

# Jefferies

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May 6, 2005

Via Fax and Overnight Mail  
Ms. Anne Dansard Glowacki  
NASD  
Los Angeles District Office  
One California Plaza  
300 South Grand Avenue, Suite 1600  
Los Angeles, CA 90071

Re: CMKX

Dear Anne:

This letter responds to your request to summarize circumstances surrounding Jefferies & Company, Inc.'s failure to report certain transactions in CMKX Diamonds Inc. ("CMKX") to the National Trade Reporting System (the "Tape") in 2004.

By way of background, the Automated Confirmation Transaction Service ("ACT") is an automated system which (a) compares trade information entered by ACT participants and submits "locked-in" trades to the National Securities Clearing Corporation ("NSCC") for clearance and settlement and (b) transmits reports of transactions automatically to the Tape. Under the NASD rules, a member firm and ACT participant may elect to clear transactions outside of ACT and NSCC and thereby settle transactions manually. In such cases, the member firm may utilize ACT for (b), trade reporting only (called "Tape only") and not (a), NSCC clearance (called "Ex-Clearing").

In March of 2004, two broker-dealer customers of Jefferies approached the firm requesting that transactions in CMKX be settled on an "Ex-Clearing basis". These broker-dealer customers were long sellers of CMKX. The reason for their request was economics: because CMKX traded in such large volumes and at such a low price, NSCC required a significant deposit for long sellers of the security to ensure settlement. The cost of this deposit negatively impacted the broker-dealer's customers. Jefferies made a business and operational risk decision to allow a limited number of broker dealer customers who were long sellers of CMKX to settle the trades "Ex-Clearing". These Ex-Clearing transactions were monitored to ensure that the sellers properly delivered the securities and the trades settled on a timely basis. From a settlement perspective, these Ex-Clearing trades settled without incident and things went smoothly for a period of several months.

Unfortunately, unbeknownst to the firm, from a trade reporting perspective, these Ex-Clearing trades presented a problem. As you may know, there is a size limitation on ACT

so that any single transaction of greater than 10 million shares automatically rejects on ACT. The firm had built a proprietary system so that any order greater than 10 million shares was submitted in component parts of less than 10 million shares first through BRASS (our front-end system)<sup>1</sup> and then to ACT for (a) clearing and (b) Tape reporting purposes (called "the Big Report"). In short, the Big Report allowed trades of over 10 million shares to be accepted rather than rejected by ACT. However, when the firm's traders entered the "Ex-Clearing orders" they failed to enter the trades that were larger than 10 million shares on the Big Report. The traders mistakenly believed that since these trades were 'Ex-Clearing', the ACT limits would not affect their Tape reports. We now know that the Ex-Clearing trades over 10 million shares were rejected by ACT. While BRASS has a pop up system to alert the trade processing area that an order has been rejected by ACT, the pop up must to be activated by the member firm utilizing BRASS. The firm had not turned on this pop up feature during this time frame.

The firm would like to remedy this failure to report and would appreciate NASD's guidance. To develop the universe of trades which we believe the firm failed to report to the Tape, we ran a report that shows all the transactions of greater than 10 million shares that we executed on an Ex-Clearing basis during the period 3/25/04 (when the firm first began to process on an Ex-Clearing basis) through 9/21/04 (when the firm ceased to act as a market maker). Attached is a spreadsheet showing the transactions (a total of 111,780,681,204 shares) that we believe we failed to report to the Tape. (See spreadsheet, Exhibit A attached that shows the trade dates, execution time, buy or sell, symbol, quantity and price.) We would like to report these trades in a manner which is acceptable to you.

We have taken steps to prevent this problem from occurring in the future including procedures for approval to execute trades "Ex-Clearing" and if the decision is made to execute Ex-Clearing, procedures to ensure proper trade reporting to the Tape.

If you have any questions about this matter, please call me at 212-284-2586.

Sincerely,



Cathleen Shine  
Deputy General Counsel

Enclosure

CC: Leslie Hakala, Staff Attorney, Securities & Exchange Commission

<sup>1</sup> BRASS does not have any mechanism to break up the order to avoid the reject problem.