JEFFERIES GROUP INC /DE/
Form 10-Q
May 08, 2009

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

**FORM 10-Q**

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended March 31, 2009**

**OR**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from __________ to**

**Commission file number 1-14947**

**JEFFERIES GROUP, INC.**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 95-4719745 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 520 Madison Avenue, 10th Floor, New York, New York | 10022 |
| (Address of principal executive offices) | (Zip Code) |

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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 þ Accelerated filer o Non-accelerated filer o Smaller Reporting Company o
(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 o No þ

Indicate the number of shares outstanding of the registrant s class of common stock, as of the latest practicable date. 171,081,538 shares as of the close of business May 1, 2009.

**JEFFERIES GROUP, INC. AND SUBSIDIARIES**
**INDEX TO QUARTERLY REPORT ON FORM 10-Q**
**MARCH 31, 2009**

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

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | $ 539,026 | $ 1,294,329 |
| Cash and securities segregated and on deposit for regulatory purposes or deposited with clearing and depository organizations | 1,085,514 | 1,151,522 |
| Financial instruments owned, including securities pledged to creditors of $614,705 and $361,765 in 2009 and 2008, respectively: | | |
| Corporate equity securities | 1,153,653 | 945,747 |
| Corporate debt securities | 2,146,640 | 1,851,216 |
| U.S. Government, federal agency and other sovereign obligations | 1,061,919 | 447,233 |
| Mortgage- and asset-backed securities | 1,372,792 | 1,035,996 |
| Loans | 172,114 | 34,407 |
| Derivatives | 291,092 | 298,144 |
| Investments at fair value | 71,348 | 75,059 |
| Total financial instruments owned | 6,269,558 | 4,687,802 |
| Investments in managed funds | 92,616 | 100,245 |
| Other investments | 144,902 | 140,012 |
| Securities borrowed | 7,518,895 | 9,011,903 |
| Securities purchased under agreements to resell | 3,014,454 | 1,247,002 |
| Receivable from brokers, dealers and clearing organizations | 964,446 | 710,199 |
| Receivable from customers | 552,225 | 499,315 |
| Premises and equipment | 137,388 | 139,390 |
| Goodwill | 359,405 | 358,837 |
| Other assets | 613,397 | 638,129 |
| Total assets | $ 21,291,826 | $ 19,978,685 |

See accompanying unaudited notes to consolidated financial statements.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (UNAUDITED) CONTINUED**
**(Dollars in thousands, except per share amounts)**

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Financial instruments sold, not yet purchased: | | |
| Corporate equity securities | $ 1,394,326 | $ 739,166 |
| Corporate debt securities | 1,574,635 | 1,578,395 |
| U.S. Government, federal agency and other sovereign obligations | 769,562 | 211,045 |
| Derivatives | 189,690 | 220,738 |
| Loans and other receivables | 58,681 | |
| Other | 313 | 223 |
| Total financial instruments sold, not yet purchased | 3,987,207 | 2,749,567 |
| Securities loaned | 3,197,413 | 3,259,575 |
| Securities sold under agreements to repurchase | 6,591,715 | 6,727,390 |
| Payable to brokers, dealers and clearing organizations | 686,547 | 291,291 |
| Payable to customers | 1,978,781 | 1,736,971 |
| Accrued expenses and other liabilities | 350,060 | 634,618 |
| | 16,791,723 | 15,399,412 |
| Long-term debt | 1,748,708 | 1,764,274 |
| Mandatorily redeemable convertible preferred stock | 125,000 | 125,000 |
| Mandatorily redeemable preferred interest of consolidated subsidiaries | 275,620 | 280,923 |
| Total liabilities | 18,941,051 | 17,569,609 |
| **STOCKHOLDERS EQUITY** | | |
| Common stock, $.0001 par value. Authorized 500,000,000 shares; issued 183,316,506 shares in 2009 and 171,167,666 shares in 2008 | 18 | 17 |
| Additional paid-in capital | 1,861,679 | 1,870,120 |
| Retained earnings | 456,782 | 418,445 |
| Less: | | |
| Treasury stock, at cost, 14,121,605 shares in 2009 and 7,951,628 shares in 2008 | (193,982) | (115,190) |
| Accumulated other comprehensive loss: | | |
| Currency translation adjustments | (47,170) | (43,675) |
| Additional minimum pension liability | (8,446) | (8,446) |
| Total accumulated other comprehensive loss | (55,616) | (52,121) |
| Total common stockholders equity | 2,068,881 | 2,121,271 |
| Noncontrolling interests | 281,894 | 287,805 |
| Total stockholders equity | 2,350,775 | 2,409,076 |

| | | |
|---|---|---|
| Total liabilities and stockholders equity | $ 21,291,826 | $ 19,978,685 |

See accompanying unaudited notes to consolidated financial statements.

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

| | Three Months Ended March 31, 2009 | March 31, 2008 |
|---|---|---|
| **Revenues:** | | |
| Commissions | $ 101,851 | $ 113,651 |
| Principal transactions | 152,345 | 54 |
| Investment banking | 37,086 | 99,207 |
| Asset management fees and investment (loss) from managed funds | (37) | (27,796) |
| Interest | 102,087 | 204,891 |
| Other | 12,572 | 6,480 |
| Total revenues | 405,904 | 396,487 |
| Interest expense | 63,947 | 195,291 |
| Net revenues | 341,957 | 201,196 |
| Interest on mandatorily redeemable preferred interest of consolidated subsidiaries | (5,303) | (20,951) |
| Net revenues, less mandatorily redeemable preferred interest | 347,260 | 222,147 |
| **Non-interest expenses:** | | |
| Compensation and benefits | 213,381 | 259,951 |
| Floor brokerage and clearing fees | 14,780 | 12,948 |
| Technology and communications | 30,785 | 30,916 |
| Occupancy and equipment rental | 16,296 | 17,257 |
| Business development | 9,445 | 12,900 |
| Other | 13,391 | 20,481 |
| Total non-interest expenses | 298,078 | 354,453 |
| Earnings (loss) before income taxes | 49,182 | (132,306) |
| Income tax expense (benefit) | 16,756 | (57,892) |
| Net earnings (loss) | 32,426 | (74,414) |
| Net (loss) to noncontrolling interests | (5,911) | (13,877) |
| Net earnings (loss) to common shareholders | $ 38,337 | $ (60,537) |
| Earnings (loss) per common share: | | |
| Basic | $ 0.19 | $ (0.45) |
| Diluted | $ 0.19 | $ (0.45) |
| Weighted average common shares: | | |

| | | |
|---|---|---|
| Basic | 203,310 | 141,784 |
| Diluted | 203,326 | 141,784 |

See accompanying unaudited notes to consolidated financial statements.

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**JEFFERIES GROUP, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY**
**(Unaudited)**
**(Dollars in thousands, except per share amounts)**

| | Three Months Ended March 31, 2009 | Year Ended December 31, 2008 |
|---|---|---|
| **Common stock, par value $0.0001 per share** | | |
| Balance, beginning of period | $ 17 | $ 16 |
| Issued | 1 | 1 |
| Balance, end of period | 18 | 17 |
| **Additional paid in capital** | | |
| Balance, beginning of period | 1,870,120 | 1,115,011 |
| Benefit plan share activity (1) | 9,728 | 52,912 |
| Share-based expense | 683 | 561,661 |
| Proceeds from exercise of stock options | 69 | 840 |
| Acquisitions and contingent consideration | | 5,647 |
| Tax (deficiency) benefit for issuance of share-based awards | (18,921) | 6,233 |
| Issuance of treasury stock | | 90,160 |
| Dividend equivalents on restricted stock units | | 37,656 |
| Balance, end of period | 1,861,679 | 1,870,120 |
| **Retained earnings** | | |
| Balance, beginning of period | 418,445 | 1,031,764 |
| Net earnings (loss) to common shareholders | 38,337 | (536,128) |
| Dividends | | (76,477) |
| Acquisition adjustments | | (714) |
| Balance, end of period | 456,782 | 418,445 |
| **Treasury stock, at cost** | | |
| Balance, beginning of period | (115,190) | (394,406) |
| Purchases | (75,549) | (21,765) |
| Returns / forfeitures | (3,243) | (42,438) |
| Issued | | 343,419 |
| Balance, end of period | (193,982) | (115,190) |
| **Accumulated other comprehensive (loss) income** | | |
| Balance, beginning of period | (52,121) | 9,159 |

| | | | | |
|---|---|---|---|---|
| Currency adjustment, net of tax | | (3,495) | | (54,661) |
| Pension adjustment, net of tax | | | | (6,619) |
| Balance, end of period | | (55,616) | | (52,121) |
| **Total common stockholders equity** | | 2,068,881 | | 2,121,271 |
| **Noncontrolling interests** | | | | |
| Balance, beginning of period | | 287,805 | | 249,380 |
| Net (loss) to noncontrolling interests | | (5,911) | | (53,884) |
| Contributions | | | | 99,725 |
| Distributions | | | | (11,553) |
| Consolidation of asset management entity | | | | 4,137 |
| Balance, end of period | | 281,894 | | 287,805 |
| **Total stockholders equity** | $ | 2,350,775 | $ | 2,409,076 |

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

See accompanying unaudited notes to consolidated financial statements.

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

| | Three Months Ended March 31, 2009 | Three Months Ended March 31, 2008 |
|---|---|---|
| Net earnings (loss) to common shareholders | $ 38,337 | $ (60,537) |
| Other comprehensive (loss) income: | | |
| Currency translation adjustments | (3,495) | 2,250 |
| Total other comprehensive (loss) income (1) | (3,495) | 2,250 |
| Comprehensive (loss) | $ 34,842 | $ (58,287) |

(1) Total other comprehensive income, net of tax, is attributable to Jefferies Group. No other comprehensive income is attributable to noncontrolling interests.

See accompanying notes to consolidated financial statements.

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

| | Three Months Ended March 31, 2009 | March 31, 2008 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net earnings (loss) | $ 32,426 | $ (74,414) |
| Adjustments to reconcile net earnings (loss) to net cash used in operating activities: | | |
| Depreciation and amortization | 7,148 | 13,844 |
| Gain on repurchase of long-term debt | (5,946) | |
| Interest on mandatorily redeemable preferred interests of consolidated subsidiaries | (5,303) | (20,951) |
| Accruals related to various benefit plans, stock issuances, net of forfeitures | 7,169 | 45,974 |
| Decrease (increase) in cash and securities segregated and on deposit for regulatory purposes or deposited with clearing and depository organizations | 65,956 | (497,216) |
| Decrease (increase) in receivables: | | |
| Securities borrowed | 1,494,964 | 4,743,141 |
| Brokers, dealers and clearing organizations | 54,268 | (139,992) |
| Customers | (58,171) | 82,009 |
| (Increase) decrease in financial instruments owned | (1,549,463) | 83,887 |
| (Increase) decrease in other investments | (4,890) | 282 |
| Decrease in investments in managed funds | 7,629 | 52,219 |
| (Increase) decrease in securities purchased under agreements to resell | (1,767,452) | 1,540,619 |
| Decrease (increase) in other assets | 27,090 | (180,334) |
| (Decrease) increase in payables: | | |
| Securities loaned | (62,162) | 15,450 |
| Brokers, dealers and clearing organizations | 92,619 | 143,946 |
| Customers | 252,122 | (2,701) |
| Increase in financial instruments sold, not yet purchased | 1,236,556 | 732,660 |
| Decrease in securities sold under agreements to repurchase | (135,675) | (6,502,923) |
| Decrease in accrued expenses and other liabilities | (311,486) | (148,725) |
| Net cash used in operating activities | (622,601) | (113,225) |
| Cash flows from investing activities: | | |
| Purchase of premises and equipment | (5,516) | (17,579) |
| Business acquisition | (38,760) | |
| Cash paid for contingent consideration | (8,163) | (30,329) |
| Net cash used in investing activities | (52,439) | (47,908) |

Continued on next page.

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2009 | March 31, 2008 |
| Cash flows from financing activities: | | |
| Excess tax benefits from the issuance of share-based awards | $ 4,299 | $ 5,374 |
| Net (payments on) proceeds from: | | |
| Repurchase of long-term debt | (9,515) | |
| Bank loans | | (263,375) |
| Mandatorily redeemable preferred interest of consolidated subsidiaries | | (4,257) |
| Noncontrolling interest | | 712 |
| Repurchase of treasury stock | (75,549) | (6,326) |
| Dividends | | (16,533) |
| Exercise of stock options, not including tax benefits | 69 | 120 |
| Net cash used in financing activities | (80,696) | (284,285) |
| Effect of foreign currency translation on cash and cash equivalents | 433 | 377 |
| Net decrease in cash and cash equivalents | (755,303) | (445,041) |
| Cash and cash equivalents at beginning of year | 1,294,329 | 897,872 |
| Cash and cash equivalents at end of year | $ 539,026 | $ 452,831 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid (received) during the year for: | | |
| Interest | $ 73,524 | $ 218,510 |
| Income taxes | (1,061) | (19,702) |
| Acquisitions: | | |
| Fair value of assets acquired, including goodwill | 53,104 | |
| Liabilities assumed | 14,344 | |
| Cash paid for acquisition | 38,760 | |

See accompanying unaudited notes to consolidated financial statements.

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

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

**Organization**

The accompanying unaudited consolidated financial statements include the accounts of Jefferies Group, Inc. and all its subsidiaries (together, we or us ), including Jefferies & Company, Inc. ( Jefferies ), Jefferies Execution Services, Inc., ( Jefferies Execution ), Jefferies International Limited, Jefferies Asset Management, LLC, Jefferies Financial Products, LLC and all other entities in which we have a controlling financial interest or are the primary beneficiary, including Jefferies High Yield Holdings, LLC ( JHYH ), Jefferies Special Opportunities Partners, LLC ( JSOP ) and Jefferies Employees Special Opportunities Partners, LLC ( JESOP ). The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S generally accepted accounting principles for complete financial statements. All adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. These unaudited consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2008.

On April 21, 2008, we issued 26,585,310 shares of common stock and made a cash payment to Leucadia National Corporation ( Leucadia ) of approximately $100 million. In exchange, we received from Leucadia 10,000,000 common shares of Leucadia. During the second quarter of 2008, we sold the 10,000,000 common shares of Leucadia and thus realized approximately $433.6 million in net cash from the issuance of our shares.

***Reclassifications***

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

**Summary of Significant Accounting Policies**

***Principles of Consolidation***

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

All material intercompany accounts and transactions are eliminated in consolidation.

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

***Revenue Recognition***

*Commissions.* All customer securities transactions are reported on the Consolidated Statements 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 $7.1 million and $9.6 million for the three months ended March 31, 2009 and 2008, respectively. We account for the cost of these arrangements on an accrual basis. Our accounting policy for commission revenues incorporates the guidance contained in Emerging Issues Task Force ( EITF ) Issue No. 99-19, *Reporting Revenues Gross versus Net*, because we are not the primary obligor of such arrangements, and accordingly, expenses relating to soft dollars are netted against the commission revenues.

*Principal Transactions.* Financial instruments owned, securities pledged and financial instruments sold, but not yet purchased (all of which are recorded on a trade-date basis) are carried at fair value with unrealized gains and losses reflected in principal transactions in the Consolidated Statements of Earnings on a trade date basis, except for unrealized gains and losses on financial instruments held by consolidated asset management entities, which are presented in asset management fees and investment income (loss) from managed funds.

*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 assignments 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 Statements of Earnings. Reimbursed expenses totaled approximately $0.8 million and $3.3 million for the three months ended March 31, 2009 and 2008, respectively.

*Asset Management Fees and Investment Income (Loss) From Managed Funds.* Asset management fees and investment income (loss) 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 (loss) 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 fair 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 and securities purchased under agreements to resell activities and interest expense related to our securities loaned and securities sold under agreements to repurchase activities on an accrual basis.

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

***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 (loss). Gains or losses resulting from foreign currency transactions are included in principal transactions in the Consolidated Statements of Earnings.

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

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. These instruments primarily represent our trading activities and include both cash and derivative products. Realized and unrealized gains and losses are recognized in principal transactions in our Consolidated Statements of Earnings. 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).

**Fair Value Hierarchy**

FASB 157, *Fair Value Measurements* ( 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 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 based on market data obtained from independent sources. Unobservable inputs reflect our assumptions that 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 transparency of inputs as follows:

Level 1: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

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.

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

Level 3: Instruments that have little to no pricing observability as of the reported date. These financial instruments 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.

**Valuation Process for Financial Instruments**

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. For financial instruments whose inputs are based on bid-ask prices, mid-market pricing is applied and adjusted 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.

The valuation process for financial instruments may include the use of valuation models and other techniques. Adjustments to valuations (such as counterparty, credit, concentration or liquidity) derived from valuation models may be made when, in management s judgment, either the size of the position in the financial instrument in a nonactive market or other features of the financial instrument such as its complexity, or the market in which the financial instrument is traded require that an adjustment be made to the value derived from the models. An adjustment may be made if a financial instrument is subject to sales restrictions that would result in a price less than the quoted market price. Adjustments from the price derived from a valuation model reflect management s judgment that other participants in the market for the financial instrument being measured at fair value would also consider in valuing that same financial instrument and are adjusted for assumptions about risk uncertainties and market conditions. Results from valuation models and valuation techniques in one period may not be indicative of future period fair value measurements.

Cash products Where quoted prices are available in an active market, cash products are classified in Level 1 of the fair value hierarchy and valued based on the quoted price, primarily quoted exchange prices. Level 1 cash products are highly liquid instruments and include listed equity and money market securities and G-7 government and agency securities. Cash products classified within Level 2 of the fair value hierarchy are based primarily on broker quotations, pricing service data from external providers and prices for actual executed market transactions. If quoted market prices are not available for the specific security then fair values are estimated by using pricing models, quoted prices of cash products with similar characteristics or discounted cash flow models. Examples of cash products classified within Level 2 of the fair value hierarchy are corporate, convertible and municipal bonds and agency and non-agency mortgage-backed securities. If there is limited transaction activity or less transparency to observe market-based inputs to valuation models, cash products presented at fair value are classified in Level 3 of the fair value hierarchy. Fair values of cash products classified in Level 3 are generally based on an assessment of each underlying investment, cash flow models, market data of any recent comparable company transactions and trading multiples of companies considered comparable to the instrument being valued and incorporate assumptions regarding market outlook, among other factors. Cash products in this category include illiquid equity securities, equity interests in private companies, auction rate securities, commercial loans, private equity and hedge fund investments, distressed debt instruments and Alt-A and subprime non-agency mortgage-backed securities as little external price information is currently available for these products. For distressed debt instruments, commercial loans and loan commitments, loss assumptions must be made based on default scenarios and market liquidity and prepayment assumptions must be made for mortgage-backed securities.

Derivative products Exchange-traded derivatives are valued using quoted market prices and are classified within Level 1 of the fair value hierarchy. Over-the-counter ( OTC ) derivative products are generally valued using models, whose inputs reflect assumptions that we believe market participants would use in valuing the derivative in a current

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**
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period transaction. Inputs to valuation models are appropriately calibrated to market data, including but not limited to yield curves, interest rates, volatilities, equity, debt and commodity prices and credit curves. Fair value can be modeled using a series of techniques, including the Black-Scholes option pricing model and simulation models. For certain OTC derivative contracts, inputs to valuation models do not involve a high degree of subjectivity as the valuation model inputs are readily observable or can be derived from actively quoted markets. OTC derivative contracts thus classified in Level 2 include certain credit default swaps, interest rate swaps, commodity swaps, debt and equity option contracts and to-be-announced ( TBA ) securities. Derivative products that are valued based on models with significant unobservable market inputs are classified within Level 3 of the fair value hierarchy. Level 3 derivative products include total return swaps and equity warrant and option contracts where the volatility of the underlying equity securities are not observable due to the terms of the contracts and correlation sensitivity to market indices is not transparent for the term of the derivatives.

***Investments in Managed Funds***

Investments in managed funds include 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 nonconsolidated 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 (loss) 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 and loans issued in connection with such activities. Other investments are accounted for on the equity method or at cost, as appropriate.

***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.

***Securities Borrowed and Securities Loaned***

Securities borrowed and securities loaned are carried at cost. 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.

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

Securities purchased under agreements to resell and securities sold under agreements to repurchase (collectively repos ) are accounted for as collateralized financing transactions and are recorded at their contracted repurchase amount. We earn net interest revenues from this activity which is reflected in our Consolidated Statements of Earnings.

We monitor the fair value of the underlying securities daily versus the related receivable or payable balances. Should the fair value of the underlying securities 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, and more frequently if warranted, we assess whether goodwill has been impaired by comparing the estimated fair value, calculated based on earnings and book value multiples, of each reporting unit 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 impairment charge is recorded and the magnitude of such a charge. We have completed our annual assessment of goodwill as of September 30, 2008 and no impairment was identified. We updated our assessment of goodwill for impairment as of December 31, 2008 and no impairment was identified. We do not believe there have been any events or changes in circumstances since our last assessment warranting an update of our evaluation.

***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 and for tax loss carry-forwards. 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, share-based compensation, 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.

We adopted EITF Issue No. 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* ( EITF 06-11 ), as of January 1, 2008. EITF 06-11 requires that the tax benefit related to dividends and dividend equivalents paid on nonvested share based payment awards and outstanding equity options should be recognized as an increase to additional paid in capital. Prior to EITF 06-11, such income tax benefit was recognized as

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a reduction of income tax expense. These amounts are included in tax benefits for issuance of share-based awards on the Consolidated Statement of Changes in Stockholders Equity.

***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. We consider 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.

***Share-Based Compensation***

We account for share-based compensation under the guidance of FASB 123R, *Share-Based Payment* ( FASB 123R ). Share-based awards are measured based on the grant-date fair value of the award and recognized over the period from the service inception date through the date the employee is no longer required to provide service to earn the award. Expected forfeitures are included in determining share-based compensation expense.

***Earnings per Common Share***

Basic earnings per share ( EPS ) is computed by dividing net earnings (loss) available to common shareholders by the weighted average number of common shares outstanding and certain other shares committed to be, but not yet issued. Net earnings (loss) available to common shareholders represents net earnings (loss) to common shareholders reduced by the allocation of earnings to participating securities. Losses are not allocated to participating securities. Common shares outstanding and certain other shares committed to be, but not yet issued, include restricted stock and restricted stock units for which no future service is required. Diluted EPS is computed by dividing net earnings available to common shareholders plus dividends on dilutive mandatorily redeemable convertible preferred stock by the weighted average number of common shares outstanding and certain other shares committed to be, but not yet issued, plus all dilutive common stock equivalents outstanding during the period.

We adopted FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* ( FSP EITF 03-6-1) on January 1, 2009. Under FSP EITF 03-6-1, unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and, therefore, are included in the earnings allocation in computing earnings per share under the two-class method described in FASB 128, *Earnings per Share*. We grant restricted stock and restricted stock units as part of our share-based compensation that contain nonforfeitable rights to dividends and dividend equivalents, respectively, and therefore, prior to the requisite service being rendered for the right to retain the award, restricted stock and restricted stock units meet the definition of a participating security under FSP EITF 03-6-1. As such, we calculate Basic and Diluted earnings per share under the two-class method. FSP EITF 03-6-1 is to be applied retrospectively. All prior-period earnings per share data presented have been adjusted to comply with the provisions of FSP EITF 03-6-1.

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***Securitization Activities***

We engage in securitization activities related to residential mortgage-backed securities. Generally, such transfers of financial assets are accounted for as sales when we have relinquished control over the transferred assets. The gain or loss on sale of such financial assets depends, in part, on the previous carrying amount of the assets involved in the transfer allocated between the assets sold and the retained interests, if any, based upon their respective fair values at the date of sale. We may retain interests in the securitized financial assets as one or more tranches of the securitization. These retained interests are included in the Consolidated Statement of Financial Condition at fair value. Any changes in the fair value of such retained interests are recognized in the Consolidated Statement of Earnings.

***Accounting and Regulatory Developments***

**FASB 141R.** 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 apply the provisions of FASB 141R to business combinations occurring after January 1, 2009. Adoption of FASB 141R did not affect our financial condition, results of operations or cash flows, but may have an effect on accounting for future business combinations.

**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. We adopted FASB 160 on January 1, 2009. Refer to Note 10 for further discussion on the adoption of FASB 160.

**FSP FAS 140-3.** In February 2008, the FASB issued FSP FAS 140-3*, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* ( FSP FAS 140-3 ). FSP FAS 140-3 requires an initial transfer of a financial asset and a repurchase financing that was entered into contemporaneously or in contemplation of the initial transfer to be evaluated as a linked transaction under FASB 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* ( FASB No. 140 ) unless certain criteria are met. FSP FAS 140-3 is effective for fiscal years beginning after November 15, 2008. FSP FAS 140-3 is to be applied prospectively for new transactions entered into after the adoption date. The adoption of FSP FAS 140-3 did not have a material effect on financial condition, cash flows or results of operations.

**FASB 161.** In March 2008, the FASB issued FASB 161, *Disclosures about Derivative Instruments and Hedging Activities* ( FASB 161 ). FASB 161 amends and expands the disclosure requirements of FASB 133, *Accounting for Derivative Instruments and Hedging Activities*, and requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair values and amounts of gains and losses on derivative contracts and disclosures about credit-risk-related contingent features in derivative agreements. FASB 161 is effective for the fiscal years and interim periods beginning after November 15, 2008. Accordingly, we adopted FASB 161 effective January 1, 2009. Since FASB 161 requires only additional disclosures concerning derivatives and hedging activities, adoption of FASB 161 did not affect our financial condition, results of operations or cash flows.

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**FSP APB 14-1.** In May 2008, the FASB issued FSP APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* ( FSP APB 14-1 ). FSP APB 14-1 clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by APB 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants* and specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity s nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. FSP APB 14-1 is effective for fiscal years and interim periods beginning after December 31, 2008. The adoption of FSP APB 14-1 did not affect our financial condition, results of operations or cash flows.

**FSP EITF 03-6-1.** In June 2008, the FASB issued FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, are included in the earnings allocation in computing earnings per share under the two-class method described in FASB 128, *Earnings per Share*. Under FSP EITF 03-6-1, unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of EPS pursuant to the two-class method. FSP EITF 03-6-1 is effective for fiscal years and interim periods beginning after December 31, 2008. Accordingly, we adopted FSP EITF 03-6-1 on January 1, 2009. All prior-period EPS data presented has been adjusted to comply with the provisions of FSP EITF 03-6-1. The adoption of FSP EITF 03-6-1 reduced previously reported Basic and Diluted EPS from a loss of $0.43 to a loss of $0.45 for the three months ended March 31, 2008.

**FSP FAS 133-1 and FIN 45-4.** In September 2008, the FASB issued FSP FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161* ( FSP FAS 133-1 and FIN 45-4 ). FSP FAS 133-1 and FIN 45-4 require enhanced disclosures by sellers of credit derivatives, including credit derivatives embedded in a hybrid instrument, and require additional disclosure about the current status of the payment/performance risk of a guarantee. We adopted FSP FAS 133-1 and FIN 45-4 for our year end consolidated financial statements as of December 31, 2008. Since FSP FAS 133-1 and FIN 45-4 require only additional disclosures, the adoption did not have an effect on our financial condition, results of operations or cash flows.

**FSP FAS 157-4.** In April 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ( FSP FAS 157-4 ). FSP FAS 157-4 provides additional guidance for estimating fair value in accordance with FASB Statement No. 157, *Fair Value Measurements*, when the volume and level of activity for the asset or liability have significantly decreased. FSP FAS 157-4 also includes guidance on identifying circumstances that indicate a transaction is not orderly. FSP FAS 157-4 is effective for fiscal years and interim periods beginning after June 15, 2009. We do not expect the adoption of FSP FAS 157-4 to have a material effect on our financial condition, results of operations and cash flows.

***Use of Estimates***

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

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**Note 2. Cash, Cash Equivalents and Short-Term Investments**

We generally invest our excess cash in money market funds and other short-term investments. Cash equivalents include highly liquid investments not held for resale with original maturities of three months or less. The following are financial instruments that are cash and cash equivalents or are deemed by us to be generally readily convertible into cash as of March 31, 2009 and December 31, 2008 (in thousands of dollars):

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| Cash and cash equivalents: | | |
| Cash in banks | $ 199,803 | $ 765,056 |
| Money market investments | 339,223 | 529,273 |
| Total cash and cash equivalents | 539,026 | 1,294,329 |
| Cash and securities segregated (1) | 1,085,514 | 1,151,522 |
| | $ 1,624,540 | $ 2,445,851 |

(1) Consists of deposits at exchanges and clearing organizations, as well as deposits in accordance with Rule 15c3-3 of the Securities Exchange Act of 1934, which subjects Jefferies, as a broker dealer carrying client accounts, to requirements related to maintaining cash or qualified securities in a segregated reserve account for the exclusive benefit of its clients.

**Note 3. Financial Instruments**

The following is a summary of the fair value of major categories of financial instruments owned and financial instruments sold, not yet purchased, as of March 31, 2009 and December 31, 2008 (in thousands of dollars):

| | March 31, 2009 | | December 31, 2008 | |
|---|---|---|---|---|
| | Financial Instruments Owned | Financial Instruments Sold, Not Yet Purchased | Financial Instruments Owned | Financial Instruments Sold, Not Yet Purchased |
| Corporate equity securities | $ 1,153,653 | $ 1,394,326 | $ 945,747 | $ 739,166 |
| Corporate debt securities | 2,146,640 | 1,574,635 | 1,851,216 | 1,578,395 |
| U.S. Government, federal agency and other sovereign obligations | 1,061,919 | 769,562 | 447,233 | 211,045 |
| Mortgage- and asset-backed securities | 1,372,792 | | 1,035,996 | |
| Loans | 172,114 | 58,681 | 34,407 | |
| Derivatives | 291,092 | 189,690 | 298,144 | 220,738 |
| Investments at fair value | 71,348 | | 75,059 | |
| Other | | 313 | | 223 |
| | $ 6,269,558 | $ 3,987,207 | $ 4,687,802 | $ 2,749,567 |

We elected to apply the fair value option to loans and loan commitments made in connection with our investment banking activities and 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*. Loans and investments at fair value are included in financial instruments owned and loan commitments are included in financial instruments sold, not yet purchased derivatives on the Consolidated Statements of Financial Condition. The fair value option was elected for

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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.

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 March 31, 2009 and December 31, 2008 (in thousands of dollars):

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| Corporate equity securities | $ 601,059 | $ 360,356 |
| Corporate debt securities | 13,646 | 1,409 |
| | $ 614,705 | $ 361,765 |

At March 31, 2009 and December 31, 2008, the approximate fair value of collateral received by us that may be sold or repledged by us was $10.0 billion and $9.7 billion, respectively. This collateral was received in connection with resale agreements and securities borrowings. At March 31, 2009 and December 31, 2008, a substantial portion of this collateral received by us had been sold or repledged.

The following is a summary of our financial assets and liabilities that are accounted for at fair value as of March 31, 2009 and December 31, 2008 by level within the fair value hierarchy (in thousands of dollars):

| | As of March 31, 2009 | | | | |
|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Counterparty and Cash Collateral Netting | Total |
| **Assets:** | | | | | |
| Financial instruments owned: | | | | | |
| Securities | $ 1,299,284 | $ 4,093,038 | $ 342,682 | $ ¾ | $ 5,735,004 |
| Loans | ¾ | 11,830 | 160,284 | ¾ | 172,114 |
| Derivative instruments | 214,708 | 275,997 | 3,087 | (202,700) | 291,092 |
| Investments at fair value | ¾ | ¾ | 71,348 | ¾ | 71,348 |
| Total financial instruments owned | 1,513,992 | 4,380,865 | 577,401 | (202,700) | 6,269,558 |
| Level 3 assets for which the firm does not bear economic exposure (1) | | | (181,814) | | |
| Level 3 assets for which the firm bears economic exposure | | | 395,587 | | |
| **Liabilities:** | | | | | |
| Financial instruments sold, not yet purchased: | | | | | |
| Securities | 1,930,961 | 1,807,650 | 58,906 | ¾ | 3,797,517 |
| Derivative instruments | 153,460 | 130,316 | 3,873 | (97,959) | 189,690 |

| | | | | | |
|---|---|---|---|---|---|
| Total financial instruments sold, not yet purchased | 2,084,421 | 1,937,966 | 62,779 | (97,959) | 3,987,207 |

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

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| | As of December 31, 2008 | | | | |
|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Counterparty and Cash Collateral Netting | Total |
| **Assets:** | | | | | |
| Financial instruments owned: | | | | | |
| Securities | $ 1,125,752 | $ 2,782,707 | $ 371,733 | $ ¾ | $ 4,280,192 |
| Loans | ¾ | 11,824 | 22,583 | ¾ | 34,407 |
| Derivative instruments | 258,827 | 920,687 | ¾ | (881,370) | 298,144 |
| Investments at fair value | ¾ | ¾ | 75,059 | ¾ | 75,059 |
| Total financial instruments owned | 1,384,579 | 3,715,218 | 469,375 | (881,370) | 4,687,802 |
| Level 3 assets for which the firm does not bear economic exposure (1) | | | (146,244) | | |
| Level 3 assets for which the firm bears economic exposure | | | 323,131 | | |
| **Liabilities:** | | | | | |
| Financial instruments sold, not yet purchased: | | | | | |
| Securities | 757,260 | 1,768,054 | 3,515 | ¾ | 2,528,829 |
| Derivative instruments | 187,806 | 491,876 | 8,197 | (467,141) | 220,738 |
| Total financial instruments sold, not yet purchased | 945,066 | 2,259,930 | 11,712 | (467,141) | 2,749,567 |

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

The following is a summary of changes in fair value of our financial assets and liabilities that have been classified as Level 3 for the three months ended March 31, 2009 and 2008 (in thousands of dollars):

Three Months Ended March 31, 2009

| | Non-derivative instruments - Assets | Non-derivative instruments - Liabilities | Derivative instruments - Assets | Derivative instruments - Liabilities | Investments |
|---|---|---|---|---|---|
| Balance, December 31, 2008 | $ 394,316 | $ (3,515) | $ ¾ | $ (8,197) | $ 75,059 |
| Total gains/ (losses) (realized and unrealized) (1) | (39,296) | (390) | 3,087 | 4,324 | (6,474) |
| Purchases, sales, settlements, and issuances | 134,968 | (58,516) | ¾ | ¾ | 2,757 |
| Transfers into Level 3 | 25,528 | ¾ | ¾ | ¾ | 6 |
| Transfers out of Level 3 | (12,550) | 3,515 | ¾ | ¾ | ¾ |
| Balance, March 31, 2009 | $ 502,966 | $ (58,906) | $ 3,087 | $ (3,873) | $ 71,348 |
| Change in unrealized gains/ (losses) relating to instruments still held at March 31, 2009 (1) | $ (37,511) | $ (390) | $ 3,087 | $ 4,324 | $ (7,013) |

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

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| | Three Months Ended March 31, 2008 | | | |
|---|---|---|---|---|
| | Non-derivative instruments - Assets | Non-derivative instruments - Liabilities | Derivative instruments - Liabilities | Investments |
| Balance, December 31, 2007 | $ 248,397 | $ (8,703) | $ (12,929) | $ 104,199 |
| Total gains/ (losses) (realized and unrealized) (1) | (21,554) | ¾ | 304 | (5,539) |
| Purchases, sales, settlements, and issuances | 21,418 | 2,120 | 11,726 | (3,328) |
| Transfers into Level 3 | 48,370 | ¾ | (22,358) | ¾ |
| Transfers out of Level 3 | (7,675) | ¾ | ¾ | ¾ |
| Balance, March 31, 2008 | $ 288,956 | $ (6,583) | $ (23,257) | $ 95,332 |
| Change in unrealized gains/ (losses) relating to instruments still held at March 31, 2008 (1) | $ (11,391) | $ ¾ | $ 938 | $ (5,539) |

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

Level 3 cash instruments are frequently hedged with instruments classified within Level 1 and Level 2, and accordingly, gains or losses that have been reported in Level 3 are frequently offset by gains or losses attributable to instruments classified within Level 1 or Level 2 or by gains or losses on derivative contracts classified in Level 3 of the fair value hierarchy.

**Note 4. 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 resell, repurchase agreements, future purchases and sales of foreign currencies, securities transactions on a when-issued basis 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, 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. 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.

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

A portion of our derivative activities are performed by Jefferies Financial Products, LLC ( JFP ). JFP is a market maker in commodity index products and a trader in commodity futures and options. Where appropriate, JFP utilizes various credit enhancements, including guarantees, collateral, margin and master netting 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. JFP maintains credit intermediation facilities with highly rated European banks (the Banks ), which allow JFP customers that require a counterparty with a high credit rating for commodity index transactions to transact with the Banks. The Banks simultaneously enter into offsetting transactions with JFP and receive a fee from JFP for providing credit support. In certain cases, JFP is responsible to the Banks for the performance of JFP s customers.

The fair value of derivative assets and derivative liabilities are presented on the Consolidated Statements on Financial Condition in Financial Instruments Owned Derivatives and Financial Instruments Sold, Not Yet Purchased Derivatives net of cash paid or received under credit support agreements and on a net counterparty basis when a legal right to offset exists under a master netting agreement. Net unrealized and realized gains and losses on derivative contracts are recognized within principal transactions revenue in our Consolidated Statements of Earnings. (See Notes 3 and 16 for additional disclosures about derivative instruments.)

The following table presents the fair value and related notional amounts of derivative contracts at March 31, 2009 categorized by predominant risk exposure. The fair value of assets/liabilities related to derivative contracts represents our receivable/payable for derivative financial instruments, gross of counterparty netting and cash collateral received and pledged:

| | March 31, 2009 | | | |
|---|---|---|---|---|
| | Assets | | Liabilities | |
| (in thousands) | Fair Value | Notional Amount | Fair Value | Notional Amount |
| Interest rate contracts | $ 40,497 | $ 3,905,335 | $ 35,428 | $ 6,827,082 |
| Foreign exchange contracts | 8,864 | 247,028 | 13,548 | 149,873 |
| Equity contracts | 222,424 | 2,747,352 | 179,256 | 2,812,273 |
| Commodity contracts | 214,251 | 2,227,208 | 54,405 | 2,406,816 |
| Credit contracts | 7,756 | 43,628 | 5,012 | 15,000 |
| Total | $ 493,792 | $ 9,170,551 | $ 287,649 | $ 12,211,044 |
| Counterparty/cash-collateral netting | (202,700) | | (97,959) | |