 100%         | \$ 1,204,700 | 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 reorganized high yield secondary market trading activities during the second, third, and fourth quarter of 2007 and revenue generated by our pari passu share of high yield revenue during the first quarter of 2007 and the full year of 2006. For the prior year, we recorded 100% of the revenue related to our pari passu share of our high yield revenue.
- (3) First quarter 2007 and 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**

### **2007 Compared to 2006**

#### ***Net Revenues***

Net revenues increased \$110.5 million, or 8%, to \$1,568.1 million, compared to \$1,457.6 million for 2006. The increase was primarily due to a \$209.6 million, or 39%, increase in investment banking revenues and a \$58.3 million, or 11%, increase in equity product revenues; partially offset by a \$25.9 million, or 16%, decrease in fixed income (excluding high yield) and commodities revenues, a \$46.3 million, or 58%, decrease in high yield revenues and a \$86.0 million, or 79%, decrease in asset management fees and investment income (loss) from managed funds.

#### ***Equity Product Revenue***

Equity product revenue is comprised of equity (including principal transactions and commission revenue), correspondent clearing and prime brokerage, and execution product revenues. Equity product revenue was \$597.2 million, up 11% from 2006 primarily attributable to strong contributions from our U.S. and international agency cash equity and derivative products offset by principal trading losses from certain derivative and cash proprietary equity trading activities for the later half of the year. These principal trading losses were caused by illiquidity and volatility in the U.S. equity marketplace.

**Table of Contents*****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 \$173.1 million, down 29% over 2006. The decrease was driven by (1) extremely challenging and illiquid U.S. high yield credit markets for the latter half characterized by wider spreads and reduced levels of liquidity, and (2) strong prior period performance in high yield secondary market trading; offset by (1) consistent contributions throughout 2007 from our investment grade fixed income products despite a severe decline in fixed income liquidity and (2) a strong fourth quarter 2007 performance from JFP due to volatility in energy related commodities markets.

***Investment Banking Product Revenue***

|                 | Year Ended              |                         | Percentage<br>Change |
|-----------------|-------------------------|-------------------------|----------------------|
|                 | December<br>31,<br>2007 | December<br>31,<br>2006 |                      |
|                 | (Dollars in Thousands)  |                         |                      |
| Capital markets | \$ 388,675              | \$ 231,261              | 68%                  |
| Advisory        | 361,517                 | 309,335                 | 17%                  |
| Total           | \$ 750,192              | \$ 540,596              | 39%                  |

Capital markets revenues, which consists primarily of debt, equity and convertible financing services, were \$388.7 million, an increase of 68% from 2006. The increase in capital markets revenues was a result of increased U.S. and international debt underwritings and increased activity from our leverage finance group.

Revenues from advisory activities were \$361.5 million, an increase of 17% from 2006. The increase in advisory revenues was led by services rendered on assignments in the technology, industrial, energy, maritime and shipping, healthcare 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 \$23.5 million, down \$86.0 million over 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 performance from our equity funds and managed CLO s offset by strong operating performance and increased assets under managements from our international global convertible funds.

**Table of Contents*****Changes in Assets under Management***

| <b>Dollars In millions</b>   | <b>Year<br/>Ended<br/>December<br/>31, 2007</b> | <b>Year<br/>Ended<br/>December<br/>31, 2006</b> | <b>Percent<br/>Change</b> |
|------------------------------|-------------------------------------------------|-------------------------------------------------|---------------------------|
| Balance, beginning of period | \$ 5,282                                        | \$ 4,031                                        | 31%                       |
| Net cash flow in             | 269                                             | 792                                             |                           |
| Net market appreciation      | 224                                             | 459                                             |                           |
|                              | 493                                             | 1,251                                           |                           |
| Balance, end of period       | \$ 5,775                                        | \$ 5,282                                        | 9%                        |

The net cash inflow during 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 \$646.0 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 \$645.2 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 \$155.1 million, or 20%, while net revenues increased 8%. The ratio of compensation to net revenues was approximately 60.3% for 2007 as compared to 54.3% for 2006. Average employee headcount increased 12% from 2,140 during 2006 to 2,394 during 2007. Employee headcount increased 13% from 2,275 as of December 31, 2006 to 2,568 as of December 31, 2007.

***Cash Compensation***

Cash compensation and benefits increased \$95.7 million, or 14%, while net revenues increased 8%. The ratio of cash compensation to net revenues was approximately 51% for 2007 as compared to 48% for 2006. The ratio of cash compensation to average employee headcount was approximately \$334 thousand for 2007 as compared to \$329 thousand for 2006. The increase in cash compensation is primarily due to increased business activities and growth initiatives, both domestically and internationally. Specifically, during 2007 we hired numerous senior level employees as part of our growth initiatives requiring us to incur significant upfront cash compensation outflows including sign-on and guaranteed bonuses.

***Issuance of Stock-Based Compensation to Employees***

Restricted stock and restricted stock units ( RSU s ) are an important component of employee compensation. We believe they motivate employees and encourage long-term commitment to us. Restricted stock and RSU s are awarded to employees subject to risk of forfeiture and/or vesting conditions. Typically the vesting occurs over a prescribed period of time and requires continued service and employment by the recipient. Restricted stock and RSU s are valued at the date of grant and are amortized over the requisite service period which is typically five years.



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The following table summarizes selected financial ratios related to the issuance of stock-based compensation to our employees (dollars in thousands):

|                                                      | <b>2007</b>  | <b>2006</b>  |
|------------------------------------------------------|--------------|--------------|
| Stock based compensation (1)                         | \$ 145,839   | \$ 86,190    |
| Net revenues                                         | \$ 1,568,090 | \$ 1,457,602 |
| Compensation and benefits                            | \$ 946,309   | \$ 791,255   |
| Stock based compensation / net revenues              | 9%           | 6%           |
| Stock based compensation / compensation and benefits | 15%          | 11%          |

(1) Stock based compensation is the pre-tax expense associated with all of our employee stock-based compensation plans, including the discount on DCP deferred shares, restricted stock amortization, discounts on employee stock purchase plans and ESOP contributions.

The increase in stock-based compensation/net revenues and stock-based compensation/total compensation is primarily due to the increase in the amortization of stock-based awards from prior years. The increase in stock-based compensation is consistent with our change in compensation policies initiated during 2005 whereby we issue greater amounts of stock-based compensation to senior level employees as compared to cash compensation.

The following table summarizes estimated future amortization expense related to the issuance of stock-based awards to our employees prior to January 1, 2008. This table does not reflect the potential impact of future grants, modifications, if any, or actual forfeitures (in millions):

|       |          |
|-------|----------|
| 2008  | \$ 104.8 |
| 2009  | 81.5     |
| 2010  | 63.1     |
| 2011  | 35.1     |
| 2012  | 13.2     |
| Total | 297.7    |

On January 22, 2008 we granted \$180 million of RSU s and restricted stock to our employees. These stock-based awards will generally be amortized into compensation and benefits expense on a straight-line basis over their five year vesting period.

Additional information relating to issuances pursuant to our employee stock-based compensation plans is contained in Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income (Loss) on page 50, Stock-Based Compensation included in note 1 of the Notes to the Consolidated Financial Statements, and Defined Benefit Plan included in note 11 of the Notes to the Consolidated Financial Statements.

***Non-Personnel Expenses***

Non-personnel expense was \$376.0 million for 2007 versus \$317.7 million for 2006 or 24.0% of net revenues for 2007 versus 21.8% of net revenues for 2006. The increase in non-personnel expenses is consistent with our revenue growth and primarily attributable to increased compliance, technology and communications costs as well as increased occupancy related to the expansion of our London and New York offices.

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### ***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 \$102.9 million, or 29.5%, to \$245.7 million, compared to \$348.7 million for 2006. The effective tax rates were approximately 37.9% for 2007 and 39.4% for 2006. The lower effective tax rate is due to (1) the minority interest holdings in JHYH which are not taxed at the Jefferies Group level (2) a decrease in state and local income taxes and (3) return to provision adjustments for amounts previously deemed to be non-deductible.

#### ***Minority Interest***

Minority interest consists of third party interests in JHYH (effective April 2, 2007) and our consolidated asset management funds. Minority interest was \$7.9 million compared to \$7.0 million for 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 \$0.97 for 2007 on 153,807,000 shares compared to \$1.42 for 2006 on 147,531,000 shares. The diluted earnings per share calculation for 2007 and 2006 includes an addition of \$4.1 and \$3.5 million, respectively, to net earnings for preferred dividends.

Basic net earnings per share were \$1.02 for 2007 on 141,515,000 shares compared to \$1.54 for 2006 on 133,898,000 shares.

### **2006 Compared to 2005**

#### ***Net Revenues***

Net revenues increased \$252.9 million, or 21%, to \$1,457.6 million, compared to \$1,204.7 million for 2005. The increase was primarily due to a \$167.4 million, or 27%, increase in equity and fixed income and commodities revenues, a \$27.5 million, or 34%, increase in asset management fees and investment income from managed funds and a \$45.6 million, or 9%, increase in investment banking revenue. The 2006 results included an after-tax gain of \$1.6 million, or \$0.01 per diluted common share, as a cumulative effect of change in accounting principle associated with our adoption of FASB 123R on January 1, 2006.

#### ***Equity Product Revenue***

Equity product revenue is comprised of equity (including principal transactions and commission revenue), correspondent clearing and prime brokerage, and execution product revenues. Equity product revenue was \$538.9 million, up 23% from 2005 reflecting higher revenues across most of our core equity businesses. The increase in equity product revenue was due to moderate volatility in the market, several large block and proprietary trading opportunities generated from our investment banking relationships and the continued expansion of our secondary trading activity generated off of our capital markets platform.

#### ***Fixed Income and Commodities Revenue***

Fixed income and commodities revenue is comprised of high yield, investment grade fixed income, convertible and commodities product revenue. Fixed income and commodities revenue was \$245.3 million, up 37% over last year driven by increased activity in the high yield, investment grade corporate bond and commodity markets. High Yield revenues increased primarily due to energy related proprietary trading. Investment grade fixed income revenues increased primarily as a result of increased activity in the trading of corporate bonds. The increase in commodities revenue was due to the overall expansion of JFP, as well as, increased activity in most commodities, including energy related commodities markets.

**Table of Contents****Investment Banking Product Revenue**

|                 | Year Ended              |                         |                      |
|-----------------|-------------------------|-------------------------|----------------------|
|                 | December<br>31,<br>2006 | December<br>31,<br>2005 | Percentage<br>Change |
|                 | (Dollars in Thousands)  |                         |                      |
| Capital markets | \$ 231,261              | \$ 221,479              | 4%                   |
| Advisory        | 309,335                 | 273,535                 | 13%                  |
| Total           | \$ 540,596              | \$ 495,014              | 9%                   |

Capital markets revenues, which consist primarily of debt, equity and convertible financing services were \$231.3 million, an increase of 4% from 2005. The increase in capital markets revenues is primarily attributable to increases in revenue from equity and convertible underwritings, offset by the decrease in revenue generated from high yield underwritings.

Revenues from advisory activities were \$309.3 million, an increase of 13% from 2005. The increase is primarily attributable to services rendered on assignments in the technology, aerospace and defense, industrial and energy 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 \$109.6 million, up 34% over 2005. The increase in asset management revenue was a result of solid performance and expansion of the JAM platform along with strong 2006 results from our High Yield Funds. During 2006, we formed a total of four new funds, one focused on distressed debt and risk arbitrage, two technology-oriented long-short equity funds, and one financial services long-short equity fund. In addition, we launched the Summit Lake CLO and Diamond Lake CLO.

**Changes in Assets under Management (1)**

|                              | Year<br>Ended<br>December<br>31, 2006 | Year<br>Ended<br>December<br>31, 2005 | Percent<br>Change |
|------------------------------|---------------------------------------|---------------------------------------|-------------------|
| <b>Dollars In millions</b>   |                                       |                                       |                   |
| Balance, beginning of period | \$ 4,031                              | \$ 3,287                              | 23%               |
| Net cash flow in             | 792                                   | 556                                   |                   |
| Net market appreciation      | 459                                   | 188                                   |                   |
|                              | 1,251                                 | 744                                   |                   |
| Balance, end of period       | \$ 5,282                              | \$ 4,031                              | 31%               |

(1) Excludes certain third party managed funds that are no longer considered

assets under  
management.

***Net Interest***

Interest income increased \$224.8 million primarily as a result of increased stock borrowing activity and increases in interest rates, and interest expense increased by \$212.4 million primarily as a result of increased stock lending activity, increases in interest rates, the issuance of our \$500 million of senior unsecured debentures and our \$125 million in Series A Mandatorily Convertible Preferred Stock.

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***Compensation and Benefits***

Compensation and benefits, including the amortization of previously awarded equity awards, increased \$121.3 million, or 18%, versus the 21% increase in net revenues. The increase was consistent with our increase in headcount and change to our revenue mix offset by changes to FASB 123R guidance regarding the timing of expense recognition for non-retirement-eligible employees. Under FASB 123 we defined the service period (over which compensation costs should be recognized) to generally include the year prior to the grant and the subsequent vesting periods. With the adoption of FASB 123R, 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.

Average employee headcount increased 10% from 1,937 during 2005 to 2,140 during 2006. The ratio of compensation to net revenues was approximately 54.3% for 2006 as compared to 55.6% for 2005.

***Non-Personnel Expenses***

Non-personnel expense was \$317.7 million or 21.8% of net revenues for 2006 versus \$266.3 or 22.1% of net revenues for 2005. The increase in non-personnel expenses is consistent with our revenue growth and primarily attributable to increased technology and communications, occupancy, legal and compliance and other costs associated with higher levels of business activity.

***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 \$80.2 million, or 30%, to \$348.7 million, compared to \$268.4 million for 2005. The effective tax rates were approximately 39.4% for 2006 and 38.8% for 2005. The 2006 basic and diluted calculations included an additional \$0.01 per share related to the cumulative effect of the change in accounting principle, net.

***Minority Interest***

Minority interest was \$7.0 million compared to \$6.9 million for 2005.

***Earnings per Share***

Diluted net earnings per share were \$1.42 for 2006 on 147,531,000 shares compared to \$1.16 in 2005 on 135,569,000 shares. The diluted earnings per share calculation for 2006 includes an addition of \$3.5 million to net earnings for preferred dividends.

Basic net earnings per share were \$1.54 for 2006 on 133,898,000 shares compared to \$1.27 in 2005 on 123,646,000 shares.

Both the 2006 basic and diluted calculations included an additional \$0.01 per share related to the cumulative effect of the change in accounting principle, net.

**Table of Contents****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):

|                                    | December 31,<br>2007 | December 31,<br>2006 |
|------------------------------------|----------------------|----------------------|
| Cash and cash equivalents:         |                      |                      |
| Cash in banks                      | \$ 248,174           | \$ 107,488           |
| Money market investments           | 649,698              | 405,553              |
| Total cash and cash equivalents    | 897,872              | 513,041              |
| Cash and securities segregated (1) | 659,219              | 508,303              |
| Other (2)                          | $\frac{3}{4}$        | 71,160               |
|                                    | \$ 1,557,091         | \$ 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 federal funds rate. We had no outstanding secured bank loans as of December 31, 2007 and 2006. Unsecured bank loans are typically overnight loans used to finance financial instruments owned or clearing related balances. We had \$280.4 million and \$0 of outstanding unsecured bank loans as of December 31, 2007 and 2006, respectively. Average daily bank loans for the years ended December 31, 2007 and 2006 were \$267.1 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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Our assets are funded by equity capital, senior debt, mandatorily redeemable convertible preferred stock, securities loaned, securities sold under agreements to repurchase, 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 \$308.0 million in letters of credit outstanding as of December 31, 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 \$1,185.0 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 \$11,968.4 million, or 67%, from \$17,825.5 million at December 31, 2006 to \$29,793.8 million at December 31, 2007 primarily due to increased repo activity. Our financial instruments owned, including securities pledged to creditors, increased \$1,092.5 million, while our financial instruments sold, not yet purchased decreased \$266.2 million. Our securities borrowed and securities purchased under agreements to resell increased \$9,856.4 million, while our securities loaned and securities sold under agreements to repurchase increased \$10,119.6 million.

Level 3 assets, as defined by FASB 157, decreased to approximately 6.1% of total financial instruments owned as of December 31, 2007, compared to approximately 7.4% in the trailing quarter. The decrease in Level 3 assets resulted largely from the repayment of \$148.1 million in bridge loans from investment-banking clients in acquisition-finance transactions.

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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):

|                                                                           | December 31,<br>2007 | December 31,<br>2006 |
|---------------------------------------------------------------------------|----------------------|----------------------|
| Stockholders' equity                                                      | \$ 1,761,544         | \$ 1,581,087         |
| Less: Goodwill                                                            | (344,063)            | (257,321)            |
| Tangible stockholders' equity                                             | \$ 1,417,481         | \$ 1,323,766         |
| Stockholders' equity                                                      | \$ 1,761,544         | \$ 1,581,087         |
| Add: Projected tax benefit on vested portion of restricted stock          | 84,729               | 130,700              |
| Pro forma stockholders' equity                                            | \$ 1,846,273         | \$ 1,711,787         |
| Tangible stockholders' equity                                             | \$ 1,417,481         | \$ 1,323,766         |
| Add: Projected tax benefit on vested portion of restricted stock          | 84,729               | 130,700              |
| Pro forma tangible stockholders' equity                                   | \$ 1,502,210         | \$ 1,454,466         |
| Shares outstanding                                                        | 124,453,174          | 119,546,914          |
| Add: Shares not issued, to the extent of related expense amortization     | 22,577,007           | 24,139,907           |
| Less: Shares issued, to the extent related expense has not been amortized | (4,439,790)          | (1,813,423)          |
| Adjusted shares outstanding                                               | 142,590,391          | 141,873,398          |
| Book value per share (1)                                                  | \$ 14.15             | \$ 13.23             |
| Pro forma book value per share (2)                                        | \$ 12.95             | \$ 12.07             |
| Tangible book value per share (3)                                         | \$ 11.39             | \$ 11.07             |
| Pro forma tangible book value per share (4)                               | \$ 10.54             | \$ 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****Capital Resources**

We had total long-term capital of \$3.7 billion and \$2.9 billion resulting in a long-term debt to total capital ratio of 48% and 41%, at year end 2007 and 2006, respectively. Our total capital base as of December 31, 2007 and 2006 was as follows (in thousands):

|                                                    | December 31,<br>2007 | December 31,<br>2006 |
|----------------------------------------------------|----------------------|----------------------|
| Long-Term Debt                                     | \$ 1,764,067         | \$ 1,168,562         |
| Mandatorily Redeemable Convertible Preferred Stock | 125,000              | 125,000              |
| Total Stockholders' Equity                         | 1,761,544            | 1,581,087            |
| <br>Total Capital                                  | <br>\$ 3,650,611     | <br>\$ 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 \$1,185.0 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 December 31, 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, \$248.4 million and \$328.6 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+   |
| <i>Net Capital</i>         |        |

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.

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As of December 31, 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 Capital |
|------------------------------|-------------|--------------------|
| Jefferies                    | \$505,080   | \$ 483,108         |
| Jefferies Execution          | \$ 30,297   | \$ 30,047          |
| Jefferies High Yield Trading | \$558,087   | \$ 557,837         |

*Guarantees*

As of December 31, 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 \$4.5 million) to Jefferies (Japan) Limited. In addition, as of December 31, 2007, we had commitments to invest up to \$500.1 million in various investments, including \$195.0 million in Jefferies Finance LLC, \$18.0 million in Babson-Jefferies Loan Opportunity CLO, \$25.9 million in Fund IV, \$250.0 million in JHYH and \$11.2 million in other investments.

*Leverage Ratios*

The following table presents total assets, adjusted assets, total stockholders' equity and tangible stockholders' equity with the resulting leverage ratios as of December 31, 2007 and December 31, 2006:

|                                                                                                                                       | December 31,<br>2007 | December 31,<br>2006 |
|---------------------------------------------------------------------------------------------------------------------------------------|----------------------|----------------------|
| Total assets                                                                                                                          | \$ 29,793,817        | \$ 17,825,457        |
| Deduct: Securities borrowed                                                                                                           | (16,422,130)         | (9,711,894)          |
| Securities purchased under agreements to resell                                                                                       | (3,372,294)          | (226,176)            |
| Add: Financial instruments sold, not yet purchased                                                                                    | 3,334,678            | 3,600,869            |
| Less derivative liabilities                                                                                                           | (331,788)            | (240,231)            |
| Subtotal                                                                                                                              | 3,002,890            | 3,360,638            |
| Deduct: Cash and securities segregated and on deposit for regulatory purposes or deposited with clearing and depository organizations | (659,219)            | (508,303)            |
| Goodwill                                                                                                                              | (344,063)            | (257,321)            |
| Adjusted assets                                                                                                                       | 11,999,001           | 10,482,401           |
| Total stockholders' equity                                                                                                            | \$ 1,761,544         | \$ 1,581,087         |
| Deduct: Goodwill                                                                                                                      | (344,063)            | (257,321)            |
| Tangible stockholders' equity                                                                                                         | 1,417,481            | 1,323,766            |
| Leverage ratio (1)                                                                                                                    | 16.9                 | 11.3                 |
| Adjusted leverage ratio (2)                                                                                                           | 8.5                  | 7.9                  |

- (1) Leverage ratio  
equals total  
assets divided  
by total  
stockholders  
equity.
- (2) Adjusted  
leverage ratio  
equals adjusted  
assets divided  
by tangible  
stockholders  
equity.

**Table of Contents****Commitments**

The tables below provide information about our commitments related to debt obligations, leases, guarantees, letters of credit and investments as of December 31, 2007. For debt obligations, leases and investments, the table presents principal cash flows with expected maturity dates. For guarantees and letters of credit, the table presents notional amounts with expected maturity dates.

|                                                    | 2008     | 2009    | Expected Maturity Date |         |          | After 2012 | Total      |
|----------------------------------------------------|----------|---------|------------------------|---------|----------|------------|------------|
|                                                    |          |         | 2010                   | 2011    | 2012     |            |            |
| (Dollars in Millions)                              |          |         |                        |         |          |            |            |
| <b>Debt obligations</b>                            |          |         |                        |         |          |            |            |
| Senior notes                                       |          |         |                        |         | \$ 325.0 | \$ 1,450.0 | \$ 1,775.0 |
| Mandatorily redeemable convertible preferred stock |          |         |                        |         |          | \$ 125.0   | \$ 125.0   |
| <b>Leases</b>                                      |          |         |                        |         |          |            |            |
| Gross lease commitments                            | \$ 47.5  | \$ 48.0 | \$ 45.8                | \$ 43.6 | \$ 37.5  | \$ 149.9   | \$ 372.3   |
| Sub-leases                                         | 10.6     | 10.7    | 10.4                   | 10.0    | 6.7      | 14.7       | 63.1       |
| Net lease commitments                              | \$ 36.9  | 37.3    | \$ 35.4                | \$ 33.6 | \$ 30.8  | \$ 135.2   | \$ 309.2   |
| <b>Guarantees</b>                                  | \$ 20.0  |         |                        |         | \$ 36.0  | \$ 4.5     | \$ 60.5    |
| <b>Letters of credit</b>                           | \$ 307.7 | \$ 0.1  | \$ 0.2                 |         |          |            | \$ 308.0   |
| <b>Commitments to invest</b>                       |          | \$ 0.1  |                        | \$ 0.9  | \$ 0.4   | \$ 498.7   | \$ 500.1   |
| <b>High yield loan commitment</b>                  |          |         | \$ 5.0                 |         |          |            | \$ 5.0     |
| <b>Derivative contracts</b>                        | \$ 392.5 |         |                        |         | \$ 5.0   |            | \$ 397.5   |

**Off Balance Sheet Arrangements**

Information concerning our off balance sheet arrangements are included in note 18 of the Notes to Consolidated Financial Statements. Such information is hereby incorporated by reference.

**Effects of Changes in Foreign Currency Rates**

We maintain a foreign securities business in our foreign offices (London, Paris, Tokyo and Zurich) as well as in some of our domestic offices. Most of these activities are hedged by related foreign currency liabilities or by forward exchange contracts. However, we are still subject to some foreign currency risk. A change in the foreign currency rates could create either a foreign currency transaction gain/loss (recorded in our Consolidated Statements of Earnings) or a foreign currency translation adjustment to the stockholders' equity section of our Consolidated Statements of Financial Condition.

**Effects of Inflation**

Based on today's modest inflationary rates and because our assets are primarily monetary in nature, consisting of cash and cash equivalents, financial instruments and receivables, we believe that our assets are not significantly affected by inflation. The rate of inflation, however, can affect various expenses, including employee compensation, communications and technology and occupancy, which may not be readily recoverable in charges for services provided by us.





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### **Risk Management**

Risk is an inherent part of our business and activities. The extent to which we properly and effectively identify, assess, monitor and manage each of the various types of risk involved in our activities is critical to our financial soundness and profitability. We seek to identify, assess, monitor and manage the following principal risks involved in our business activities: market, credit, operational, legal and compliance, new business, reputational and other. Risk management is a multi-faceted process that requires communication, judgment and knowledge of financial products and markets. Senior management takes an active role in the risk management process and requires specific administrative and business functions to assist in the identification, assessment and control of various risks. Our risk management policies, procedures and methodologies are fluid in nature and are subject to ongoing review and modification.

*Market Risk.* The potential for changes in the value of financial instruments is referred to as market risk. Our market risk generally represents the risk of loss that may result from a change in the value of a financial instrument as a result of fluctuations in interest rates, credit spreads, equity prices, commodity prices and foreign exchange rates, along with the level of volatility. Interest rate risks result primarily from exposure to changes in the yield curve, the volatility of interest rates, and credit spreads. Equity price risks result from exposure to changes in prices and volatilities of individual equities, equity baskets and equity indices. Commodity price risks result from exposure to the changes in prices and volatilities of individual commodities, commodity baskets and commodity indices. We make dealer markets in equity securities, debt securities and commodities. We attempt to hedge our exposure to market risk by managing our net long or short positions. Due to imperfections in correlations, gains and losses can occur even for positions that are hedged. Position limits in trading and inventory accounts are established and monitored on an ongoing basis. Each day, consolidated position and exposure reports are prepared and distributed to various levels of management, which enable management to monitor inventory levels and results of the trading groups.

*Credit Risk.* Credit risk represents the loss that we would incur if a client, counterparty or issuer of financial instruments, such as securities and derivatives, held by us fails to perform its contractual obligations. We follow industry practices to reduce credit risk related to various trading, investing and financing activities by obtaining and maintaining collateral. We adjust margin requirements if we believe the risk exposure is not appropriate based on market conditions. Liabilities to other brokers and dealers related to unsettled transactions (i.e., securities failed-to-receive) are recorded at the amount for which the securities were purchased, and are paid upon receipt of the securities from other brokers or dealers. In the case of aged securities failed-to-receive, we may purchase the underlying security in the market and seek reimbursement for losses from the counterparty in accordance with standard industry practices.

*Operational Risk.* Operational risk generally refers to the risk of loss resulting from our operations, including, but not limited to, improper or unauthorized execution and processing of transactions, deficiencies in our operating systems, business disruptions and inadequacies or breaches in our internal control processes. Our businesses are highly dependent on our ability to process, on a daily basis, a large number of transactions across numerous and diverse markets in many currencies. In addition, the transactions we process have become increasingly complex. If any of our financial, accounting or other data processing systems do not operate properly or are disabled or if there are other shortcomings or failures in our internal processes, people or systems, we could suffer an impairment to our liquidity, financial loss, a disruption of our businesses, liability to clients, regulatory intervention or reputational damage. These systems may fail to operate properly or become disabled as a result of events that are wholly or partially beyond our control, including a disruption of electrical or communications services or our inability to occupy one or more of our buildings. The inability of our systems to accommodate an increasing volume of transactions could also constrain our ability to expand our businesses.

We also face the risk of operational failure or termination of any of the clearing agents, exchanges, clearing houses or other financial intermediaries we use to facilitate our securities transactions. Any such failure or termination could adversely affect our ability to effect transactions and manage our exposure to risk.

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In addition, despite the contingency plans we have in place, our ability to conduct business may be adversely impacted by a disruption in the infrastructure that supports our businesses and the communities in which they are located. This may include a disruption involving electrical, communications, transportation or other services used by us or third parties with which we conduct business.

Our operations rely on the secure processing, storage and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, our computer systems, software and networks may be vulnerable to unauthorized access, computer viruses or other malicious code, and other events that could have a security impact. If one or more of such events occur, this potentially could jeopardize our or our clients' or counterparties' confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our, our clients', our counterparties' or third parties' operations. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance maintained by us.

*Legal and Compliance Risk.* Legal and compliance risk includes the risk of non-compliance with applicable legal and regulatory requirements. We are subject to extensive regulation in the different jurisdictions in which we conduct our business. We have various procedures addressing issues such as regulatory capital requirements, sales and trading practices, use of and safekeeping of customer funds, credit granting, collection activities, anti-money laundering and record keeping. We also maintain an anonymous hotline for employees or others to report suspected inappropriate actions by us or by our employees or agents.

*New Business Risk.* New business risk refers to the risks of entering into a new line of business or offering a new product. By entering a new line of business or offering a new product, we may face risks that we are unaccustomed to dealing with and may increase the magnitude of the risks we currently face. We review proposals for new businesses and new products to determine if we are prepared to handle the additional or increased risks associated with entering into such activities.

*Reputational Risk.* We recognize that maintaining our reputation among clients, investors, regulators and the general public is an important aspect of minimizing legal and operational risks. Maintaining our reputation depends on a large number of factors, including the selection of our clients and the conduct of our business activities. We seek to maintain our reputation by screening potential clients and by conducting our business activities in accordance with high ethical standards.

*Other Risk.* Other risks encountered by us include political, regulatory and tax risks. These risks reflect the potential impact that changes in local and international laws and tax statutes have on the economics and viability of current or future transactions. In an effort to mitigate these risks, we continuously review new and pending regulations and legislation and participate in various industry interest groups.

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### **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. We adopted FIN 48 as of the beginning of 2007. The transition adjustment to beginning retained earnings was a reduction of approximately \$0.4 million.

**FASB 157.** In September 2006, the FASB issued FASB 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 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.

**FASB 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 as of December 31, 2006.

**FASB 159.** In February 2007, the FASB issued FASB 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 159 are elective; however, the amendment to FASB 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  
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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 fiscal years beginning after November 15, 2007, with early application permitted. The adoption of FSP FIN 39-1 on January 1, 2008 did 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 and FSP FIN No. 46R-7.** 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 May 2007, the FASB issued FSP FIN 46R-7, *Application of FIN 46R to Investment Companies* ( FSP FIN 46R-7 ). FSP FIN 46R-7 amends FIN 46R to make permanent the temporary deferral of the application of FIN 46R to entities within the scope of the revised Guide under SOP 07-1. FSP FIN 46R-7 is effective upon the adoption of SOP 07-1. In November 2007, the FASB issued a proposed FSP SOP No. 07-1-a, *The Effective Date of AICPA Statement of Position 07-1*, which proposes to indefinitely defer the effective date for SOP 07-1 and, consequently, FSP FIN 46R-7. We are currently evaluating the potential impact of adopting SOP 07-1 and FSP FIN 46R-7 in light of the proposed FSP SOP No. 07-1-a.

**FASB 141(R).** In December 2007, the FASB issued FASB 141 (revised 2007), *Business Combinations* ( FASB 141R ). Under FASB 141R, an entity is required to recognize the assets acquired, liabilities assumed, contractual

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contingencies and contingent consideration measured at their fair value at the acquisition date for any business combination consummated after the effective date. It further requires that acquisition-related costs are to be recognized separately from the acquisition and expensed as incurred. This statement is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, we will adopt FASB 141R effective January 1, 2009.

**FASB 160.** In December 2007, the FASB issued FASB 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* ( FASB 160 ). FASB 160 requires an entity to clearly identify and present ownership interests in subsidiaries held by parties other than the entity in the Consolidated Financial Statements within the equity section but separate from the entity's equity. It also requires the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income; changes in ownership interest be accounted for similarly, as equity transactions; and when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary and the gain or loss on the deconsolidation of the subsidiary be measured at fair value. This statement is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, we will adopt FASB 160 effective January 1, 2009. We are currently evaluating the impact of FASB 160 on our Consolidated Financial Statements.



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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, 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:

| Risk Categories               | Daily VaR (1)<br>(in millions)      |          |                       |         |        |                       |         |        |
|-------------------------------|-------------------------------------|----------|-----------------------|---------|--------|-----------------------|---------|--------|
|                               | Value-at-Risk in trading portfolios |          |                       |         |        |                       |         |        |
|                               | VaR at                              |          | Year Ended 12/31/2007 |         |        | Year Ended 12/31/2006 |         |        |
|                               | 12/31/07                            | 12/31/06 | Average               | High    | Low    | Average               | High    | Low    |
| Interest Rates                | \$ 1.70                             | \$ 1.39  | \$ 1.60               | \$ 2.24 | \$0.97 | \$ 0.81               | \$ 1.50 | \$0.41 |
| Equity Prices                 | \$16.73                             | \$ 6.37  | \$ 8.42               | \$17.01 | \$4.94 | \$ 4.35               | \$13.30 | \$1.10 |
| Currency Rates                | \$ 0.47                             | \$ 0.34  | \$ 0.41               | \$ 1.06 | \$0.13 | \$ 0.37               | \$ 0.53 | \$0.24 |
| Commodity Prices              | \$ 2.07                             | \$ 0.80  | \$ 1.22               | \$ 2.36 | \$0.27 | \$ 1.98               | \$ 4.87 | \$0.61 |
| Diversification<br>Effect (2) | \$ (7.24)                           | \$(3.36) | \$(3.53)              |         |        | \$(2.76)              |         |        |
| Firmwide                      | \$13.73                             | \$ 5.54  | \$ 8.12               | \$14.02 | \$5.31 | \$ 4.75               | \$13.90 | \$1.95 |

(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.

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Average firmwide VaR of \$8.12 million during 2007 increased from the \$4.75 million average during 2006 primarily due to an increase in exposure to equity prices, and interest rates.

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

**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. A back-testing exception occurs when the daily loss exceeds the daily VaR estimate. Results of the process at the aggregate level demonstrated nineteen outliers when comparing the 95% one-day VaR with the back-testing profit and loss in 2007. Ten of the outliers occurred during the third quarter as result of increased market volatility. A 95% confidence one-day VaR model should not have more than twelve (1 out of 20 days) back-testing exceptions on an annual basis under normal market conditions. Back-testing profit and loss is a subset of actual trading revenue and includes 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 profit and loss and daily VaR for us in 2007.

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VaR is a model that estimates 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.

**Daily Trading Net Revenue**

(\$ in millions)

Trading revenue used in the histogram below entitled 2007 vs. 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 our trading activities:

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**Table of Contents****Maturity Data**

At December 31, 2007, we had \$1,775.0 million aggregate principal amount of senior notes outstanding, with fixed interest rates. 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 3/4% 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 approximately \$1.9 million per year over the remaining life of the notes through March 2012.

The table below provides information about our OTC derivative financial instruments and other financial instruments that are sensitive to changes in interest rates, exchange rates and price movements. For debt obligations and mandatorily redeemable convertible preferred stock, the table presents principal cash flows with expected maturity dates. For OTC derivative financial instruments, the table presents fair value amounts with expected maturity dates.

|                                                    | Expected Maturity Date |          |         |                               |          | After<br>2012 | Total     | Fair<br>Value |
|----------------------------------------------------|------------------------|----------|---------|-------------------------------|----------|---------------|-----------|---------------|
|                                                    | 2008                   | 2009     | 2010    | 2011<br>(Dollars in Millions) | 2012     |               |           |               |
| Debt obligations                                   |                        |          |         |                               |          |               |           |               |
| 7.75% Senior notes                                 |                        |          |         |                               | \$325.0  |               | \$ 325.0  | \$ 352.9      |
| 5.875% Senior notes                                |                        |          |         |                               |          | \$250.0       | \$ 250.0  | \$ 251.5      |
| 5.5% Senior notes                                  |                        |          |         |                               |          | \$350.0       | \$ 350.0  | \$ 333.8      |
| 6.45% Senior notes                                 |                        |          |         |                               |          | \$350.0       | \$ 350.0  | \$ 324.2      |
| 6.25% Senior notes                                 |                        |          |         |                               |          | \$500.0       | \$ 500.0  | \$ 446.9      |
| Mandatorily redeemable convertible preferred stock |                        |          |         |                               |          | \$125.0       | \$ 125.0  | \$ 113.9      |
| OTC derivatives                                    |                        |          |         |                               |          |               |           |               |
| Commodity swaps                                    | \$(405.7)              | \$ (0.8) | \$(0.6) |                               | \$ (0.1) |               | \$(407.2) | \$(407.2)     |
| Commodity options                                  | \$ (20.1)              | \$(29.7) | \$(6.7) | \$(28.6)                      | \$ (1.2) |               | \$ (86.3) | \$ (86.3)     |
| Equity options                                     | \$ (10.6)              | \$ (0.9) |         |                               |          | \$ (22.4)     | \$ (33.9) | \$ (33.9)     |
| Credit default swaps                               | \$ (0.4)               |          |         |                               | \$ 2.3   | \$ 0.1        | \$ 2.0    | \$ 2.0        |
| Total return swaps                                 | \$ (9.4)               |          |         |                               |          |               | \$ (9.4)  | \$ (9.4)      |
| Forward contracts                                  | \$ (0.3)               |          |         | \$ 0.5                        |          |               | \$ 0.2    | \$ 0.2        |

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**Item 8. Financial Statements and Supplementary Data.**

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**Management's Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management evaluated our internal control over financial reporting as of December 31, 2007. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework*. As a result of this assessment and based on the criteria in this framework, management has concluded that, as of December 31, 2007, our internal control over financial reporting was effective.

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

Jefferies Group, Inc.:

We have audited the accompanying consolidated statements of financial condition of Jefferies Group, Inc. and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of earnings, changes in stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2007. These Consolidated Financial Statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these Consolidated Financial Statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the Consolidated Financial Statements referred to above present fairly, in all material respects, the financial position of Jefferies Group, Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As more fully described in note 1 to the Consolidated Financial Statements, in 2006 the company changed its method of accounting for share based payments.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Jefferies Group, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 28, 2008 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

KPMG LLP  
New York, New York  
February 28, 2008



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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

Jefferies Group, Inc.:

We have audited Jefferies Group, Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management's Report on Internal Control over Financial Reporting*. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Jefferies Group, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of Jefferies Group, Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of earnings, changes in stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2007, and our report dated February 28, 2008 expressed an unqualified opinion on those Consolidated Financial Statements.

/s/ KPMG LLP

KPMG LLP

New York, New York

February 28, 2008

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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES  
Consolidated Statements of Financial Condition  
December 31, 2007 and 2006  
(Dollars in thousands, except per share amounts)**

|                                                                                                                                       | December 31,<br>2007 | December 31,<br>2006 |
|---------------------------------------------------------------------------------------------------------------------------------------|----------------------|----------------------|
| <b>ASSETS</b>                                                                                                                         |                      |                      |
| Cash and cash equivalents                                                                                                             | \$ 897,872           | \$ 513,041           |
| Cash and securities segregated and on deposit for regulatory purposes or deposited with clearing and depository organizations         | 659,219              | 508,303              |
| Financial instruments owned, including securities pledged to creditors of \$1,087,906 and \$1,481,098 in 2007 and 2006, respectively: |                      |                      |
| Corporate equity securities                                                                                                           | 2,266,679            | 1,737,174            |
| Corporate debt securities                                                                                                             | 2,162,893            | 1,918,829            |
| U.S. Government and agency obligations                                                                                                | 730,921              | 592,374              |
| Mortgage-backed securities                                                                                                            | 26,895               | 85,040               |
| Asset-backed securities                                                                                                               | ¾                    | 28,009               |
| Derivatives                                                                                                                           | 501,502              | 234,646              |
| Investments at fair value                                                                                                             | 104,199              | 97,289               |
| Other                                                                                                                                 | 2,889                | 10,151               |
| <br>Total financial instruments owned                                                                                                 | <br>5,795,978        | <br>4,703,512        |
| Investments in managed funds                                                                                                          | 293,523              | 372,869              |
| Other investments                                                                                                                     | 78,715               | 28,244               |
| Securities borrowed                                                                                                                   | 16,422,130           | 9,711,894            |
| Securities purchased under agreements to resell                                                                                       | 3,372,294            | 226,176              |
| Receivable from brokers, dealers and clearing organizations                                                                           | 508,926              | 254,580              |
| Receivable from customers                                                                                                             | 764,833              | 663,552              |
| Premises and equipment                                                                                                                | 141,472              | 91,375               |
| Goodwill                                                                                                                              | 344,063              | 257,321              |
| Other assets                                                                                                                          | 514,792              | 494,590              |
| <br>Total Assets                                                                                                                      | <br>\$ 29,793,817    | <br>\$ 17,825,457    |

See accompanying notes to Consolidated Financial Statements.

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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES**  
**Consolidated Statements of Financial Condition (Continued)**  
**December 31, 2007 and 2006**  
**(Dollars in thousands, except per share amounts)**

|                                                                                                                                  | December 31,<br>2007 | December 31,<br>2006 |
|----------------------------------------------------------------------------------------------------------------------------------|----------------------|----------------------|
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                      |                      |                      |
| Bank loans and current portion of long-term debt                                                                                 | \$ 280,378           | \$ 99,981            |
| Financial instruments sold, not yet purchased:                                                                                   |                      |                      |
| Corporate equity securities                                                                                                      | 1,389,099            | 1,835,046            |
| Corporate debt securities                                                                                                        | 1,407,387            | 1,185,400            |
| U.S. Government and agency obligations                                                                                           | 206,090              | 339,891              |
| Derivatives                                                                                                                      | 331,788              | 240,231              |
| Other                                                                                                                            | 314                  | 301                  |
| Total financial instruments sold, not yet purchased                                                                              | 3,334,678            | 3,600,869            |
| Securities loaned                                                                                                                | 7,681,464            | 6,794,554            |
| Securities sold under agreements to repurchase                                                                                   | 11,325,562           | 2,092,838            |
| Payable to brokers, dealers and clearing organizations                                                                           | 874,028              | 669,196              |
| Payable to customers                                                                                                             | 1,415,803            | 1,010,486            |
| Accrued expenses and other liabilities                                                                                           | 627,597              | 650,974              |
|                                                                                                                                  | 25,539,510           | 14,918,898           |
| Long-term debt                                                                                                                   | 1,764,067            | 1,168,562            |
| Mandatorily redeemable convertible preferred stock                                                                               | 125,000              | 125,000              |
| Minority interest                                                                                                                | 603,696              | 31,910               |
| Total Liabilities                                                                                                                | 28,032,273           | 16,244,370           |
| <b>STOCKHOLDERS' EQUITY</b>                                                                                                      |                      |                      |
| Common stock, \$.0001 par value. Authorized 500,000,000 shares; issued 155,375,808 shares in 2007 and 145,628,024 shares in 2006 | 16                   | 14                   |
| Additional paid-in capital                                                                                                       | 1,115,011            | 876,393              |
| Retained earnings                                                                                                                | 1,031,764            | 952,263              |
| Less:                                                                                                                            |                      |                      |
| Treasury stock, at cost, 30,922,634 shares in 2007 and 26,081,110 shares in 2006                                                 | (394,406)            | (254,437)            |
| Accumulated other comprehensive gain:                                                                                            |                      |                      |
| Currency translation adjustments                                                                                                 | 10,986               | 9,764                |
| Additional minimum pension liability                                                                                             | (1,827)              | (2,910)              |
| Total accumulated other comprehensive gain                                                                                       | 9,159                | 6,854                |
| Total stockholders' equity                                                                                                       | 1,761,544            | 1,581,087            |
| Total Liabilities and Stockholders' Equity                                                                                       | \$ 29,793,817        | \$ 17,825,457        |



**Table of Contents****JEFFERIES GROUP, INC.  
AND SUBSIDIARIES****Consolidated Statements of Earnings****For each of the years in the three-year period ended December 31, 2007  
(In thousands, except per share amounts)**

|                                                                                                         | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|---------------------------------------------------------------------------------------------------------|-------------|-------------|-------------|
| <b>Revenues:</b>                                                                                        |             |             |             |
| Commissions                                                                                             | \$ 355,601  | \$ 280,681  | \$ 246,943  |
| Principal transactions                                                                                  | 390,374     | 468,002     | 349,489     |
| Investment banking                                                                                      | 750,192     | 540,596     | 495,014     |
| Asset management fees and investment income from managed funds                                          | 23,534      | 109,550     | 82,052      |
| Interest                                                                                                | 1,174,883   | 528,882     | 304,053     |
| Other                                                                                                   | 24,311      | 35,497      | 20,322      |
| Total revenues                                                                                          | 2,718,895   | 1,963,208   | 1,497,873   |
| Interest expense                                                                                        | 1,150,805   | 505,606     | 293,173     |
| Revenues, net of interest expense                                                                       | 1,568,090   | 1,457,602   | 1,204,700   |
| <b>Non-interest expenses:</b>                                                                           |             |             |             |
| Compensation and benefits                                                                               | 946,309     | 791,255     | 669,957     |
| Floor brokerage and clearing fees                                                                       | 71,851      | 62,564      | 46,644      |
| Technology and communications                                                                           | 103,763     | 80,840      | 67,666      |
| Occupancy and equipment rental                                                                          | 76,765      | 59,792      | 47,040      |
| Business development                                                                                    | 56,594      | 48,634      | 42,512      |
| Other                                                                                                   | 67,074      | 65,863      | 62,474      |
| Total non-interest expenses                                                                             | 1,322,356   | 1,108,948   | 936,293     |
| Earnings before income taxes, minority interest and cumulative effect of change in accounting principle | 245,734     | 348,654     | 268,407     |
| Income taxes                                                                                            | 93,178      | 137,541     | 104,089     |
| Earnings before minority interest and cumulative effect of change in accounting principle               | 152,556     | 211,113     | 164,318     |
| Minority interest in earnings of consolidated subsidiaries, net                                         | 7,891       | 6,969       | 6,875       |
| Earnings before cumulative effect of change in accounting principle, net                                | 144,665     | 204,144     | 157,443     |
| Cumulative effect of change in accounting principle, net                                                |             | 1,606       |             |
| Net earnings                                                                                            | \$ 144,665  | \$ 205,750  | \$ 157,443  |
| <b>Earnings per share:</b>                                                                              |             |             |             |
| Basic-                                                                                                  |             |             |             |
| Earnings before cumulative effect of change in accounting principle, net                                | \$ 1.02     | \$ 1.53     | \$ 1.27     |

|                                                                          |    |         |         |         |
|--------------------------------------------------------------------------|----|---------|---------|---------|
| Cumulative effect of change in accounting principle, net                 |    |         | 0.01    |         |
| Net earnings                                                             | \$ | 1.02    | \$      | 1.54    |
|                                                                          |    |         | \$      | 1.27    |
| Diluted-                                                                 |    |         |         |         |
| Earnings before cumulative effect of change in accounting principle, net | \$ | 0.97    | \$      | 1.41    |
|                                                                          |    |         | \$      | 1.16    |
| Cumulative effect of change in accounting principle, net                 |    |         | 0.01    |         |
| Net earnings                                                             | \$ | 0.97    | \$      | 1.42    |
|                                                                          |    |         | \$      | 1.16    |
| <b>Weighted average shares of common stock:</b>                          |    |         |         |         |
| Basic                                                                    |    | 141,515 | 133,898 | 123,646 |
| Diluted                                                                  |    | 153,807 | 147,531 | 135,569 |

See accompanying notes to Consolidated Financial Statements.

**Table of Contents****JEFFERIES GROUP, INC.  
AND SUBSIDIARIES****Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income  
For each of the years in the three-year period ended December 31, 2007  
(Dollars in thousands, except per share amounts)**

|                                                         | <b>Year Ended December 31,</b> |             |             |
|---------------------------------------------------------|--------------------------------|-------------|-------------|
|                                                         | <b>2007</b>                    | <b>2006</b> | <b>2005</b> |
| <b>Common stock, par value \$0.0001 per share</b>       |                                |             |             |
| Balance, beginning of year                              | 14                             | 7           | 7           |
| Issued / stock dividend                                 | 2                              | 7           |             |
| Balance, end of year                                    | 16                             | 14          | 7           |
| <b>Additional paid in capital</b>                       |                                |             |             |
| Balance, beginning of year                              | 876,393                        | 709,447     | 508,221     |
| Benefit plan share activity (1)                         | 38,053                         | 33,360      | 13,432      |
| Share-based amortization expense                        | 144,382                        | 83,137      | 100,217     |
| Proceeds from exercise of stock options                 | 5,233                          | 17,543      | 33,661      |
| Acquisitions and contingent consideration               | 9,240                          |             | 26,998      |
| Tax benefits for issuance of stock-based awards         | 41,710                         | 32,906      | 26,918      |
| Balance, end of year                                    | 1,115,011                      | 876,393     | 709,447     |
| <b>Retained earnings</b>                                |                                |             |             |
| Balance, beginning of year                              | 952,263                        | 803,262     | 677,464     |
| Cumulative effect of adjustment from adoption of FIN 48 | (410)                          |             |             |
| Net earnings                                            | 144,665                        | 205,750     | 157,443     |
| Dividends                                               | (64,754)                       | (56,749)    | (31,645)    |
| Balance, end of year                                    | 1,031,764                      | 952,263     | 803,262     |
| <b>Treasury stock, at cost</b>                          |                                |             |             |
| Balance, beginning of year                              | (254,437)                      | (220,703)   | (149,039)   |
| Purchases                                               | (147,809)                      | (23,972)    | (76,291)    |
| Returns / forfeitures                                   | (7,785)                        | (9,762)     | (6,717)     |
| Issued                                                  | 15,625                         |             | 11,344      |
| Balance, end of year                                    | (394,406)                      | (254,437)   | (220,703)   |
| <b>Accumulated other comprehensive income (loss)</b>    |                                |             |             |
| Balance, beginning of year                              | 6,854                          | (5,163)     | 2,480       |
| Currency adjustment, net of tax                         | 1,222                          | 8,802       | (8,386)     |
| Pension adjustment, net of tax                          | 1,083                          | 3,215       | 743         |

|                                               |                  |                  |                  |
|-----------------------------------------------|------------------|------------------|------------------|
| Balance, end of year                          | 9,159            | 6,854            | (5,163)          |
| <b>Total stockholders' equity</b>             | <b>1,761,544</b> | <b>1,581,087</b> | <b>1,286,850</b> |
| <b>Comprehensive income</b>                   |                  |                  |                  |
| Net earnings                                  | 144,665          | 205,750          | 157,443          |
| Other comprehensive income (loss), net of tax | 2,305            | 12,017           | (7,643)          |
| Total comprehensive income                    | 146,970          | 217,767          | 149,800          |

(1) Includes grants related to the Incentive Plan, Deferred Compensation Plan, and Director Plan.

See accompanying notes to Consolidated Financial Statements.



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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES  
Consolidated Statements of Cash Flows  
Three years ended December 31, 2007  
(Dollars in thousands)**

|                                                                                                                                                            | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|-------------|-------------|
| Cash flows from operating activities:                                                                                                                      |             |             |             |
| Net earnings                                                                                                                                               | \$ 144,665  | \$ 205,750  | \$ 157,443  |
| Adjustments to reconcile net earnings to net cash (used in)<br>provided by operating activities:                                                           |             |             |             |
| Cumulative effect of accounting change, net                                                                                                                |             | (1,606)     |             |
| Depreciation and amortization                                                                                                                              | 27,863      | 19,891      | 15,556      |
| Accruals related to various benefit plans, stock issuances, net<br>of forfeitures                                                                          | 174,652     | 109,505     | 118,276     |
| Deferred income taxes                                                                                                                                      | (6,269)     | (37,982)    | (23,475)    |
| Minority interest                                                                                                                                          | 7,891       | 6,969       | 6,875       |
| (Increase) decrease in cash and securities segregated and on<br>deposit for regulatory purposes or deposited with clearing and<br>depository organizations | (150,883)   | 120,862     | (75,640)    |
| (Increase) decrease in receivables:                                                                                                                        |             |             |             |
| Securities borrowed                                                                                                                                        | (6,710,158) | (1,568,414) | 2,089,418   |
| Brokers, dealers and clearing organizations                                                                                                                | (296,599)   | 149,026     | (92,263)    |
| Customers                                                                                                                                                  | (101,261)   | (186,651)   | (105,113)   |
| Increase in financial instruments owned                                                                                                                    | (788,715)   | (2,777,970) | (579,779)   |
| Increase in other investments                                                                                                                              | (35,955)    | (16,084)    | (12,160)    |
| Decrease (increase) in investments in managed funds                                                                                                        | 20,653      | (94,753)    | (82,134)    |
| Increase in securities purchased under agreements to resell                                                                                                | (3,146,118) | (226,176)   |             |
| Increase in other assets                                                                                                                                   | (21,559)    | (65,031)    | (34,020)    |
| Increase (decrease) in payables:                                                                                                                           |             |             |             |
| Securities loaned                                                                                                                                          | 920,290     | (934,990)   | (1,601,436) |
| Brokers, dealers and clearing organizations                                                                                                                | 282,117     | 347,797     | (58,856)    |
| Customers                                                                                                                                                  | 405,368     | 183,265     | 127,959     |
| (Decrease) increase in financial instruments sold, not yet<br>purchased                                                                                    | (336,498)   | 2,300,552   | 180,144     |
| Increase in securities sold under agreements to repurchase                                                                                                 | 9,232,724   | 2,092,838   |             |
| (Decrease) increase in accrued expenses and other liabilities                                                                                              | (51,785)    | 103,636     | 182,275     |
| Net cash (used in) provided by operating activities                                                                                                        | (429,577)   | (269,566)   | 213,070     |
| Cash flows from investing activities:                                                                                                                      |             |             |             |
| Decrease (increase) in short-term bond funds                                                                                                               |             | 7,037       | (176)       |
| Purchase of premises and equipment                                                                                                                         | (76,893)    | (39,342)    | (27,186)    |
| Business acquisitions, net of cash received                                                                                                                | (33,437)    |             | (53,030)    |
| Cash paid for contingent consideration                                                                                                                     | (25,720)    | (19,944)    | (8,925)     |
| Net cash flows used in investing activities                                                                                                                | (136,050)   | (52,249)    | (89,317)    |

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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES  
Consolidated Statements of Cash Flows (Continued)  
Three years ended December 31, 2007  
(Dollars in thousands)**

|                                                                                                    | <b>2007</b>  | <b>2006</b> | <b>2005</b> |
|----------------------------------------------------------------------------------------------------|--------------|-------------|-------------|
| Cash flows from financing activities:                                                              |              |             |             |
| Tax benefits from the issuance of stock-based awards                                               | 41,710       | 32,906      |             |
| Proceeds from reorganization of high yield secondary market trading                                | 361,735      |             |             |
| Redemptions and distributions related to our reorganization of high yield secondary market trading | (31,858)     |             |             |
| Repayment of long-term debt                                                                        | (100,000)    |             |             |
| Net proceeds from (payments on):                                                                   |              |             |             |
| Bank loans                                                                                         | 280,386      |             | (70,000)    |
| Issuance of senior notes                                                                           | 593,176      | 492,155     |             |
| Termination of interest rate swaps                                                                 | 8,452        |             |             |
| Issuance of mandatorily redeemable convertible preferred stock                                     |              | 125,000     |             |
| Minority interest holders of consolidated subsidiaries related to asset management activities      | 3,849        | (11,553)    | (5,467)     |
| Repurchase of treasury stock                                                                       | (147,809)    | (23,972)    | (76,291)    |
| Dividends                                                                                          | (64,754)     | (56,749)    | (31,645)    |
| Exercise of stock options, not including tax benefits                                              | 5,233        | 17,543      | 33,661      |
| Net cash provided by (used in) financing activities                                                | 950,120      | 575,330     | (149,742)   |
| Effect of foreign currency translation on cash and cash equivalents                                | 338          | 3,593       | (2,189)     |
| Net increase (decrease) in cash and cash equivalents                                               | 384,831      | 257,108     | (28,178)    |
| Cash and cash equivalents at beginning of year                                                     | 513,041      | 255,933     | 284,111     |
| Cash and cash equivalents at end of year                                                           | \$ 897,872   | \$ 513,041  | \$ 255,933  |
| Supplemental disclosures of cash flow information:                                                 |              |             |             |
| Cash paid during the year for:                                                                     |              |             |             |
| Interest                                                                                           | \$ 1,133,861 | \$ 492,179  | \$ 283,318  |
| Income taxes                                                                                       | 69,973       | 198,294     | 87,013      |
| Acquisitions:                                                                                      |              |             |             |
| Fair value of assets acquired, including goodwill                                                  | \$ 61,999    |             | \$ 95,118   |
| Liabilities assumed                                                                                | (6,150)      |             | (13,854)    |
| Stock issued                                                                                       | (22,412)     |             | (26,998)    |
| Cash paid for acquisition                                                                          | 33,437       |             | 54,266      |
| Cash acquired in acquisition                                                                       |              |             | 1,435       |
| Net cash paid for acquisition                                                                      | 33,437       |             | 52,831      |

Supplemental disclosure of non-cash financing activities:

|                                                                              |         |
|------------------------------------------------------------------------------|---------|
| Non-cash proceeds from reorganization of high yield secondary market trading | 230,169 |
|------------------------------------------------------------------------------|---------|

In 2005, the additional minimum pension liability included in stockholders' equity of \$6,125 resulted from a decrease of \$743 to accrued expenses and other liabilities and an offsetting increase in stockholders' equity. In 2006, the additional minimum pension liability included in stockholders' equity of \$2,910 resulted from a decrease of \$3,215 to accrued expenses and other liabilities and an offsetting increase in stockholders' equity. In 2007, the additional minimum pension liability included in stockholders' equity of \$1,827 resulted from a decrease of \$1,083 to accrued expenses and other liabilities and an offsetting increase in stockholders' equity.

See accompanying notes to Consolidated Financial Statements.

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AND SUBSIDIARIES  
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December 31, 2007 and 2006  
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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

**December 31, 2007 and 2006**

**(1) Organization and Summary of Significant Accounting Policies**

**Organization**

The accompanying audited 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 Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles for financial information and with the instructions to Form 10-K.

**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 taken as a whole. 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.

**Common Stock**

On April 18, 2006, we declared a 2-for-1 split of all outstanding shares of our common stock, payable May 15, 2006 to stockholders of record as of April 28, 2006. The stock split was effected as a stock dividend of one share for each one share outstanding on the record date. All share, share price and per share information included in this annual report, including the Consolidated Financial Statements and the notes thereto, have been restated to retroactively reflect the effect of the 2-for-1 stock split.

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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

**December 31, 2007 and 2006**

**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 Emerging Issues Task Force ( EITF ) 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.

***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 \$39.3 million, \$32.1 million and \$37.7 million for 2007, 2006 and 2005 respectively. We are accounting for the cost of these arrangements on an accrual basis. Our accounting for commission revenues includes the guidance contained in EITF 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) are carried at fair value 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 \$11.2 million, \$17.9 million and \$16.3 million for the years ended December 31, 2007, 2006 and 2005 respectively.



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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES  
Notes to Consolidated Financial Statements (Continued)  
December 31, 2007 and 2006**

*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 and expense. 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, long-term borrowings and our mandatorily redeemable convertible preferred stock 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***

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 other comprehensive income. Gains or losses resulting from foreign currency transactions are included in the principal transactions in the Consolidated Statements of Earnings.

***Financial Instruments Owned and Financial Instruments Sold, not yet Purchased and Fair Value***

Our financial instruments owned and financial instruments sold, not yet purchased are recorded at fair value, either through the fair value option election or as required by other accounting pronouncements. A description of our policies regarding fair value measurement and its application to these financial instruments follows. These instruments primarily represent our trading activities and include both cash and derivative products. Gains and losses on all of these instruments carried at fair value are reflected in principal transactions.

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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES  
Notes to Consolidated Financial Statements (Continued)  
December 31, 2007 and 2006**

*Definition of 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 a critical accounting policy. Unrealized gains or losses are generally recognized in principal transactions in our Consolidated Statements 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. Certain financial instruments have bid and ask prices that can be observed in the marketplace. Bid prices reflect the highest price that we and others are willing to pay for an asset. Ask prices represent the lowest price that we and others are willing to accept for an asset. For financial instruments whose inputs are based on bid-ask prices, we do not require that fair value always be a predetermined point in the bid-ask range. Our policy is to allow for mid-market pricing and adjusting to the point within the bid-ask range that meets our best estimate of fair value. For offsetting positions in the same financial instrument, the same price within the bid-ask spread is used to measure both the long and short positions.

*Fair Value Hierarchy*

We adopted FASB 157, *Fair Value Measurements* ( FASB 157 ), as of the beginning of 2007. FASB 157 defines fair value, establishes a framework for measuring fair value, establishes a fair value hierarchy based on the inputs used to measure fair value and enhances disclosure requirements for fair value measurements. FASB 157 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

- Level 1: Quoted prices are available in active markets for identical assets or liabilities as of the reported date. The type of financial instruments included in Level 1 are highly liquid cash instruments with quoted prices such as G-7 government, agency securities, listed equities and money market securities, as well as listed derivative instruments;
- Level 2: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these financial instruments include cash instruments for which quoted prices are available but traded less frequently, derivative instruments whose fair value have been derived using a model where inputs to the model are directly observable in the market, or can be derived principally from or corroborated by observable market data, and instruments that are fair valued using other financial instruments, the parameters of which can be directly observed. Instruments which are generally included in this category are corporate bonds, convertible bonds, municipal bonds and OTC derivatives;
- Level 3: Instruments that have little to no pricing observability as of the reported date. These financial instruments do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation. Instruments that are included in this category generally

include certain illiquid equity securities, commercial loans and loan commitments,  
investments, distressed debt, as well as certain highly structured OTC derivative contracts.

*Valuation Process for Financial Instruments*

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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES  
Notes to Consolidated Financial Statements (Continued)  
December 31, 2007 and 2006**

The overall valuation process for financial instruments may include adjustments to valuations derived from pricing models. These adjustments may be made when, in management's judgment, either the size of the position in the financial instrument or other features of the financial instrument such as its complexity, or the market in which the financial instrument is traded (such as counterparty, credit, concentration or liquidity) require that an adjustment be made to the value derived from the pricing models. An adjustment may be made if a trade of a financial instrument is subject to sales restrictions that would result in a price less than the computed fair value measurement from a quoted market price. Additionally, an adjustment from the price derived from a model typically reflects management's judgment that other participants in the market for the financial instrument being measured at fair value would also consider such an adjustment in pricing that same financial instrument.

*Valuation Models Used to Determine Fair Value*

Non-derivative financial assets and liabilities presented at fair value and categorized as Level 3 are generally those that are based on an assessment of each underlying investment, incorporating valuations that consider the evaluation of financing and sale transactions with third parties, expected cash flows models, market-based information, including comparable company transactions, performance multiples and changes in market outlook, among other factors. Derivative financial instruments are generally those that are marked-to-model using relevant empirical data to estimate fair value. The models' inputs reflect assumptions that market participants would use in pricing the instrument in a current period transaction and outcomes from the models represent an assumed exit price and expected future cash flows. Our valuation models are calibrated to the market on a frequent basis. The parameters and inputs are adjusted for assumptions about risk and current market conditions. Changes to inputs in valuation models are not necessarily changes to valuation methodologies; rather, the inputs are modified to reflect direct or indirect impacts on asset classes from changes in market conditions. Accordingly, results from valuation models in one period may not be indicative of future period measurements.

*Derivatives*

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 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 our derivative inventory, on a counterparty basis provided that all FIN 39 criteria are met.

Prior to the adoption of FASB 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, and therefore this change did not have a significant impact on our results of operations.

*Investments in Managed Funds*



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Investments in managed funds includes our investments in 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. Gains or losses on our investments in managed funds are included in asset management fees and investment income from managed funds in the Consolidated Statements of Earnings.

***Other Investments***

Other investments includes investments entered into where we exercise significant influence over operating and capital decisions in private equity and other operating entities in connection with our capital market activities. Other investments 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.

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***Securities Borrowed and Securities Loaned***

Due to their short-term nature, securities borrowed and securities loaned are carried at cost which approximates fair value. 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***

Due to their short-term nature, Securities purchased under agreements to resell and securities sold under agreements to repurchase ( repos ) are carried at cost which approximates fair value. Repos are treated as collateralized financing transactions and are recorded at their contracted repurchase amount which approximates fair value. We earn net interest revenues from this activity which is reflected in our Consolidated Statements of Operations.

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 the related leases or the estimated useful lives of the assets, whichever is shorter.

***Goodwill***

At least annually, we assess whether goodwill has been impaired by comparing the estimated fair value, calculated based on earnings and book value multiples, of each business segment with its estimated net book value, by estimating the amount of stockholders' equity required to support each business segment. Periodically estimating the fair value of a reporting unit requires significant judgment and often involves the use of significant estimates and assumptions. These estimates and assumptions could have a significant effect on whether or not an impairment charge is recorded and the magnitude of such a charge. We completed our last impairment test on goodwill as of September 30, 2007, and no impairment was identified.

Our Jefferies Execution subsidiary recorded a goodwill impairment charge of \$26 million during the fourth quarter of 2007. Jefferies Execution is a registered broker-dealer. Therefore, goodwill relating to the acquisition of Jefferies Execution in 2001, formerly Helfant Group, Inc., was pushed down from us to Jefferies Execution in accordance with Emerging Issues Task Force Issue No. D-97, *Push Down Accounting*.

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We have two reporting units, Capital Markets and Asset Management, as defined by FASB 142, *Goodwill and Other Intangible Assets*. Jefferies Execution is not a reporting unit of ours and we have not recorded this \$26 million goodwill impairment charge to our Consolidated Financial Statements.

***Income Taxes***

We file a consolidated U.S. Federal income tax return, which includes all of our qualifying subsidiaries. We also are subject to income tax in various states and municipalities and those foreign jurisdictions in which we operate. 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. The realization of deferred tax assets is assessed and a valuation allowance is recorded to the extent that it is more likely than not that any portion of the deferred tax asset will not be realized. 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 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***

Under FASB 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 fourth quarter of 2007, we undertook a comprehensive review of the retirement eligibility requirements of certain share-based awards, examining the impact to both us and our employees. Upon completion of this review during the fourth quarter of 2007, we determined that future share-based grants should contain more stringent provisions that include increased length of service requirements for





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certain senior level employees to be eligible to retire and retain the award. As a result of this comprehensive review, we reversed \$8.2 million of previously accrued compensation and benefits expense during the fourth quarter of 2007. The \$8.2 million reversal will be amortized over the subsequent three year period.

***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. We adopted FIN 48 as of the beginning of 2007. The transition adjustment to beginning retained earnings was a reduction of approximately \$0.4 million.

***FASB 157.*** In September 2006, the FASB issued FASB 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 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.

***FASB 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  
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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 as of December 31, 2006.

**FASB 159.** In February 2007, the FASB issued FASB 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 159 are elective; however, the amendment to FASB 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 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 fiscal years beginning after November 15, 2007, with early application permitted. The adoption of FSP FIN No. 39-1 on January 1, 2008 did not have a material impact on our Consolidated Financial Statements.

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**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 and FSP FIN No. 46R-7.** 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 May 2007, the FASB issued FSP FIN No. 46R-7, *Application of FIN 46R to Investment Companies* ( FSP FIN 46R-7 ). FSP FIN 46R-7 amends FIN 46R to make permanent the temporary deferral of the application of FIN 46R to entities within the scope of the revised Guide under SOP 07-1. FSP FIN 46R-7 is effective upon the adoption of SOP 07-1. In November, the FASB issued a proposed FSP SOP No. 07-1-a, *The Effective Date of AICPA Statement of Position 07-1*, which proposes to indefinitely defer the effective date for SOP 07-1 and, consequently, FSP FIN 46R-7. We are currently evaluating the potential impact of adopting SOP 07-1 and FSP FIN 46R-7 in light of the proposed FSP SOP No. 07-1-a.

**FASB 141(R).** In December 2007, the FASB issued FASB 141 (revised 2007), *Business Combinations* ( FASB 141R ). Under FASB 141R, an entity is required to recognize the assets acquired, liabilities assumed, contractual contingencies and contingent consideration measured at their fair value at the acquisition date for any business combination consummated after the effective date. It further requires that acquisition-related costs are to be recognized separately from the acquisition and expensed as incurred. This statement is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, we will adopt FASB 141R effective January 1, 2009.

**FASB 160.** In December 2007, the FASB issued FASB 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51* ( FASB 160 ). FASB 160 requires an entity to clearly identify and present ownership interests in subsidiaries held by parties other than the entity in the Consolidated Financial Statements within the equity section but separate from the entity's equity. It also requires the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income; changes in ownership interest be accounted for similarly, as equity transactions; and when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary and the gain or loss on the deconsolidation of the subsidiary be measured at fair value. This statement is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, we will adopt FASB 160 effective January 1, 2009. We are currently evaluating the impact of FASB 160 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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Period end assets under management by predominant asset strategy were as follows (in millions of dollars):

|                                               | <b>December<br/>31,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|-----------------------------------------------|----------------------------------|----------------------------------|
| Assets under management:                      |                                  |                                  |
| Fixed Income (1)                              | \$ 1,802                         | \$ 1,439                         |
| Equities                                      | 295                              | 475                              |
| Convertibles                                  | 2,872                            | 2,486                            |
|                                               | 4,969                            | 4,400                            |
| Assets under management by third parties (2): |                                  |                                  |
| Equities, Convertibles and Fixed Income       | 206                              | 282                              |
| Private Equity                                | 600                              | 600                              |
|                                               | 806                              | 882                              |
| Total                                         | \$ 5,775                         | \$ 5,282                         |

(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 \$447 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 from managed funds relating to funds managed by us and funds managed by third parties for the years ended December 31, 2007, 2006 and 2005 (in thousands of dollars):

|                                                | 2007                        | 2006       | 2005      |
|------------------------------------------------|-----------------------------|------------|-----------|
| Asset management fees:                         |                             |            |           |
| Fixed Income (1)                               | \$ 12,129                   | \$ 24,604  | \$ 19,556 |
| Equities                                       | 4,140                       | 16,366     | 15,415    |
| Convertibles                                   | 12,264                      | 12,256     | 7,516     |
| Real Assets                                    | <sup>3</sup> / <sub>4</sub> | 2,236      | 8,456     |
|                                                | 28,533                      | 55,462     | 50,943    |
| Investment income (loss) from managed funds(1) | (4,999)                     | 54,088     | 31,109    |
| Total                                          | \$ 23,534                   | \$ 109,550 | \$ 82,052 |

(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 as of April 2, 2007. For the years ended December 31, 2007, 2006 and 2005, asset management fees and investment income from



managed funds  
related to our  
high yield funds  
amounted to  
\$3.9 million,  
\$37.5 million  
and  
\$31.1 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 years ended December 31, 2007 and 2006 (in millions of dollars):

**Year Ended December 31, 2007**

|                  | Average<br>Investment<br>(2) | Investment<br>Income<br>(Loss)<br>from<br>Managed<br>Funds | Investment<br>Income 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) | \$ 241.1                     | \$ (10.0)                                                  | \$ 0.4                                                                             | \$ (10.4)                                                         |
| Equities         | 172.9                        | 3.8                                                        | 0.9                                                                                | 2.9                                                               |
| Convertibles     | 34.3                         | 1.2                                                        | $\frac{3}{4}$                                                                      | 1.2                                                               |
| Total            | \$ 448.3                     | \$ (5.0)                                                   | \$ 1.3                                                                             | \$ (6.3)                                                          |

(1) Excludes high yield secondary market trading activities for the nine month period ended December 31, 2007.

(2) Includes our average investment in consolidated asset management entities of \$112.3 million for which we are not recognizing asset management

fees. Because these entities are consolidated, the financial instruments are reflected in financial instruments owned or financial instruments sold, not yet purchased, in our Consolidated Financial Statements.

**Year Ended December 31, 2006**

|              |                              | Investment<br>Income<br>from<br>Managed<br>Funds | Investment<br>Income from<br>Managed<br>Funds -<br>Minority<br>Interest<br>Portion | Net<br>Investment<br>Income<br>from<br>Managed<br>Funds |
|--------------|------------------------------|--------------------------------------------------|------------------------------------------------------------------------------------|---------------------------------------------------------|
|              | Average<br>Investment<br>(3) |                                                  |                                                                                    |                                                         |
| Fixed Income | \$ 198.8                     | \$ 41.4                                          | \$ 6.9                                                                             | \$ 34.5                                                 |
| Equities     | 89.6                         | 10.5                                             | 0.2                                                                                | 10.3                                                    |
| Convertibles | 12.8                         | 1.5                                              | $\frac{3}{4}$                                                                      | 1.5                                                     |
| Real Assets  | 3.5                          | 0.7                                              | $\frac{3}{4}$                                                                      | 0.7                                                     |
| Total        | \$ 304.7                     | \$ 54.1                                          | \$ 7.1                                                                             | \$ 47.0                                                 |

(3) Includes our average investment in consolidated asset management entities of \$59.5 million and non-consolidated high yield funds of \$52.5 million for which we are not recognizing asset management fees. Because these

entities are  
consolidated, the  
financial  
instruments are  
reflected in  
financial  
instruments  
owned or  
financial  
instruments sold,  
not yet  
purchased, in our  
Consolidated  
Financial  
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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 December 31, 2007 and 2006 (in thousands of dollars):

|                                    | December 31,<br>2007 | December 31,<br>2006 |
|------------------------------------|----------------------|----------------------|
| Cash and cash equivalents:         |                      |                      |
| Cash in banks                      | \$ 248,174           | \$ 107,488           |
| Money market investments           | 649,698              | 405,553              |
| Total cash and cash equivalents    | 897,872              | 513,041              |
| Cash and securities segregated (1) | 659,219              | 508,303              |
| Other (2)                          | $\frac{3}{4}$        | 71,160               |
|                                    | \$ 1,557,091         | \$ 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 and are included in financial instruments owned.

**(4) Receivable from, and Payable to, Customers**

The following is a summary of the major categories of receivables from customers as of December 31, 2007 and 2006 (in thousands of dollars):

|                                                                                                | <b>2007</b>       | <b>2006</b>       |
|------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Customers (net of allowance for uncollectible accounts of \$1,493 in 2007 and \$1,402 in 2006) | \$ 754,472        | \$ 650,590        |
| Officers and directors                                                                         | 10,361            | 12,962            |
|                                                                                                | <b>\$ 764,833</b> | <b>\$ 663,552</b> |

Receivable from officers and directors represents standard margin loan balances arising from their individual security transactions. These transactions are subject to the same terms and conditions as customer transactions.

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AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****December 31, 2007 and 2006****(5) Financial Instruments Owned and Financial Instruments Sold, Not Yet Purchased**

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 December 31, 2007 and 2006 (in thousands of dollars):

|                                        | December 31, 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            | \$ 2,266,679                      | \$ 1,389,099                                              | \$ 1,737,174                      | \$ 1,835,046                                              |
| Corporate debt securities              | 2,162,893                         | 1,407,387                                                 | 1,918,829                         | 1,185,400                                                 |
| U.S. Government and agency obligations | 730,921                           | 206,090                                                   | 592,374                           | 339,891                                                   |
| Mortgage-backed securities             | 26,895                            | $\frac{3}{4}$                                             | 85,040                            | $\frac{3}{4}$                                             |
| Asset-backed securities                | $\frac{3}{4}$                     | $\frac{3}{4}$                                             | 28,009                            | $\frac{3}{4}$                                             |
| Derivatives                            | 501,502                           | 331,788                                                   | 234,646                           | 240,231                                                   |
| Investments at fair value              | 104,199                           | $\frac{3}{4}$                                             | 97,289                            | $\frac{3}{4}$                                             |
| Other                                  | 2,889                             | 314                                                       | 10,151                            | 301                                                       |
|                                        | \$ 5,795,978                      | \$ 3,334,678                                              | \$ 4,703,512                      | \$ 3,600,869                                              |

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 December 31, 2007 and 2006 (in thousands of dollars):

|                             | December 31,<br>2007 | December 31,<br>2006 |
|-----------------------------|----------------------|----------------------|
| Corporate equity securities | \$ 985,783           | \$ 1,068,498         |
| Corporate debt securities   | 102,123              | 412,600              |
|                             | \$ 1,087,906         | \$ 1,481,098         |

At December 31, 2007 and 2006, the approximate fair value of collateral received by us that may be sold or repledged by us was \$19.8 billion and \$9.8 billion, respectively. This collateral was received in connection with resale agreements and securities borrowings. At December 31, 2007 and 2006, a substantial portion of this collateral received by us had been sold or repledged.

**Table of Contents****JEFFERIES GROUP, INC.  
AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****December 31, 2007 and 2006**

The following is a summary of our financial assets and liabilities that are accounted for at fair value as of December 31, 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                                                            | \$ 2,122,640 | \$ 2,819,240 | \$ 248,397 | \$ ¾                                              | \$ 5,190,277 |
| Derivative instruments                                                | 763,529      | 118,905      | ¾          | (380,932)                                         | 501,502      |
| Investments at fair value                                             | ¾            | ¾            | 104,199    | ¾                                                 | 104,199      |
| Total financial instruments owned                                     | 2,886,169    | 2,938,145    | 352,596    | (380,932)                                         | 5,795,978    |
| Level 3 assets for which the firm does not bear economic exposure (1) |              |              | (106,106)  |                                                   |              |
| Level 3 assets for which the firm bears economic exposure             |              |              | 246,490    |                                                   |              |
| <b>Liabilities:</b>                                                   |              |              |            |                                                   |              |
| Financial instruments sold, not yet purchased:                        |              |              |            |                                                   |              |
| Securities                                                            | 1,425,789    | 1,568,398    | 8,703      | ¾                                                 | 3,002,890    |
| Derivative instruments                                                | 532,895      | 642,507      | 12,929     | (856,543)                                         | 331,788      |
| Total financial instruments sold, not yet purchased                   | 1,958,684    | 2,210,905    | 21,632     | (856,543)                                         | 3,334,678    |

(1) Consists of level 3 assets which are attributable to minority investors or attributable to employee interests in certain consolidated funds.

The following is a summary of changes in fair value of our financial assets and liabilities that have been classified as Level 3 for year ended December 31, 2007 (in thousands of dollars):

|                            | Non-derivative<br>instruments -<br>Assets | Non-derivative<br>instruments<br>Liabilities | Derivative<br>instruments<br>Liabilities | Investments         |
|----------------------------|-------------------------------------------|----------------------------------------------|------------------------------------------|---------------------|
| Balance, December 31, 2006 | \$ 205,278<br>(6,139)                     | \$ ¾<br>(46)                                 | \$ ¾<br>(22,962)                         | \$ 97,289<br>23,494 |



Total gains/ (losses) (realized and unrealized)

(1)

|                                              |          |         |          |                             |
|----------------------------------------------|----------|---------|----------|-----------------------------|
| Purchases, sales, settlements, and Issuances | (13,492) | (9,154) | 26,385   | (16,584)                    |
| Net transfers in and/or out of Level 3       | 62,750   | 497     | (16,352) | <sup>3</sup> / <sub>4</sub> |

|                            |    |         |    |         |    |          |    |         |
|----------------------------|----|---------|----|---------|----|----------|----|---------|
| Balance, December 31, 2007 | \$ | 248,397 | \$ | (8,703) | \$ | (12,929) | \$ | 104,199 |
|----------------------------|----|---------|----|---------|----|----------|----|---------|

Change in unrealized gains/ (losses) relating to instruments still held at December 31, 2007 (1)

|    |         |    |                             |    |         |    |        |
|----|---------|----|-----------------------------|----|---------|----|--------|
| \$ | (7,866) | \$ | <sup>3</sup> / <sub>4</sub> | \$ | (7,384) | \$ | 23,474 |
|----|---------|----|-----------------------------|----|---------|----|--------|

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

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**JEFFERIES GROUP, INC.  
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**Notes to Consolidated Financial Statements (Continued)**  
**December 31, 2007 and 2006**

**(6) Premises and Equipment**

The following is a summary of premises and equipment as of December 31, 2007 and 2006 (in thousands of dollars):

|                                                | <b>2007</b>    | <b>2006</b>   |
|------------------------------------------------|----------------|---------------|
| Furniture, fixtures and equipment              | \$ 189,376     | \$ 147,868    |
| Leasehold improvements                         | 109,895        | 81,923        |
| <br>Total                                      | <br>299,271    | <br>229,791   |
| Less accumulated depreciation and amortization | 157,799        | 138,416       |
|                                                | <br>\$ 141,472 | <br>\$ 91,375 |

Depreciation and amortization expense amounted to \$27,047,000, \$18,902,000 and \$14,705,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

**(7) Short-Term Borrowings**

Bank loans represent short-term borrowings that are payable on demand and generally bear interest at a spread over the federal funds rate. We had no outstanding secured bank loans as of December 31, 2007 and 2006. Unsecured bank loans are typically overnight loans used to finance securities owned or clearing related balances. We had \$280.4 million and \$0 of outstanding unsecured bank loans as of December 31, 2007 and 2006, respectively. Average daily bank loans for the years ended December 31, 2007 and 2006 were \$267.1 million and \$12.4 million, respectively.

**(8) Long-Term Debt**

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

|                                                                                  | 2007             | 2006             |
|----------------------------------------------------------------------------------|------------------|------------------|
| 7.75% Senior Notes, due 2012, net of unamortized discount of \$3,933 (2007)      | 328,594          | 328,003          |
| 5.875% Senior Notes, due 2014, net of unamortized discount of \$1,598 (2007)     | 248,402          | ¾                |
| 5.5% Senior Notes, due 2016, net of unamortized discount of \$1,499 (2007)       | 348,501          | 348,320          |
| 6.45% Senior Debentures, due 2027, net of unamortized discount of \$3,764 (2007) | 346,236          | ¾                |
| 6.25% Senior Debentures, due 2036, net of unamortized discount of \$7,666 (2007) | 492,334          | 492,239          |
|                                                                                  | <br>\$ 1,764,067 | <br>\$ 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 7.75% 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 \$500.0 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 \$600.0 million aggregate principal amount of our senior debt, consisting of \$250.0 million of 5.875% senior notes due June 8, 2014 and \$350.0 million of 6.45% senior debentures due June 8, 2027.

**(9) Mandatorily Redeemable Convertible Preferred Stock**

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AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****December 31, 2007 and 2006**

In February 2006, Massachusetts Mutual Life Insurance Company ( MassMutual ) purchased in a private placement \$125.0 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 4,082,538 shares of our common stock at an effective conversion price of approximately \$30.62 per share. The preferred stock is callable beginning in 2016 and will mature in 2036. As of December 31, 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.

**(10) Income Taxes**

Total income taxes for the years ended December 31, 2007, 2006 and 2005 were allocated as follows (in thousands of dollars):

|                                                                                                                                  | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|----------------------------------------------------------------------------------------------------------------------------------|-------------|-------------|-------------|
| Earnings                                                                                                                         | \$ 93,178   | \$ 137,541  | \$ 104,089  |
| Stockholders' equity, for compensation expense for tax purposes in excess of amounts recognized for financial reporting purposes | (41,710)    | (32,906)    | (26,918)    |
|                                                                                                                                  | \$ 51,468   | \$ 104,635  | \$ 77,171   |

Income taxes (benefits) for the years ended December 31, 2007, 2006 and 2005 consist of the following (in thousands of dollars):

|                  | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|------------------|-------------|-------------|-------------|
| <b>Current:</b>  |             |             |             |
| Federal          | \$ 78,715   | \$ 129,648  | \$ 95,341   |
| State and city   | 9,379       | 31,557      | 24,771      |
| Foreign          | 11,353      | 14,318      | 7,452       |
|                  | 99,447      | 175,523     | 127,564     |
| <b>Deferred:</b> |             |             |             |
| Federal          | (13,030)    | (29,414)    | (14,251)    |
| State and city   | 4,218       | (6,938)     | (6,344)     |
| Foreign          | 2,543       | (1,630)     | (2,880)     |
|                  | (6,269)     | (37,982)    | (23,475)    |
|                  | \$ 93,178   | \$ 137,541  | \$ 104,089  |

Income taxes differed from the amounts computed by applying the Federal income tax rate of 35% for 2007, 2006 and 2005 as a result of the following (in thousands of dollars):

| <b>2007</b>   |          | <b>2006</b>   |          | <b>2005</b>   |          |
|---------------|----------|---------------|----------|---------------|----------|
| <b>Amount</b> | <b>%</b> | <b>Amount</b> | <b>%</b> | <b>Amount</b> | <b>%</b> |

|                                                                |           |       |            |       |            |       |
|----------------------------------------------------------------|-----------|-------|------------|-------|------------|-------|
| Computed expected income taxes                                 | \$ 86,007 | 35.0% | \$ 122,029 | 35.0% | \$ 93,944  | 35.0% |
| Increase (decrease) in income taxes resulting from:            |           |       |            |       |            |       |
| State and city income taxes, net of Federal income tax benefit | 8,838     | 3.6   | 16,002     | 4.6   | 11,977     | 4.5   |
| Limited deductibility of meals and entertainment               | 1,801     | 0.7   | 1,972      | 0.5   | 1,634      | 0.6   |
| Minority interest, not subject to tax                          | (2,762)   | (1.1) | (2,439)    | (0.7) | (2,887)    | (1.1) |
| Foreign income                                                 | 2,593     | 1.1   | (143)      | (0.1) | (1,086)    | (0.4) |
| Other, net                                                     | (3,299)   | (1.4) | 120        | 0.1   | 507        | 0.2   |
| Total income taxes                                             | \$ 93,178 | 37.9% | \$ 137,541 | 39.4% | \$ 104,089 | 38.8% |

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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES**  
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**December 31, 2007 and 2006**

The following table presents a reconciliation of gross unrecognized tax benefits between January 1, 2007 and December 31, 2007 (in thousands of dollars):

|                                                     |          |
|-----------------------------------------------------|----------|
| Balance at January 1, 2007                          | \$ 5,114 |
| Additions for tax positions related to current year | 2,167    |
| Additions for tax positions related to prior year   | 2,839    |
| Reductions for tax positions related to prior year  | (153)    |
| Settlements                                         | (1,142)  |
| Balance at December 31, 2007                        | \$ 8,825 |

The total amount of unrecognized benefits that, if recognized, would affect the effective tax rate was \$5.7 million (net of federal benefit of state issues) at December 31, 2007. We recognize interest accrued related to unrecognized tax benefits in interest expense. Penalties, if any, are recognized in other general and administrative expenses. During the years ended December 31, 2007 and 2006, we recognized approximately \$1.0 million and \$0.3 million, respectively, in interest. We had approximately \$1.4 million and \$1.0 million for the payment of interest and penalties accrued at December 31, 2007, and 2006, respectively.

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 1999. 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. We do not expect that unrecognized tax benefits for tax positions taken with respect to 2007 and prior years will significantly change in 2008.

The cumulative tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at December 31, 2007 and 2006 are presented below (in thousands of dollars):

|                           | <b>2007</b> | <b>2006</b> |
|---------------------------|-------------|-------------|
| Deferred tax assets:      |             |             |
| Long-term compensation    | \$ 225,803  | \$ 195,079  |
| State income taxes        | 652         | 6,359       |
| Pension                   | 1,241       | 2,102       |
| Net operating loss        | 5,326       | 1,483       |
| Other                     | 2,417       | 5,415       |
| Sub-total                 | 235,439     | 210,438     |
| Valuation allowance       | (2,294)     | (1,483)     |
| Total deferred tax assets | \$ 233,145  | \$ 208,955  |
| Deferred tax liabilities: |             |             |
| Premises and equipment    | 2,467       | 2,787       |
| Goodwill amortization     | 18,480      | 13,917      |
| Investments               | 11,600      | 5,108       |
| Other                     | 4,041       | 2,906       |

|                                                  |            |            |
|--------------------------------------------------|------------|------------|
| Total deferred tax liabilities                   | \$ 36,588  | \$ 24,718  |
| Net deferred tax asset, included in other assets | \$ 196,557 | \$ 184,237 |

A valuation allowance of \$2.3 million and \$1.5 million was recorded at December 31, 2007 and 2006, respectively, and represents the portion of our deferred tax assets for which it is more likely than not that the benefit of such items will not be realized. Such valuation allowance increased by approximately \$0.8 million and \$1.5 million for the years ended December 31, 2007 and 2006, respectively. We believe it is more likely than not that we will realize our other deferred tax assets through future earnings.

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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

**December 31, 2007 and 2006**

As of December 31, 2007 we have net operating losses in certain foreign jurisdictions totaling approximately \$16.2 million. These losses begin to expire in the year 2013.

The current tax receivable, included in other assets, was \$37,267,000 and \$28,044,000 as of December 31, 2007 and 2006, respectively.

Withholding and U.S. taxes have not been provided on approximately \$66.0 million of unremitted earnings of certain non-U.S. subsidiaries because we reinvested these earnings permanently in such operations. Such earnings would become taxable upon the sale or liquidation of these non- U.S. subsidiaries or upon the remittance of dividends; however, management does not believe the related tax on such taxable amounts would be material.



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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Continued)**  
**December 31, 2007 and 2006**

**(11) Defined Benefit Plan*****Pension Plan***

We have a defined benefit pension plan which covers certain of our employees. The plan is subject to the provisions of the Employee Retirement Income Security Act of 1974. Benefits are based on years of service and the employee's career average pay. Our funding policy is to contribute to the plan at least the minimum amount that can be deducted for Federal income tax purposes. Differences in each year, if any, between expected and actual returns in excess of a 10% corridor (as defined in FASB 87, *Employers' Accounting for Pensions*) are amortized in net periodic pension calculations. Effective December 31, 2005, benefits under the pension plan have been frozen. Accordingly, there will be no further benefit accruals for future service after December 31, 2005.

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 in the 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.

The following tables set forth the plan's funded status and amounts recognized in our accompanying consolidated statements of financial condition and consolidated statements of earnings (in thousands of dollars):

|                                                           | <b>December 31</b> |             |
|-----------------------------------------------------------|--------------------|-------------|
|                                                           | <b>2007</b>        | <b>2006</b> |
| Accumulated benefit obligation                            | \$ 40,828          | \$ 42,892   |
| Projected benefit obligation for service rendered to date | \$ 40,828          | \$ 42,892   |
| Plan assets, at fair value                                | 41,634             | 39,484      |
| Funded status                                             | \$ 806             | \$ (3,408)  |
| Unrecognized net loss                                     | 3,068              | 5,013       |
| Prepaid benefit cost                                      | \$ 3,874           | \$ 1,605    |
| Adjustment to recognize minimum asset (liability)         | (3,068)            | (5,013)     |
| Pension asset (liability)                                 | \$ 806             | \$ (3,408)  |

|                                                     | <b>Year ended December 31</b> |             |             |
|-----------------------------------------------------|-------------------------------|-------------|-------------|
|                                                     | <b>2007</b>                   | <b>2006</b> | <b>2005</b> |
| Net pension cost included the following components: |                               |             |             |
| Service cost – benefits earned during the period    | \$ 275                        | \$ 275      | \$ 2,077    |
| Interest cost on projected benefit obligation       | 2,378                         | 2,361       | 2,551       |
| Expected return on plan assets                      | (2,923)                       | (2,514)     | (2,239)     |
| Net amortization                                    | $\frac{3}{4}$                 | 562         | 1,008       |
| Net periodic pension (income) cost                  | \$ (270)                      | \$ 684      | \$ 3,397    |



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**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Continued)**  
**December 31, 2007 and 2006**

|                                         | <b>Year ended December 31</b> |             |
|-----------------------------------------|-------------------------------|-------------|
|                                         | <b>2007</b>                   | <b>2006</b> |
| Fair value of assets, beginning of year | \$ 39,484                     | \$ 33,062   |
| Employer contributions                  | 2,000                         | 2,000       |
| Benefit payments made                   | (2,394)                       | (1,061)     |
| Administrative expenses paid            | (174)                         | (267)       |
| Total investment return                 | 2,718                         | 5,750       |
| Fair value of assets, end of year       | \$ 41,634                     | \$ 39,484   |

|                                                 | <b>Year ended December 31</b> |             |
|-------------------------------------------------|-------------------------------|-------------|
|                                                 | <b>2007</b>                   | <b>2006</b> |
| Projected benefit obligation, beginning of year | \$ 42,892                     | \$ 43,287   |
| Service cost                                    | 275                           | 275         |
| Interest cost                                   | 2,378                         | 2,361       |
| Actuarial gains and losses                      | (2,149)                       | (1,703)     |
| Administrative expenses paid                    | (174)                         | (267)       |
| Benefits paid                                   | (2,394)                       | (1,061)     |
| Projected benefit obligation, end of year       | \$ 40,828                     | \$ 42,892   |

The plan assets consist of approximately 56% equities, 41% fixed income and 3% other securities in 2007 versus approximately 60% equities and 40% fixed income in 2006. The target allocation of plan assets for 2008 is approximately 60% equities and 40% fixed income securities.

The weighted average discount rate and the rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation were 6.25% and 0.00%, respectively, in 2007, 5.90% and 0.00%, respectively, in 2006, and 5.55% and 4.00%, respectively, in 2005. The expected long-term rate of return on assets was 7.5% in 2007, 2006 and 2005.

The expected long-term rate of return assumption is based on an analysis of historical experience of the portfolio and the summation of prospective returns for each asset class in proportion to the fund's current asset allocation. The target asset allocation was determined based on the risk tolerance characteristics of the plan and, at times, may be adjusted to achieve the plan's investment objective and to minimize any concentration of investment risk.

We have contributed \$2.0 million to our pension plan during 2007. Effective December 31, 2005, benefits under the pension plan have been frozen. There will be no further benefit accruals for service after December 31, 2005. The amounts in accumulated other comprehensive income that have not yet been recognized as components of net periodic benefit cost include \$3,068,000 and \$5,013,000 as of December 31, 2007 and 2006, respectively.

During 2008, we do not expect to recognize an amortization of net loss as a component of net periodic benefit cost.

Expected benefit payments through December 31, 2017 are as follows (in thousands of dollars):

|      |          |
|------|----------|
| 2008 | \$ 1,967 |
| 2009 | 2,130    |
| 2010 | 3,126    |
| 2011 | 1,389    |

|                   |    |        |
|-------------------|----|--------|
| 2012              |    | 2,971  |
| 2013 through 2017 |    | 12,091 |
|                   | 75 |        |

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**JEFFERIES GROUP, INC.  
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December 31, 2007 and 2006**

**(12) Minority Interest**

Under FASB 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 \$607.6 million at December 31, 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 represents 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 \$253.3 million at December 31, 2007, resulting in minority interest related to JHYH on a consolidated basis of approximately \$354.3 million at December 31, 2007.

Minority interest also includes the minority equity holders' proportionate share of the equity of JSOP and JESOP. At December 31, 2007, minority interest related to JSOP and JESOP was approximately \$212.1 million and \$26.5 million, respectively.

At December 31, 2007, we had other minority interests of approximately \$10.8 million primarily related to our start-up asset management funds.

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**JEFFERIES GROUP, INC.  
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**December 31, 2007 and 2006**

**(13) Earnings per Share**

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the years 2007, 2006 and 2005 (in thousands, except per share amounts):

|                                                                          | <b>Year Ended December 31,</b> |             |               |
|--------------------------------------------------------------------------|--------------------------------|-------------|---------------|
|                                                                          | <b>2007</b>                    | <b>2006</b> | <b>2005</b>   |
| <b>Earnings:</b>                                                         |                                |             |               |
| Earnings before cumulative effect of change in accounting principle, net | \$ 144,665                     | \$ 204,144  | \$ 157,443    |
| Cumulative effect of change in accounting principle, net                 | $\frac{3}{4}$                  | 1,606       | $\frac{3}{4}$ |
| Net earnings                                                             | \$ 144,665                     | \$ 205,750  | \$ 157,443    |
| Add: Convertible preferred stock dividends                               | 4,063                          | 3,543       | $\frac{3}{4}$ |
| Net earnings for diluted earnings per share                              | \$ 148,728                     | \$ 209,293  | \$ 157,443    |
| <b>Shares:</b>                                                           |                                |             |               |
| Average shares used in basic computation                                 | 141,515                        | 133,898     | 123,646       |
| Stock options                                                            | 388                            | 1,251       | 2,747         |
| Mandatorily redeemable convertible preferred stock                       | 4,068                          | 3,521       | $\frac{3}{4}$ |
| Unvested restricted stock / restricted stock units                       | 7,836                          | 8,861       | 9,176         |
| Average shares used in diluted computation                               | 153,807                        | 147,531     | 135,569       |
| <b>Earnings per share:</b>                                               |                                |             |               |
| Basic-                                                                   |                                |             |               |
| Earnings before cumulative effect of change in accounting principle, net | \$ 1.02                        | \$ 1.53     | \$ 1.27       |
| Cumulative effect of change in accounting principle, net                 | $\frac{3}{4}$                  | 0.01        | $\frac{3}{4}$ |
| Net earnings                                                             | \$ 1.02                        | \$ 1.54     | \$ 1.27       |
| Diluted-                                                                 |                                |             |               |
| Earnings before cumulative effect of change in accounting principle, net | \$ 0.97                        | \$ 1.41     | \$ 1.16       |
| Cumulative effect of change in accounting principle, net                 | $\frac{3}{4}$                  | 0.01        | $\frac{3}{4}$ |
| Net earnings                                                             | \$ 0.97                        | \$ 1.42     | \$ 1.16       |

We had no anti-dilutive securities for purposes of the annual earnings per share computations in 2007, 2006 and 2005.



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**(14) Leases**

As lessee, we lease certain premises and equipment under noncancelable agreements expiring at various dates through 2022 which are operating leases. Future minimum lease payments for all noncancelable operating leases at December 31, 2007 are as follows (in thousands of dollars):

|            | <b>Gross</b> | <b>Sub-leases</b> | <b>Net</b> |
|------------|--------------|-------------------|------------|
| 2008       | \$ 47,494    | \$ 10,609         | \$ 36,885  |
| 2009       | 48,043       | 10,667            | 37,376     |
| 2010       | 45,841       | 10,427            | 35,414     |
| 2011       | 43,561       | 10,002            | 33,559     |
| 2012       | 37,500       | 6,716             | 30,784     |
| Thereafter | 149,947      | 14,704            | 135,243    |

Rental expense amounted to \$50,443,000, \$43,406,000 and \$34,959,000, in 2007, 2006 and 2005, respectively.

**(15) 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 Statements 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 Statements 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 3/4% 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 approximately \$1.9 million per year over the remaining life of the notes through March 2012.



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

| (in thousands)                                                                                                    | <b>December 31, 2007</b> |                    | <b>December 31, 2006</b> |                    |
|-------------------------------------------------------------------------------------------------------------------|--------------------------|--------------------|--------------------------|--------------------|
|                                                                                                                   | <b>Assets</b>            | <b>Liabilities</b> | <b>Assets</b>            | <b>Liabilities</b> |
| Derivative instruments included in financial instruments owned and financial instruments sold, not yet purchased: |                          |                    |                          |                    |
| Exchange traded futures                                                                                           | \$ 162,723               | \$ 4,712           | \$ 19,724                | \$ 2,116           |
| Swaps (1)                                                                                                         | 2,424                    | 417,020            | 173,821                  | 20,251             |
| Option contracts (1)                                                                                              | 355,119                  | 404,525            | 152,361                  | 238,115            |
| Forward contracts                                                                                                 | 3,348                    | 3,254              | 820                      |                    |
| <b>Total</b>                                                                                                      | <b>\$ 523,614</b>        | <b>\$ 829,511</b>  | <b>\$ 346,726</b>        | <b>\$ 260,482</b>  |

Derivative instruments included in other assets:

|                     |  |  |       |   |
|---------------------|--|--|-------|---|
| Interest rate swaps |  |  | 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. At December 31, 2007, collateral received and collateral pledged were \$22.1 million and

\$497.7 million, respectively. At December 31, 2006, collateral received and collateral pledged were \$112.1 million and \$20.3 million, respectively.

The following table set forth the fair value of OTC derivative assets and liabilities by contract type as of December 31, 2007:

| (in millions)        | 0 12<br>Months | 1 5<br>Years | 5 10<br>Years | Total      |
|----------------------|----------------|--------------|---------------|------------|
| Commodity swaps      | \$ (405.7)     | \$ (1.5)     | \$            | \$ (407.2) |
| Commodity options    | (20.1)         | (66.2)       |               | (86.3)     |
| Equity options       | (10.6)         | (23.3)       |               | (33.9)     |
| Credit default swaps | (0.4)          | 2.4          |               | 2.0        |
| Total return swaps   | (9.4)          |              |               | (9.4)      |
| Forward contracts    | (0.3)          | 0.5          |               | 0.2        |
| Total                | \$ (446.5)     | \$ (88.1)    | \$            | \$ (534.6) |

At December 31, 2007, the counterparty credit quality with respect to the fair value of our OTC derivatives was as follows:

| (in millions)                | December 31,<br>2007 |
|------------------------------|----------------------|
| Counterparty credit quality: |                      |
| A or higher                  | \$ (491.4)           |
| B to BBB                     | (22.4)               |
| Lower than B                 |                      |
| Unrated                      | (20.8)               |
| Total                        | \$ (534.6)           |

Table of Contents**JEFFERIES GROUP, INC.  
AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****December 31, 2007 and 2006*****Jefferies Financial Products, LLC***

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 highly rated 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 \$(407.2) million and \$(84.0) million, respectively at December 31, 2007 and \$156.1 million and \$(125.4) million, respectively at December 31, 2006.

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 December 31, 2007:

| (in millions)           | 0 12<br>Months | 1 5<br>Years | 5 10<br>Years | Total      |
|-------------------------|----------------|--------------|---------------|------------|
| Swaps                   | \$ (405.7)     | \$ (1.5)     | \$            | \$ (407.2) |
| Options                 | (16.3)         | (67.7)       |               | (84.0)     |
| FX forwards             | 0.6            | 0.5          |               | 1.1        |
| Exchange-traded futures | 296.4          | (133.9)      |               | 162.5      |
| Total                   | \$ (125.0)     | \$ (202.6)   | \$            | \$ (327.6) |

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.



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

|                                         | <b>Fair Value</b>       |                         |
|-----------------------------------------|-------------------------|-------------------------|
|                                         | December<br>31,<br>2007 | December<br>31,<br>2006 |
| (in millions)                           |                         |                         |
| Counterparty credit quality:            |                         |                         |
| A or higher                             | \$ (494.4)              | \$ 37.5                 |
| Exchange-traded futures and options (1) | 166.8                   | 13.4                    |
| Total                                   | \$ (327.6)              | \$ 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.

At December 31, 2007 and 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:

|                                                                                                               | <b>Fair Value</b>       |                         |
|---------------------------------------------------------------------------------------------------------------|-------------------------|-------------------------|
|                                                                                                               | December<br>31,<br>2007 | December<br>31,<br>2006 |
| (in millions)                                                                                                 |                         |                         |
| Foundations, trusts and endowments                                                                            | \$ (47.8)               | \$ (6.4)                |
| Financial services                                                                                            | (223.8)                 | 4.7                     |
| Sovereign entity                                                                                              | (32.5)                  |                         |
| Collective investment vehicles (including pension plans, mutual funds and other institutional counterparties) | (190.3)                 | 39.2                    |
| Exchanges (1)                                                                                                 | 166.8                   | 13.4                    |
| Total                                                                                                         | \$ (327.6)              | \$ 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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The following summarizes other comprehensive income and accumulated other comprehensive income (loss) at December 31, 2007 and for the year then ended (in thousands of dollars):

|                                      | <b>Before-Tax<br/>Amount</b> | <b>Income<br/>Tax<br/>or Benefit</b> | <b>Net-of-Tax<br/>Amount</b> |
|--------------------------------------|------------------------------|--------------------------------------|------------------------------|
| Currency translation adjustments     | \$ 1,222                     | \$                                   | \$ 1,222                     |
| Minimum pension liability adjustment | 1,945                        | (862)                                | 1,083                        |
| Other comprehensive income           | \$ 3,167                     | \$ (862)                             | \$ 2,305                     |

|                   | <b>Currency<br/>Translation<br/>Adjustments</b> | <b>Minimum<br/>Pension<br/>Liability<br/>Adjustment</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss)</b> |
|-------------------|-------------------------------------------------|---------------------------------------------------------|----------------------------------------------------------------------|
| Beginning balance | \$ 9,764                                        | \$ (2,910)                                              | \$ 6,854                                                             |
| Change in 2007    | 1,222                                           | 1,083                                                   | 2,305                                                                |
| Ending balance    | \$ 10,986                                       | \$ (1,827)                                              | \$ 9,159                                                             |

The following summarizes other comprehensive income and accumulated other comprehensive income (loss) at December 31, 2006 and for the year then ended (in thousands of dollars):

|                                      | <b>Before-Tax<br/>Amount</b> | <b>Income<br/>Tax<br/>or Benefit</b> | <b>Net-of-Tax<br/>Amount</b> |
|--------------------------------------|------------------------------|--------------------------------------|------------------------------|
| Currency translation adjustments     | \$ 8,802                     | \$                                   | \$ 8,802                     |
| Minimum pension liability adjustment | 5,502                        | (2,287)                              | 3,215                        |
| Other comprehensive income           | \$ 14,304                    | \$ (2,287)                           | \$ 12,017                    |

|                   | <b>Currency<br/>Translation<br/>Adjustments</b> | <b>Minimum<br/>Pension<br/>Liability<br/>Adjustment</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss)</b> |
|-------------------|-------------------------------------------------|---------------------------------------------------------|----------------------------------------------------------------------|
| Beginning balance | \$ 962                                          | \$ (6,125)                                              | \$ (5,163)                                                           |
| Change in 2006    | 8,802                                           | 3,215                                                   | 12,017                                                               |
| Ending balance    | \$ 9,764                                        | \$ (2,910)                                              | \$ 6,854                                                             |

The following summarizes other comprehensive loss and accumulated other comprehensive income (loss) at December 31, 2005 and for the year then ended (in thousands of dollars):

|                                      | <b>Before-Tax<br/>Amount</b> | <b>Income<br/>Tax<br/>or Benefit</b> | <b>Net-of-Tax<br/>Amount</b> |
|--------------------------------------|------------------------------|--------------------------------------|------------------------------|
| Currency translation adjustments     | \$ (8,386)                   | \$                                   | \$ (8,386)                   |
| Minimum pension liability adjustment | 1,276                        | (533)                                | 743                          |
| Other comprehensive loss             | \$ (7,110)                   | \$ (533)                             | \$ (7,643)                   |



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|                   | Currency<br>Translation<br><br>Adjustments | Minimum<br>Pension<br>Liability<br><br>Adjustment | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) |
|-------------------|--------------------------------------------|---------------------------------------------------|-----------------------------------------------------------|
| Beginning balance | \$ 9,348                                   | \$ (6,868)                                        | \$ 2,480                                                  |
| Change in 2005    | (8,386)                                    | 743                                               | (7,643)                                                   |
| Ending balance    | \$ 962                                     | \$ (6,125)                                        | \$ (5,163)                                                |

**(17) 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.

As of December 31, 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                    | \$505,080   | \$ 483,108            |
| Jefferies Execution          | \$ 30,297   | \$ 30,047             |
| Jefferies High Yield Trading | \$558,087   | \$ 557,837            |

**(18) Commitments and Guarantees**

The following table summarizes other commitments and guarantees at December 31, 2007:

|                               | Notional /<br>Maximum<br>Payout | 2008    | 2009  | Maturity Date<br>2010<br>and<br>2011<br>(Dollars in Millions) | 2012<br>and<br>2013 | 2014<br>and<br>Later |
|-------------------------------|---------------------------------|---------|-------|---------------------------------------------------------------|---------------------|----------------------|
| Standby letters of credit     | \$308.0                         | \$307.7 | \$0.1 | \$0.2                                                         |                     |                      |
| Bank credit                   | \$ 60.5                         | \$ 20.0 |       |                                                               | \$36.0              | \$ 4.5               |
| Equity commitments            | \$500.1                         |         | \$0.1 | \$0.9                                                         | \$ 2.1              | \$497.0              |
| High yield loan<br>commitment | \$ 5.0                          |         |       | \$5.0                                                         |                     |                      |
| Derivative contracts          | \$397.5                         | \$392.5 |       |                                                               | \$ 5.0              |                      |

**Standby Letters of Credit.** In the normal course of business, we had letters of credit outstanding aggregating \$308.0 million at December 31, 2007, mostly to satisfy various collateral requirements in lieu of depositing cash or securities. These letters of credit have a minimal carrying amount. As of December 31, 2007, there were no draw

downs on these letters of credit.

**Bank Credit.** As of December 31, 2007, we had outstanding guarantees of \$56.0 million relating to bank credit obligations (\$33.2 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 \$4.5 million) to Jefferies (Japan) Limited.

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**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 total committed equity capitalization of Jefferies Finance LLC is \$500 million as of December 31, 2007. 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 December 31, 2007, we have funded \$55.0 million of our aggregate \$250.0 million commitment leaving \$195.0 million unfunded.

As of December 31, 2007, we have an aggregate capital commitment to invest in Babson-Jefferies Loan Opportunity CLO, Ltd. of approximately \$18.0 million (see note 21 of the Notes to Consolidated Financial Statements for more information related to our commitment to invest in Babson-Jefferies Loan Opportunity CLO, Ltd.).

As of December 31, 2007, we have an aggregate commitment to invest in Jefferies Capital Partners IV L.P. and its related parallel fund of approximately \$25.9 million, a private equity fund managed by a team led by Messrs. Friedman and Luikart.

As of December 31, 2007, we have funded approximately \$350.0 million of our aggregate commitment in JHYH leaving approximately \$250.0 million unfunded (see note 22 of the Notes to Consolidated Financial Statements for more information related to our commitment to invest in JHYH).

As of December 31, 2007, we had other equity commitments to invest up to \$11.2 million in various other investments.

**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 December 31, 2007, the maximum payout value of derivative contracts deemed to meet the FIN 45 definition of a guarantee was approximately \$397.5 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 December 31, 2007, the fair value of such derivative contracts approximated \$13.6 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. As of December 31, 2007 we had \$5.0 million of high yield loan commitments outstanding.

**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.



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**JEFFERIES GROUP, INC.  
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**December 31, 2007 and 2006**

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.

**(19) Segment Reporting**

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 a number of interrelated divisions. 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>Eliminating<br/>Items</b> | <b>Total</b> |
|----------------------------------------------|----------------------------|-----------------------------|------------------------------|--------------|
| <b>Twelve months ended December 31, 2007</b> |                            |                             |                              |              |
| Net revenues                                 | \$ 1,547.5                 | \$ 20.6                     | \$                           | \$ 1,568.1   |
| Expenses                                     | 1,301.7(1)                 | 46.7                        | (26.0)(1)                    | 1,322.4      |
| Income before taxes                          | \$ 245.8                   | \$ (26.1)                   | \$ 26.0                      | \$ 245.7     |
| Segment assets                               | \$ 29,417.2                | \$ 350.6                    | \$ 26.0(1)                   | \$ 29,793.8  |
| <b>Twelve months ended December 31, 2006</b> |                            |                             |                              |              |
| Net revenues                                 | \$ 1,389.5                 | \$ 68.1                     | \$                           | \$ 1,457.6   |
| Expenses                                     | 1,059.6                    | 49.3                        |                              | 1,108.9      |
| Income before taxes                          | \$ 329.9                   | \$ 18.8                     | \$                           | \$ 348.7     |
| Segment assets                               | \$ 17,676.9                | \$ 148.6                    | \$                           | \$ 17,825.5  |
| <b>Twelve months ended December 31, 2005</b> |                            |                             |                              |              |
| Net revenues                                 | \$ 1,156.1                 | \$ 48.6                     | \$                           | \$ 1,204.7   |
| Expenses                                     | 904.4                      | 31.9                        |                              | 936.3        |
| Income before taxes                          | \$ 251.7                   | \$ 16.7                     | \$                           | \$ 268.4     |
| Segment assets                               | \$ 12,762.2                | \$ 18.7                     | \$                           | \$ 12,780.9  |

(1) Our Jefferies Execution subsidiary recorded a goodwill impairment charge of \$26 million during the fourth quarter of

2007. Jefferies Execution is a registered broker-dealer. Therefore, goodwill relating to the acquisition of Jefferies Execution in 2001, formerly Helfant Group, Inc., was pushed down from us to Jefferies Execution in accordance with Emerging Issues Task Force Issue No. D-97, *Push Down Accounting*.

Jefferies Execution is not one of our reporting units as defined by FASB 142, *Goodwill and Other Intangible Assets* and therefore we have not recorded this \$26 million goodwill impairment charge to our Consolidated Financial Statements.

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**December 31, 2007 and 2006**

***Net Revenues by Geographic Region***

Net revenues are recorded in the geographic region in which the senior coverage banker is located in the case of investment banking, or where the position was risk-managed within Capital Markets or the location of the investment advisor in the case of Asset Management. In addition, certain revenues associated with U.S. financial instruments and services that result from relationships with non-U.S. clients have been classified as non-U.S. revenues using an allocation consistent with our internal reporting. The following table presents net revenues by geographic region for the years ended December 31, 2007, 2006 and 2005 (amounts in thousands):

|                              | <b>2007</b>  | <b>2006</b>  | <b>2005</b>  |
|------------------------------|--------------|--------------|--------------|
| Americas (1)                 | \$ 1,357,991 | \$ 1,333,745 | \$ 1,140,991 |
| Europe                       | 194,034      | 117,524      | 51,530       |
| Asia (including Middle East) | 16,065       | 6,333        | 12,179       |
| Net Revenues                 | \$ 1,568,090 | \$ 1,457,602 | \$ 1,204,700 |

(1) Substantially all relates to U.S. results.

**(20) 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.

The following is a summary of goodwill activity for the year ended December 31, 2007 (in thousands of dollars):

|                                       | Year Ended<br>December 31,<br>2007 |
|---------------------------------------|------------------------------------|
| Balance, at December 31, 2006         | \$ 257,321                         |
| Add: Acquisition(s)                   | 44,235                             |
| Add: Accrued contingent consideration | 42,507                             |
| Balance, at December 31, 2007         | \$ 344,063                         |

The acquisitions of LongAcre Partners Limited, Helix Associates, Randall & Dewey, and Quarterdeck Investment Partners, LLC (expired December 31, 2007) 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 year ended December 31, 2007, we paid approximately \$25.7 million in cash related to contingent consideration that had been earned during the current year 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.





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**(21) 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> Quarter | 2 <sup>nd</sup> Quarter | 3 <sup>rd</sup> Quarter | 4 <sup>th</sup> Quarter |
|------|-------------------------|-------------------------|-------------------------|-------------------------|
| 2007 | \$0.125                 | \$0.125                 | \$0.125                 | \$0.125                 |
| 2006 | \$0.075                 | \$0.125                 | \$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.

**(22) Variable Interest Entities ( VIEs )***Jefferies High Yield Holdings*

Under the provisions of FIN 46(R) we determined that Jefferies High Yield Holdings and Jefferies Employees Special Opportunities Partners 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.

*Managed CLO s*

We also own significant variable interests in various managed CLO s and for which are 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 December 31, 2007. Our exposure to loss is limited to our capital contributions. The carrying value of our aggregate investment in these variable interest entities is \$16.7 million at December 31, 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 and a 17% indirect economic interest via Jefferies Finance LLC which we are not the primary beneficiary and therefore do not consolidate this entity. This variable interest entity has assets of approximately \$461.9 million as of December 31, 2007. The fair value of our direct and indirect interest in this variable interest entity is \$49.2 million (\$32.8 million direct interest and \$16.4 million indirect interest) at December 31, 2007. The investment in this entity is accounted for at fair value in accordance with FASB 157.

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**(23) 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 \$1.2 billion as of December 31, 2007. JHYH's net revenue and formula-determined non-interest expenses for the nine month period ended December 31, 2007 (April 2, 2007, date of commencement, to December 31, 2007) amounted to \$44.7 million and \$30.3 million, respectively. These formula-determined non-interest expenses do not necessarily reflect the actual expenses of operating JHYH.

**(24) Jefferies Finance LLC**

On October 7, 2004, we entered into an agreement with Babson Capital and MassMutual to form Jefferies Finance LLC ( JFIN ), a joint venture entity created for the purpose of offering senior loans to middle market and growth companies. JFIN is a commercial finance company that provides a broad array of financial products to small and medium-sized businesses. JFIN's primary focus is the origination and syndication of senior secured debt in the form of term and revolving loans. JFIN can also originate various other debt products such as second lien term, bridge and mezzanine loans as well as related equity co-investments. JFIN also purchases syndicated loans in the secondary market, including loans that are performing, stressed and distressed loan obligations.

In February 2006, we and MassMutual reached an agreement to double our equity commitments to JFIN. With an incremental \$125 million from each partner, the new total committed equity capitalization of JFIN 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 December 31, 2007, we have funded \$55.0 million of our aggregate \$250.0 million commitment leaving \$195.0 million unfunded. Our investment

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in JFIN is accounted for under the equity method of accounting and is included in other investments in the Consolidated Statements of Financial Condition. Equity method gains and losses on JFIN are included in principal transactions in the Consolidated Statements of Earnings.

The following is a summary of selected financial information for JFIN as of and for each of the years in the three-year period ended December 31, 2007 (in millions):

|                                 | 2007      | 2006    | 2005    |
|---------------------------------|-----------|---------|---------|
| Balance Sheet                   |           |         |         |
| Total assets                    | \$1,007.5 | \$309.9 | \$139.7 |
| Total liabilities               | 884.1     | 253.4   | 115.4   |
| Total equity                    | 123.4     | 56.5    | 24.3    |
| Jefferies share of total equity | 61.7      | 28.2    | 12.1    |

**(25) Stock-based Compensation**

We sponsor the following non-share based employee incentive plans:

*Employee Stock Ownership Plan.* We have an Employee Stock Ownership Plan ( ESOP ) which was established in 1988. We had no contributions and no compensation cost related to the ESOP in 2007, 2006 and 2005.

*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 \$8,876,000, \$3,774,000, and \$3,230,000 in 2007, 2006 and 2005, respectively.

We sponsor the following share based employee incentive plans:

*Incentive Compensation Plan.* 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.

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 several 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 (which are similar to restricted stock units). These grants are made automatically on the date directors are elected or reelected at our

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annual shareholders meeting. These grants vest three years after the date of grant and are expensed over the requisite service 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.

A total of 2,000,000 shares of our common stock is reserved under the Directors Plan.

*Employee Stock Purchase Plan.* We also have an Employee Stock Purchase Plan ( ESPP ) which we consider non-compensatory effective January 1, 2007. 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).

The compensation cost related to these plans was \$0, \$1,604,000 and \$1,800,000 in 2007, 2006 and 2005, respectively.

*Deferred Compensation Plan.* We also have a Deferred Compensation Plan which was established in 2001. In 2007, 2006 and 2005, employees with annual compensation of \$200,000 or more were eligible to defer compensation by investing it in the Company's common stock ( DCP shares ), stock options (prior to 2004) or other alternatives on a pre-tax basis. The compensation deferred by our employees is expensed in the period earned. The Company's common stock can be invested in at a 10% discount through the Deferred Compensation Plan. The Company recognizes additional compensation cost related to this discount. This compensation cost was \$1,457,000, \$1,449,000 and \$1,329,000 for the years ended December 31, 2007, 2006 and 2005, respectively. A total of 16,000,000 shares of our common stock is reserved under the Deferred Compensation Plan. As of December 31, 2007, there were 6,011,000 DCP shares outstanding under the Plan.

The following table details the activity of DCP shares:

|                            | <b>Year Ended December 31,</b> |             |                  |
|----------------------------|--------------------------------|-------------|------------------|
|                            | <b>2007</b>                    | <b>2006</b> | <b>2005</b>      |
|                            |                                |             | (Shares in 000s) |
| <b>DCP deferred shares</b> |                                |             |                  |
| Balance, beginning of year | 6,730                          | 7,356       | 6,810            |
| Credits                    | 673                            | 717         | 552              |
| Withdrawals                | (1,392)                        | (1,343)     | (6)              |
| Balance, end of year       | 6,011                          | 6,730       | 7,356            |

***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



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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 \$41.7 million and \$32.9 million related to share based compensation in cash flows from financing activities in the years ended December 31, 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 common stock less the impact of selling restrictions subsequent to vesting, if any, and is amortized as compensation expense on a straight-line basis over the related requisite service periods, which are generally five years. As of December 31, 2007, there was \$313.3 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 3.7 years. The unrecognized compensation cost related to nonvested share based awards was recorded as unearned compensation in stockholders' equity at December 31, 2005. As part of the adoption of FASB 123R, the additional paid-in capital was reduced by the amount of unrecognized compensation cost related to nonvested share based awards granted prior to January 1, 2006.

The total compensation cost of all share based awards, including awards under the Deferred Compensation Plan, was \$145.8 million, \$86.2 million and \$82.9 million for the years ended December 31, 2007, 2006 and 2005, 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.

During the year ended December 31, 2007, we granted stock-based awards with a fair value of \$9.2 million, which was accrued in the year prior to the grant date.

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AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****December 31, 2007 and 2006*****Restricted Stock and Restricted Stock Units ( Share Based Awards )***

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

|                                     | <b>Year Ended December 31,</b> |             |             |
|-------------------------------------|--------------------------------|-------------|-------------|
|                                     | <b>2007</b>                    | <b>2006</b> | <b>2005</b> |
|                                     | (Shares in 000s)               |             |             |
| <b>Restricted stock</b>             |                                |             |             |
| Balance, beginning of year          | 4,336                          | 7,358       | 10,541      |
| Grants                              | 5,417                          | 395         | 2,597       |
| Forfeited                           | (476)                          | (836)       | (620)       |
| RSU conversion                      |                                |             | (3,112)     |
| Vested                              | (1,960)                        | (2,581)     | (2,048)     |
| Balance, end of year                | 7,317                          | 4,336       | 7,358       |
| <b>Restricted stock units (RSU)</b> |                                |             |             |
| Balance, beginning of year          | 28,718                         | 24,662      | 12,058      |
| Grants, includes dividends          | 5,723                          | 4,403       | 9,477       |
| Restricted stock conversion         |                                |             | 3,112       |
| Deferral expiration                 | (2,060)                        | (669)       | (536)       |
| Forfeited                           | (862)                          | (365)       | (118)       |
| Deferral of option gains            | 606                            | 687         | 669         |
| Balance, end of year                | 32,125                         | 28,718      | 24,662      |

|                            | <b>Year Ended<br/>December<br/>31, 2007</b> | <b>Weighted<br/>Average Grant<br/>Date Fair<br/>Value</b> |
|----------------------------|---------------------------------------------|-----------------------------------------------------------|
|                            | (Shares in 000s)                            |                                                           |
| <b>Restricted stock</b>    |                                             |                                                           |
| Balance, beginning of year | 4,336                                       | \$ 18.54                                                  |
| Grants                     | 5,417                                       | \$ 28.06                                                  |
| Forfeited                  | (476)                                       | \$ 25.03                                                  |
| Vested                     | (1,960)                                     | \$ 18.09                                                  |
| Balance, end of period     | 7,317                                       | \$ 25.34                                                  |



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|                                          | <b>Year Ended<br/>December 31, 2007</b><br>(Shares in 000s) |                                      | <b>Weighted<br/>Average Grant<br/>Date Fair Value</b> |                                  |
|------------------------------------------|-------------------------------------------------------------|--------------------------------------|-------------------------------------------------------|----------------------------------|
|                                          | Future<br>Service<br>Required                               | No Future<br>Service<br>Required (2) | Future<br>Service<br>Required                         | No Future<br>Service<br>Required |
| <b>Restricted stock units</b>            |                                                             |                                      |                                                       |                                  |
| Balance, beginning of year               | 14,813                                                      | 13,905                               | \$ 19.18                                              | \$ 8.33                          |
| Grants, includes dividends               | 5,198                                                       | 525(1)                               | \$ 24.12                                              | \$ (1)                           |
| Deferral expiration                      |                                                             | (2,060)                              | \$                                                    | \$ 12.78                         |
| Forfeited                                | (503)                                                       | (359)                                | \$ 21.10                                              | \$ 18.57                         |
| Vested                                   | (4,629)                                                     | 4,629                                | \$ 18.22                                              | \$ 18.22                         |
| Grants related to stock option exercises |                                                             | 606                                  | \$                                                    | \$ 11.35                         |
| Balance, end of period                   | 14,879                                                      | 17,246                               | \$ 21.18                                              | \$ 10.18                         |

(1) Represents dividend equivalents on restricted stock units declared during the twelve month period ending December 31, 2007.

(2) Represents fully vested restricted stock units which are still subject to transferability restrictions.

The compensation cost associated with restricted stock and restricted stock units amounted to \$144,382,000, \$83,137,000, and \$79,762,000 in 2007, 2006, and 2005, respectively. The average fair value of the vested awards during 2007 was approximately \$27.25 per share. The conversion of restricted stock into restricted stock units in 2005 did not impact compensation expenses because such conversion is a result of employee deferral elections under Section 409A of the Internal Revenue Code.

***Stock Options***

The fair value of all option grants 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 during 2007, 2006 or 2005. A summary of our stock option activity for the years ended December 31, 2007, 2006 and 2005 is presented below (shares in thousands):

|                                  | <b>2007</b>   |                                                    | <b>2006</b>   |                                                    | <b>2005</b>   |                                                    |
|----------------------------------|---------------|----------------------------------------------------|---------------|----------------------------------------------------|---------------|----------------------------------------------------|
|                                  | <b>Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> |
| Outstanding at beginning of year | 1,688         | \$ 11.02                                           | 4,533         | \$ 9.75                                            | 9,782         | \$ 8.87                                            |
| Granted                          |               |                                                    |               |                                                    |               |                                                    |
| Exercised                        | (1,484)       | 11.18                                              | (2,826)       | 8.98                                               | (4,988)       | 8.23                                               |
| Canceled                         |               |                                                    | (19)          | 11.53                                              | (261)         | 5.99                                               |
| Outstanding at end of year       | 204           | 9.87                                               | 1,688         | 11.02                                              | 4,533         | 9.75                                               |
| Options exercisable at year-end  | 204           | 9.87                                               | 1,688         | 11.02                                              | 4,533         | 9.75                                               |

The total intrinsic value of stock options exercised during 2007, 2006 and 2005 was \$8.2 million, \$51.9 million and \$46.2 million, respectively. Cash received from the exercise of stock options during 2007, 2006 and 2005 totaled \$5.2 million, \$17.5 million and \$33.7 million, respectively, and the tax benefit realized from stock options exercised during 2007, 2006 and 2005 was \$3.3 million, \$18.1 million and \$18.3 million, respectively.

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The table below provides additional information related to stock options outstanding at December 31, 2007:

Dollars and shares in thousands, except per share data

|                                                       | <b>Outstanding<br/>Net of<br/>Expected<br/>Forfeitures</b> | <b>Options<br/>Exercisable</b> |
|-------------------------------------------------------|------------------------------------------------------------|--------------------------------|
| <b>December 31, 2007</b>                              |                                                            |                                |
| Number of options                                     | 204                                                        | 204                            |
| Weighted-average exercise price                       | \$ 9.87                                                    | \$ 9.87                        |
| Aggregate intrinsic value                             | \$ 2,687                                                   | \$2,687                        |
| Weighted-average remaining contractual term, in years | 2.45                                                       | 2.45                           |

At December 31, 2007, the intrinsic value of vested options was approximately \$2.7 million for which tax benefits expected to be recognized in equity upon exercise are approximately \$1.1 million.

**(26) Selected Quarterly Financial Data (Unaudited)**

The following is a summary of unaudited quarterly statements of earnings for the years ended December 31, 2007 and 2006 (in thousands of dollars, except per share amounts):

|                                                                                                                 | <b>March</b> | <b>June</b> | <b>September</b> | <b>December</b> | <b>Year</b>  |
|-----------------------------------------------------------------------------------------------------------------|--------------|-------------|------------------|-----------------|--------------|
| <b>2007</b>                                                                                                     |              |             |                  |                 |              |
| Revenues                                                                                                        | \$ 623,284   | \$ 766,345  | \$ 666,964       | \$ 662,302      | \$ 2,718,895 |
| Earnings/(loss) before income taxes, minority interest, and cumulative effect of change in accounting principle | 103,493      | 128,391     | 55,321           | (41,471)        | 245,734      |
| Net earnings/ (loss)                                                                                            | 62,259       | 67,835      | 38,773           | (24,202)        | 144,665      |
| Net earnings/ (loss) per share:                                                                                 |              |             |                  |                 |              |
| Basic                                                                                                           | \$ 0.44      | \$ 0.48     | \$ 0.27          | \$ (0.17)       | \$ 1.02      |
| Diluted                                                                                                         | \$ 0.42      | \$ 0.45     | \$ 0.26          | \$ (0.17)       | \$ 0.97      |
| <b>2006</b>                                                                                                     |              |             |                  |                 |              |
| Revenues                                                                                                        | \$ 524,077   | \$ 457,119  | \$ 468,664       | \$ 513,348      | \$ 1,963,208 |
| Earnings before income taxes, minority interest, and cumulative effect of change in accounting principle        | 97,407       | 80,715      | 76,337           | 94,195          | 348,654      |
| Net earnings                                                                                                    | 58,447       | 45,580      | 45,940           | 55,783          | 205,750      |
| Net earnings per share:                                                                                         |              |             |                  |                 |              |
| Basic                                                                                                           | \$ 0.45      | \$ 0.34     | \$ 0.34          | \$ 0.41         | \$ 1.54      |
| Diluted                                                                                                         | \$ 0.41      | \$ 0.32     | \$ 0.32          | \$ 0.38         | \$ 1.42      |

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**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None

**Item 9A. 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 December 31, 2007. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of December 31, 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 fourth quarter of 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Management's annual report on internal control over financial reporting is contained in Part II, Item 8 of this report.

Our Chief Executive Officer and Chief Financial Officer filed with the SEC as exhibits to our Form 10-K for the year ended December 31, 2007 and are filing as exhibits to this report, the certifications required by Section 302 of the Sarbanes-Oxley Act of 2002 and Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.

**Item 9B. Other Information.**

None

**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance.**

Information with respect to this item will be contained in the Proxy Statement for the 2008 Annual Meeting of Stockholders, which is incorporated herein by reference.

**Item 11. Executive Compensation.**

Information with respect to this item will be contained in the Proxy Statement for the 2008 Annual Meeting of Stockholders, which is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

Information with respect to this item will be contained in the Proxy Statement for the 2008 Annual Meeting of Stockholders, which is incorporated herein by reference.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

Information with respect to this item will be contained in the Proxy Statement for the 2008 Annual Meeting of Stockholders, which is incorporated herein by reference.

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**Item 14. Principal Accountant Fees and Services.**

Information with respect to this item will be contained in the Proxy Statement for the 2008 Annual Meeting of Stockholders, which is incorporated herein by reference.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules.**

|                                                                                                                                                                                                                                                                                 | <b>Pages</b> |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|
| <b>(a)1. Financial Statements</b>                                                                                                                                                                                                                                               |              |
| Included in Part II of this report:                                                                                                                                                                                                                                             |              |
| Report of Independent Registered Public Accounting Firm                                                                                                                                                                                                                         | 46           |
| Consolidated Statements of Financial Condition                                                                                                                                                                                                                                  | 47           |
| Consolidated Statements of Earnings                                                                                                                                                                                                                                             | 49           |
| Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income                                                                                                                                                                                             | 50           |
| Consolidated Statements of Cash Flows                                                                                                                                                                                                                                           | 51           |
| Notes to Consolidated Financial Statements                                                                                                                                                                                                                                      | 53           |
| <b>(a)2. Financial Statement Schedules</b>                                                                                                                                                                                                                                      |              |
| All Schedules are omitted because they are not applicable or because the required information is shown in the Consolidated Financial Statements or notes thereto.                                                                                                               |              |
| <b>(a)3. Exhibits</b>                                                                                                                                                                                                                                                           |              |
| 2* Amendment No. 1 dated as of November 1, 2007 to the Share and Membership Interest Purchase Agreement dated as of July 18, 2005, among Brian P. Friedman, James L. Luikart, 2055 Partners L.P., Jefferies Capital Partners IV LLC, JCP IV LLC, and Jefferies Group, Inc.      |              |
| 3.1 Registrant's Amended and Restated Certificate of Incorporation is incorporated by reference to Exhibit 3 of 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 by reference to Exhibit 3.1 of Registrant's Form 8-K filed on February 21, 2006.                                                                          |              |
| 3.3 Registrant's By-Laws as amended and restated on December 3, 2007 are incorporated by reference to Exhibit 3 of Registrant's Form 8-K filed on December 4, 2007.                                                                                                             |              |
| 4 Instruments defining the rights of holders of long-term debt securities of the Registrant and its subsidiaries are omitted pursuant to Item 601(b)(4)(iii) of Regulation S-K. Registrant hereby agrees to furnish copies of these instruments to the Commission upon request. |              |
| 10.1 Jefferies Group, Inc. Deferred Compensation Plan, as Amended and Restated as of January 1, 2003 is incorporated by reference to Exhibit 4.1 of Registrant's Form S-8 filed on July 14, 2003.                                                                               |              |
| 10.2 Amendment No. 1, dated as of December 1, 2005, to the Jefferies Group, Inc. Deferred Compensation Plan, as Amended and Restated as of January 1, 2003 is incorporated by reference to Exhibit 10.2 of Registrant's Form 10-K filed on March 1, 2006.                       |              |
| 10.3 Jefferies Group, Inc. 2003 Incentive Compensation Plan is incorporated by reference to Appendix 4 of Registrant's Proxy Statement filed on April 4, 2003.                                                                                                                  |              |
| 10.4 Jefferies Group, Inc. Stock Option Gain and Stock Award Deferral Program effective as of January 21, 2003 is incorporated by reference to Exhibit 10.1 of Registrant's Form 10-Q filed on May 9, 2003.                                                                     |              |

- 10.5 Jefferies Group, Inc. 1999 Directors' Stock Compensation Plan is incorporated by reference to Exhibit 10.2 of Registrant's Form 10 filed on April 20, 1999.
- 10.6\* Form of Restricted Stock Agreement pursuant to the Jefferies Group, Inc. 2003 Incentive Compensation Plan.
- 10.7\* Form of Restricted Stock Units Agreement pursuant to the Jefferies Group, Inc. 2003 Incentive Compensation Plan.

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- 10.8 Summary of Non-Employee Director Compensation (as amended on January 17, 2006) pursuant to the Jefferies Group, Inc. 1999 Directors' Stock Compensation Plan is incorporated by reference to Exhibit 10 of Registrant's Form 8-K filed on January 18, 2006.
- 10.9 Summary of the 2007 and 2008 Executive Compensation for Messrs. Handler and Friedman is incorporated by reference to Exhibit 10 of Registrant's Form 8-K filed on August 25, 2006.
- 10.10 Summary of the 2007 Executive Compensation for Messrs. Schenk and Feller and Ms. Syrjamaki is incorporated herein by reference to Exhibit 10.2 of the Registrant's Form 10-Q filed on May 9, 2007.
- 10.11 Deferred Compensation Agreement, as amended and restated as of December 29, 2005, between Jefferies & Company, Inc. and Richard B. Handler is incorporated by reference to Exhibit 10.15 of Registrant's Form 10-K filed on March 1, 2006.
- 10.12\* Letter Agreement dated October 8, 2007 between Peregrine C. Broadbent and Jefferies Group, Inc.
- 10.13 Letter agreement dated June 1, 2007 between Joseph A. Schenk and Jefferies Group, Inc. is incorporated herein by reference to Exhibit 10.3 of the Registrant's Form 10-Q filed on August 9, 2007.
- 10.14 Letter agreement dated April 16, 2007 between Maxine Syrjamaki and Jefferies Group, Inc. is incorporated herein by reference to Exhibit 10.4 of the Registrant's Form 10-Q filed on August 9, 2007.
- 10.15 Consulting Agreement dated August 1, 2007 between Maxine Syrjamaki and Jefferies Group, Inc. is incorporated herein by reference to Exhibit 10.5 of the Registrant's Form 10-Q filed on August 9, 2007.
- 10.16 Letter agreement dated April 19, 2006 between Charles J. Hendrickson and Jefferies Group, Inc. is incorporated herein by reference to Exhibit 10.6 of the Registrant's Form 10-Q filed on August 9, 2007.
- 10.17 Purchase Agreement dated June 4, 2007 among Jefferies Group, Inc., Jefferies & Company, Inc., Citigroup Global Markets Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, BNP Paribas Securities Corp., BNY Capital Markets, Inc., Goldman, Sachs & Co., HSBC Securities (USA) Inc., J.P. Morgan Securities Inc., Greenwich Capital Markets, Inc., Banc of America Securities LLC, Fox-Pitt, Kelton Incorporated, Keefe, Bruyette & Woods, Inc., and SG Americas Securities, LLC is incorporated by reference to Exhibit 10.1 of Registrant's Form 8-K filed on June 5, 2007.
- 10.18 Master Agreement for the Formation of a Limited Liability Company, dated as of February 28, 2007 among Jefferies Group, Inc., Jefferies & Company, Inc. and Leucadia National Corporation is incorporated by reference to Exhibit 10.3 of Registrant's Form 10-Q filed on May 9, 2007.
- 12.1\* Computation of Ratio of Earnings to Fixed Charges.
- 21\* List of Subsidiaries.
- 23\* Consent of KPMG LLP.
- 31.1\* Rule 13a-14(a)/15d-14(a) Certification by Chief Financial Officer.
- 31.2\* Rule 13a-14(a)/15d-14(a) Certification by 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.

Exhibits 10.1, 10.2, 10.3, 10.4, 10.5, 10.6, 10.7, 10.8, 10.9, 10.10, 10.11, 10.12, 10.13, 10.14, 10.15 and 10.16 are management contracts or compensatory plans or arrangements.



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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

By /s/ RICHARD B. HANDLER  
Richard B. Handler  
Chairman of the Board of Directors,  
Chief Executive Officer

Dated: February 28, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| <b>Name</b>                                              | <b>Title</b>                                                   | <b>Date</b>       |
|----------------------------------------------------------|----------------------------------------------------------------|-------------------|
| /s/ RICHARD B. HANDLER<br><br>Richard B. Handler         | Chairman of the Board of Directors,<br>Chief Executive Officer | February 28, 2008 |
| /s/ PEREGRINE C. BROADBENT<br><br>Peregrine C. Broadbent | Executive Vice President and<br>Chief Financial Officer        | February 28, 2008 |
| /s/ BRIAN P. FRIEDMAN<br><br>Brian P. Friedman           | Director and<br>Chairman, Executive Committee                  | February 28, 2008 |
| /s/ W. PATRICK CAMPBELL<br><br>W. Patrick Campbell       | Director                                                       | February 22, 2008 |
| /s/ RICHARD G. DOOLEY<br><br>Richard G. Dooley           | Director                                                       | February 28, 2008 |
| /s/ ROBERT E. JOYAL<br><br>Robert E. Joyal               | Director                                                       | February 26, 2008 |
| /s/ FRANK J. MACCHIAROLA<br><br>Frank J. Macchiarola     | Director                                                       | February 24, 2008 |
| /s/ MICHAEL T. O KANE<br><br>Michael T. O Kane           | Director                                                       | February 28, 2008 |

