

FINANCIAL STATEMENTS AND SUPPLEMENTAL INFORMATION

Lehman Brothers OTC Derivatives Inc.

Year ended November 30, 2007

With Report and Supplementary Report of Independent Registered Public Accounting Firm  
(Confidential)

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

<b>OMB APPROVAL</b>	
OMB Number:	3235-0123
Expires:	
Estimated average burden hours per response . . .	12.00

<b>SEC FILE NUMBER</b> 8-65696
-----------------------------------

ANNUAL AUDITED REPORT  
FORM X-17A-5  
PART III

FACING PAGE

Information Required of Brokers and Dealers Pursuant to Section 17 of the  
Securities Exchange Act of 1934 and Rule 17a-5 Thereunder

REPORT FOR THE PERIOD BEGINNING 12/1/2006 AND ENDING 11/30/2007  
MM/DD/YY MM/DD/YY

**A. REGISTRANT IDENTIFICATION**

NAME OF BROKER-DEALER: Lehman Brothers OTC Derivatives Inc.

(Filed as Confidential Information)

OFFICIAL USE ONLY

FIRM ID. NO.

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

745 7<sup>th</sup> Avenue

New York	(No. and Street) New York	10019
(City)	(State)	(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Martin Kelly (212) 526-3606

(Area Code – Telephone No.)

**B. ACCOUNTANT IDENTIFICATION**

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report\*

Ernst & Young LLP

(Name – of individual, state last, first, middle name)

5 Times Square	New York	NY	10036
(Address)	(City)	(State)	(Zip Code)

**CHECK ONE:**

- Certified Public Accountant
- Public Accountant
- Accountant not resident in United States or any of its possessions.

**FOR OFFICIAL USE ONLY**

\*Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis for the exemption. See section 240.17a-5(e)(2).

SEC 1410 (7-00)

**Lehman Brothers OTC Derivatives Inc.**

		<u>Page</u>
This report ** contains (check all applicable boxes):		
<u>  x  </u>	(a) Facing page	Facing page
<u>  x  </u>	(b) Oath or Affirmation	i
<u>  x  </u>	(c) Statement of Income	2
<u>  x  </u>	(d) Statement of Financial Condition	3
<u>  x  </u>	(e) Statement of Changes in Stockholder's Equity	4
<u>  x  </u>	(f) Statement of Changes in Liabilities Subordinated to Claims of General Creditors	5
<u>  x  </u>	(g) Statement of Cash Flows	6
<u>  x  </u>	(h) Computation of Net Capital	S1
<u>  x  </u>	(i) Statement of Assets Deemed Non-allowable in Computing Net Capital Under Rule 15c3-1, Appendix F	S2
_____	(j) Computation for Determination of Reserve Requirements for Broker- Dealers Under Rule 15c3-3	
_____	(k) Information for Possession or Control Requirements Under Rule 15c3-3	
<u>  x  </u>	(l) Statement Pursuant to Paragraph (b) (4) of Rule 17a-12	S3
_____	(m) Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Commodity Exchanges	
_____	(n) Statement of Secured Amounts and Funds Held in Separate Accounts for Foreign Futures and Foreign Options Customers Pursuant to Commission Regulation 30.7.- Foreign Futures and Foreign Options Secured Amounts	
_____	(o) Statement of Secured Amounts and Funds Held in Separate Accounts for Foreign Futures and Foreign Options Customers Pursuant to Commission Regulation 30.7. - Funds Deposited in Separate Regulation 30.7 Accounts	
_____	(p) Statement Pursuant to Section 1.10 (d) (2) of the Commodity Exchange Act	
<u>  x  </u>	(q) Reconciliation of Assets, Liabilities and Stockholder's Equity to the Regulatory Report	S4
_____	(r) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit	
<u>  x  </u>	(s) Supplemental Report of Independent Registered Public Accounting Firm on Internal Control Required by Securities and Exchange Commission Rule 17a-12	S5
_____	(t) Supplemental Report of Independent Auditors on Internal Control Required by Commodities Futures Trading Commission Regulation 1.16	

\*\* For conditions or confidential treatment of certain portions of this filing, see Section 240.17a-5(e) (3).

OATH OR AFFIRMATION

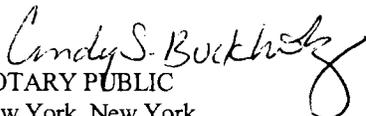
I, Erin Callan, swear that, to the best of my knowledge and belief the accompanying financial statements and supporting schedules pertaining to the firm of Lehman Brothers OTC Derivatives Inc., as of November 30, 2007 are true and correct. I further swear that neither the OTC derivatives dealer, nor any partner, officer, or director has any significant interest in any counterparty or in any account classified solely as that of a counterparty.

  
Signature

Chief Financial Officer  
Title

Subscribed and sworn to before me this 25 day of January, 2008

CINDY S. BUCKHOLZ  
Notary Public, State of New York  
No. 01BU6030825  
Qualified in Bronx County  
Certificate Filed in New York County  
Commission Expires 9/22/09

  
NOTARY PUBLIC  
New York, New York

In and for the State of New York  
Residing in New York

NOTARY PUBLIC  
Expiration 9 1201 2009

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholder of  
Lehman Brothers OTC Derivatives Inc.

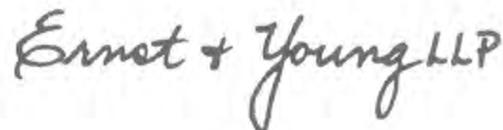
We have audited the accompanying statement of financial condition of Lehman Brothers OTC Derivatives Inc. (the "Company") as of November 30, 2007 and the related statements of income, changes in stockholder's equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the 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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Lehman Brothers OTC Derivatives Inc. at November 30, 2007, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental information is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-12 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

January 28, 2008



**Lehman Brothers OTC Derivatives Inc.**

**Statement of Income**

**In thousands**

**Year ended November 30, 2007**

<b>Revenues</b>	
Principal transactions	\$185,926
Interest	131,548
Total revenues	317,474
Interest expense	105,430
Net revenues	212,044
<b>Non-Interest Expenses</b>	
Compensation and benefits	104,538
Brokerage, clearing and exchange fees	827
Professional fees	235
Occupancy and other expenses	238
Total non-interest expenses	105,838
Income before taxes	106,206
Provision for income taxes	45,050
Net income	\$ 61,156

See Notes to Financial Statements.

**Lehman Brothers OTC Derivatives Inc.**

**Statement of Financial Condition**

**In thousands except per share data**

**November 30, 2007**

<b>Assets</b>	
Cash and cash equivalents	\$ 3,382
Financial instruments owned (including \$283,535 pledged as collateral)	1,640,444
Securities purchased under agreements to resell	88,453
Securities borrowed	169,335
Receivables:	
Affiliated broker dealer	3,605,488
Customer receivables	25,528
Other receivables	130,973
Other assets	4,364
<b>Total assets</b>	<b>\$ 5,667,967</b>
<b>Liabilities and stockholder's equity</b>	
Financial instruments sold but not yet purchased	\$4,140,276
Securities sold under agreements to repurchase	23,749
Securities loaned	28,276
Advances from Holdings and other affiliates	306,810
Payables to customers	204,434
Short-term borrowings	382,660
Subordinated indebtedness	250,000
Compensation payable	104,051
Income taxes payable	41,526
Accrued liabilities and other payables	5,339
<b>Total liabilities</b>	<b>5,487,121</b>
Stockholder's equity	
Common stock, \$1.00 par value; 100 shares authorized; 100 shares issued and outstanding	-
Additional paid-in capital	100,000
Retained earnings	80,846
<b>Total stockholder's equity</b>	<b>180,846</b>
<b>Total liabilities and stockholder's equity</b>	<b>\$ 5,667,967</b>

See Notes to Financial Statements.

**Lehman Brothers OTC Derivatives Inc.**  
**Statement of Changes in Stockholder's Equity**

**In thousands**

**Year ended November 30, 2007**

Additional paid-in capital, beginning and ending balance	\$100,000
Retained earnings:	
Beginning balance	19,498
Cumulative effect of accounting changes <sup>(1)</sup>	192
Net income	61,156
Ending balance	80,846
Total stockholder's equity	\$180,846

<sup>(1)</sup> The adoption impact of SFAS No. 157 is reflected for the year ended November 30, 2007.

See Notes to Financial Statements.

**Lehman Brothers OTC Derivatives Inc.**

**Statement of Changes in Liabilities  
Subordinated to Claims of General Creditors**

**In thousands**

**Year ended November 30, 2007**

Subordinated indebtedness, beginning of year	\$100,000
Issuance of subordinated indebtedness	150,000
Subordinated indebtedness, end of year	\$250,000

See Notes to Financial Statements.

**Lehman Brothers OTC Derivatives Inc.**

**Statement of Cash Flows**

**In thousands**

**Year ended November 30, 2007**

---

**Cash Flows From Operating Activities**

Net income	\$ 61,156
Adjustments to reconcile net income to net cash provided by operating activities:	
Deferred tax benefit	7,364
Net change in:	
Financial instruments owned	14,410
Securities purchased under agreements to resell, net	445,369
Securities borrowed	(169,335)
Affiliated broker dealers	(2,940,912)
Customer receivables	51,100
Other receivables	(130,973)
Other assets	(3,305)
Financial instruments sold but not yet purchased	2,180,760
Securities loaned	28,276
Advances from Holdings and other affiliates	59,959
Payables to customers	204,434
Compensation payable	83,119
Income taxes payable	37,928
Accrued liabilities and other payables	(59,735)
Net cash used in operating activities	(130,385)
Cash flows from financing activities	
Repayment of other secured borrowings	(400,000)
Issuance of short-term borrowings	382,660
Issuance of subordinated indebtedness	150,000
Net cash provided by financing activities	132,660
Net change in cash and cash equivalents	2,275
Cash and cash equivalents, beginning of year	1,107
Cash and cash equivalents, end of year	\$ 3,382
<hr/> <b>Supplemental Disclosure of Cash Flow Information</b>	
Interest paid	\$ 126,539
Income taxes paid	\$ 18,658

See Notes to Financial Statements.

**Lehman Brothers OTC Derivatives Inc.**

**Notes to Financial Statements**

**Contents**

	<u>Page</u>
Note 1. Summary of Significant Accounting Policies .....	8
Note 2. Financial Instruments .....	11
Note 3. Fair Value of Financial Instruments .....	12
Note 4. Securities Received and Pledged as Collateral .....	13
Note 5. Borrowings .....	13
Note 6. Commitments, Contingencies and Guarantees .....	13
Note 7. Regulatory Requirements .....	14
Note 8. Income Taxes .....	15
Note 9. Related Party Transactions .....	15

# Lehman Brothers OTC Derivatives Inc.

## Notes to Financial Statements

---

### Note 1 Summary of Significant Accounting Policies

---

#### Description of Business

Lehman Brothers OTC Derivatives Inc., (“LOTC” or the “Company,”) a Delaware Corporation, is a wholly owned and fully guaranteed subsidiary of Lehman Brothers Holdings Inc. (“Holdings”). The Company is an over-the-counter (“OTC”) derivatives dealer regulated by the Securities and Exchange Commission (“SEC”). The Company’s trading is limited to certain equity and fixed income derivative products (including options on emerging market bonds), and related hedge transactions which have been approved under rules established by the SEC. As required by the SEC, the Company clears its business activities through an affiliated registered broker dealer, Lehman Brothers Inc. (“LBI”).

LBI maintains the Company’s account on a margin basis consistent with the requirements of New York Stock Exchange Rule 431.

#### Basis of Presentation and Use of Estimates

The 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 financial statements and accompanying notes. Management estimates are required to be used in determining the valuation of trading inventory particularly in the area of OTC derivatives. Management believes the estimates used in preparing the financial statements are reasonable and prudent. Actual results could differ from these estimates.

#### Revenue Recognition Policies

**Principal Transactions** Financial instruments classified as Financial instruments owned and Financial instruments sold but not yet purchased (both of which are recorded on a trade-date basis) are valued at fair value, as appropriate, with unrealized gains and losses reflected in Principal transactions in the Statement of Income as incurred.

**Interest Revenue/Expense** The Company recognizes 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 Interest expense, respectively. Interest flows on derivative transactions are included as part of the mark-to-market valuation of these contracts in Principal transactions in the Statement of Income and are not recognized as a component of Interest revenue or expense. The Company accounts for the secured financing activities, other secured borrowings and subordinated indebtedness on an accrual basis with related interest recorded as interest revenue or interest expense, as applicable.

#### Financial Instruments

Financial instruments owned, and Financial instruments sold but not yet purchased are recognized on a trade-date basis and are carried at fair value. See note 3, “Fair Value of Financial Instruments.”

**Derivative Financial Instruments.** Derivatives are financial instruments whose value is based on an underlying asset (e.g., Treasury bond), index (e.g., S&P 500) or reference rate (e.g., LIBOR), and include futures, forwards, swaps, option contracts, or other financial instruments with similar characteristics. A derivative contract generally represents a future commitment to exchange interest payment streams or currencies based on the contract or notional amount or to purchase or sell other financial instruments or physical assets at specified terms on a specified date. OTC derivative products are privately-negotiated contractual agreements that can be tailored to meet individual client needs and include forwards, swaps and certain options including caps, collars and floors. Exchange-traded derivative products are standardized contracts transacted through regulated exchanges and include futures and certain option contracts listed on an exchange.

Derivatives are recorded at fair value and included in either Financial instruments owned or Financial instruments sold but not yet purchased in the Statement of Financial Condition. Derivatives are presented net-by-counterparty when a legal right of offset exists; net across different products or positions when applicable provisions are stated in a master netting agreement; and/or net of cash collateral received or paid on a counterparty basis, provided legal right of offset exists.

## Lehman Brothers OTC Derivatives Inc.

### Notes to Financial Statements

We adopted Statement of Financial Accounting Standards ("SFAS") No. 157, *Fair Value Measurements* ("SFAS 157") effective December 1, 2006. SFAS 157 defines fair value as the price 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. When observable prices are not available, we either use implied pricing from similar instruments or valuation models based on net present value of estimated future cash flows, adjusted as appropriate for liquidity, credit, market and/or other risk factors. For further discussion of our adoption of SFAS 157, see "Accounting Changes and Other Accounting Developments - SFAS 157" below.

#### **Collateralized Lending Agreements and Financings**

Treated as collateralized agreements and financings for financial reporting purposes are the following:

**Repurchase and resale agreements.** Securities purchased under agreements to resell and securities sold under agreements to repurchase are collateralized primarily by government and government agency securities and are carried net by counterparty, when permitted, at the amounts at which the securities subsequently will be resold or repurchased plus accrued interest. We take possession of securities purchased under agreements to resell. The fair value of the underlying positions is compared daily with the related receivable or payable balances, including accrued interest. We require counterparties to deposit additional collateral or return collateral pledged, as necessary, to ensure the fair value of the underlying collateral remains sufficient.

**Securities borrowed and securities loaned.** Securities borrowed and securities loaned are carried at the amount of cash collateral advanced or received plus accrued interest. We value the securities borrowed and loaned daily and obtain additional cash as necessary to ensure these transactions are adequately collateralized. When we act as the lender of securities in a securities-lending agreement and we receive securities that can be pledged or sold as collateral, we recognize an asset, representing the securities received and a liability, representing the obligation to return those securities.

#### **Cash and cash equivalents**

Cash and cash equivalents include highly liquid investments not held for resale with maturities of three months or less when the Company acquires them.

#### **Customer receivables**

Customer receivables represent amounts due from counterparties in connection with cash collateral posted on derivative transactions.

#### **Other receivables**

Other receivables primarily represent trade date accruals related to financial instruments sold but not yet purchased.

#### **Income Taxes**

The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, ("SFAS 109"). The Company recognizes the current and deferred tax consequences of all transactions that have been recognized in the financial statements using the provisions of the enacted tax laws. Deferred tax assets are recognized for temporary differences that will result in deductible amounts in future years and for tax loss carry-forwards. The Company records a valuation allowance to reduce deferred tax assets to an amount that more likely than not will be realized. Deferred tax liabilities are recognized for temporary differences that will result in taxable income in future years. Contingent liabilities related to income taxes are recorded when probable and reasonably estimable in accordance with SFAS No. 5, *Accounting for Contingencies*.

See "Accounting Changes and Other Accounting Developments—FIN 48" below for a discussion of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* ("FIN 48").

## Lehman Brothers OTC Derivatives Inc.

### Notes to Financial Statements

#### Accounting Changes and Other Accounting Developments

**SFAS 158.** In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Retirement Plans* ("SFAS 158"), which requires an employer to recognize the over- or under-funded status of its defined benefit postretirement plans as an asset or liability in its Statement of Financial Condition, measured as the difference between the fair value of the plan assets and the benefit obligation. For pension plans the benefit obligation is the projected benefit obligation; while for other postretirement plans the benefit obligation is the accumulated postretirement obligation. Upon adoption, SFAS 158 requires an employer to recognize previously unrecognized actuarial gains and losses and prior service costs within Accumulated other comprehensive income/(loss) (net of tax), a component of Stockholders' equity. In accordance with the guidance in SFAS 158, Holdings, as the sponsor of the defined benefit pension plan in which all employees of Holdings participate, adopted this provision of the standard for the year ended November 30, 2007. Holdings adoption of SFAS 158 had no impact on the Company's Financial Statements at November 30, 2007.

**SFAS 157.** In September 2006, the FASB issued SFAS 157, which defines fair value, establishes a framework for measuring fair value, outlines a fair value hierarchy based on inputs used to measure fair value and enhances disclosure requirements for fair value measurements. SFAS 157 does not change existing guidance as to whether or not an instrument is carried at fair value.

SFAS 157 also (i) nullifies the guidance in EITF 02-3 that precluded the recognition of a trading profit at the inception of a derivative contract, unless the fair value of such derivative was obtained from a quoted market price or other valuation technique incorporating observable inputs; (ii) clarifies that an issuer's credit standing should be considered when measuring liabilities at fair value; (iii) precludes the use of a liquidity or block discount when measuring instruments traded in an active market at fair value; and (iv) requires costs related to acquiring financial instruments carried at fair value to be included in earnings as incurred.

The Company elected to early adopt SFAS 157 beginning of its 2007 fiscal year. As a result of adopting SFAS 157, we recognized a \$192 thousand after-tax (\$273 thousand pre-tax) increase to opening retained earnings. For additional information regarding our adoption of SFAS 157, see Note 3, "Fair Value of Financial Instruments."

**FIN 48.** In June 2006, the FASB issued FIN 48, which sets out a framework for management to use to determine the appropriate level of tax reserves to maintain for uncertain tax positions. This interpretation of SFAS 109 uses a two-step approach wherein a tax benefit is recognized if a position is more likely than not to be sustained, and the amount of benefit is then measured on a probabilistic approach, as defined in FIN 48. FIN 48 also sets out disclosure requirements to enhance transparency of an entity's tax reserves. The Company must adopt FIN 48 as of the beginning of its 2008 fiscal year. The adoption of FIN 48 will have no impact on the Company's Financial Statements.

**FSP FIN 48-1.** In May 2007, the FASB directed the FASB Staff to issue FASB Staff Position No. FIN 48-1, *Definition of "Settlement" In FASB Interpretation No. 48* ("FSP FIN 48-1"). Under FSP FIN 48-1, a previously unrecognized tax benefit may be subsequently recognized if the tax position is effectively settled and other specified criteria are met. The adoption of FSP FIN 48-1 will have no impact on the Company's Financial Statements.

**FSP FIN 39-1.** In April 2007, the FASB directed the FASB Staff to issue FSP No. FIN 39-1, *Amendment of FASB Interpretation No. 39* ("FSP FIN 39-1"). FSP FIN 39-1 modifies FIN No. 39, *Offsetting of Amounts Related to Certain Contracts*, and permits companies to offset cash collateral receivables or payables with net derivative positions under certain circumstances. FSP FIN 39-1 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. FSP FIN 39-1 does not affect our Financial Statements because it clarified the acceptability of existing market practice, which we use, of netting cash collateral against net derivative assets and liabilities.

## Lehman Brothers OTC Derivatives Inc.

### Notes to Financial Statements

---

#### Note 2 Financial Instruments

---

Financial instruments owned and Financial instruments sold but not yet purchased were comprised of the following:

**In thousands**

**November 30, 2007**

Financial instruments owned:

Equity derivative contracts	\$1,288,364
Corporate equities	342,481
Governments and agencies	9,599
	<hr/>
	\$1,640,444

Financial instruments sold but not yet purchased:

Equity derivative contracts	\$1,445,678
Corporate equities	2,666,996
Governments and agencies	27,602
	<hr/>
	\$4,140,276

Cash collateral received and paid is netted on a counterparty basis against derivative contracts, providing a legal right of offset exists. Assets and liabilities at November 30, 2007 were netted down for cash collateral of approximately \$860 million and \$203 million, respectively.

OTC derivative contracts contain credit risk for unrealized gains. With respect to our OTC derivative contracts the Company views its net credit exposure, net of affiliate derivative receivables and collateral from third parties to be approximately \$262 million at November 30, 2007. This credit exposure represents the fair value of the Company's OTC contracts in an unrealized gain position, after consideration of collateral, and is primarily comprised of amounts owed from corporations, financial institutions and affiliated entities. Counterparties to the Company's OTC derivative products primarily are high net worth individuals, financial institutions, universities, and affiliated entities. Collateral held related to OTC contracts generally includes corporate equities.

At November 30, 2007 Equity derivative contracts within Financial instruments owned included approximately 57% of contracts for which a substantial upfront payment was made.

#### Concentrations of Credit Risk

The Company's counterparty exposures at November 30, 2007 primarily include financial institutions, corporations and affiliated entities. This concentration arises in the normal course of business. Collateral held for resale agreements represented approximately 2% of total assets at November 30, 2007 and consisted of investment grade mortgage backed securities, U.S. treasuries, and other government bonds.

A substantial portion of the Company's securities transactions are collateralized. The Company's exposure to credit risk associated with the non-performance of these customers and counterparties in fulfilling their contractual obligations pursuant to securities transactions can be affected by volatile or illiquid trading markets, which may impair the ability of customers and counterparties to satisfy their obligations to the Company.

## Lehman Brothers OTC Derivatives Inc.

### Notes to Financial Statements

#### Note 3 Fair Value of Financial Instruments

Financial instruments owned, and Financial instruments sold but not yet purchased, are presented at fair value. Fair value is defined as the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, willing parties. Where available, fair value is based on observable market prices or parameters or derived from such prices or parameters. Where observable prices or inputs are not available, valuation models are applied. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency for the instruments or market and the instruments' complexity.

Beginning December 1, 2006, assets and liabilities recorded at fair value in the Statement of Financial Condition are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels – defined by SFAS 157 and directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities – are as follows:

Level I – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.

Level II – Inputs (other than quoted prices included in Level I) are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.

Level III – Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

An asset or a liability's categorization within the fair value hierarchy is based on the lowest level of significant input to its valuation.

Fair valued Financial instruments owned, and Financial instruments sold but not yet purchased at November 30, 2007 were:

<b>In thousands</b>	<b>At November 30, 2007</b>			
	<b>Level I</b>	<b>Level II</b>	<b>Level III</b>	<b>Total</b>
<b>Financial instruments owned:</b>				
Equity derivative contracts <sup>(1)</sup>	\$ 39,976	\$ 990,602	\$257,786	\$1,288,364
Corporate equities	318,492	23,989	–	342,481
Governments and agencies	–	9,599	–	9,599
<b>Total Financial instruments owned</b>	<b>\$ 358,468</b>	<b>\$1,024,190</b>	<b>\$257,786</b>	<b>\$1,640,444</b>
<b>Financial instruments sold but not yet purchased:</b>				
Equity derivative contracts <sup>(1)</sup>	\$ 62,888	\$ 757,774	\$625,016	\$1,445,678
Corporate equities	2,666,996	–	–	2,666,996
Governments and agencies	–	27,602	–	27,602
<b>Total Financial instruments sold but not yet purchased:</b>	<b>\$2,729,884</b>	<b>\$ 785,376</b>	<b>\$625,016</b>	<b>\$4,140,276</b>

<sup>(1)</sup> Derivative assets and derivative liabilities are presented on a net basis by level. Inter- and intra-level cash collateral, cross-product and counterparty netting at November 30, 2007 were approximately \$32 million and \$192 million, respectively.

## Lehman Brothers OTC Derivatives Inc.

### Notes to Financial Statements

The table presented below summarizes the change in balance sheet carrying value associated with Level III financial instruments during the fiscal year ended November 30, 2007. Caution should be utilized when evaluating reported net revenues for Level III Financial instruments. The values presented exclude economic hedging activities that may be transacted in instruments categorized within other fair value hierarchy levels. Actual net revenues associated with Level III financial instruments inclusive of hedging activities could differ materially.

In thousands	Balance November 30, 2006	Net Payments, Purchases and Sales	Net Transfers In/(Out)	(Gains) / Losses <sup>(1)</sup> Realized      Unrealized		Balance November 30, 2007
Equity derivative liabilities, net	\$2,993	\$245,951	\$178,878	(\$2,993)	(\$57,599)	\$367,230

<sup>(1)</sup> The current period gains/ (losses) from changes in values of Level III Financial instruments represent gains/ (losses) from changes in values of those Financial instruments only for the period(s) in which the instruments were classified as Level III.

#### **Note 4 Securities Received and Pledged as Collateral**

The Company receives and pledges collateral in connection with its derivatives activities and in connection with resale and repurchase agreements. The Company is typically permitted to sell or repledge securities received as collateral. At November 30, 2007 the gross fair value of securities received and maintained as collateral in connection with resale agreements was approximately \$89.3 million. At November 30, 2007, the gross fair value of securities received as collateral in connection with derivative activities was approximately \$1,405 million and is held in custody through its affiliated broker dealer, LBI.

In addition, at November 30, 2007 the gross fair value of securities pledged as collateral where the counterparty has the right by contract or custom, to re-hypothecate the financial instruments was approximately \$284 million and are classified as financial instruments owned, pledged as collateral in the Statement of Financial Condition as required by SFAS 140.

#### **Note 5 Borrowings**

**Short-term borrowings.** Short-term borrowings represent cash received from customers as prepayment on certain contracts with future obligations to deliver shares (accelerated share repurchases), all maturing within one year.

**Subordinated indebtedness.** During the year ended November 30, 2007, the Company renewed its subordinated debt agreement with Holdings and increased its borrowings from \$100 million to \$250 million. This subordinated debt is scheduled to mature in July 2008 and is payable to Holdings, with an automatic rollover provision. The Company expects to renew their subordinated debt payable to Holdings. Interest on this subordinated debt is calculated and accrued monthly at the rate of LIBOR plus 80 basis points

#### **Note 6 Commitments, Contingencies and Guarantees**

**Derivative contracts.** Under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* ("FIN 45"), derivative contracts are considered to be guarantees if such contracts require us to make payments to counterparties based on changes in an underlying instrument or index (e.g., security prices, interest rates, and currency rates) and include written credit default swaps, written put options, written foreign exchange and interest rate options.

## Lehman Brothers OTC Derivatives Inc.

### Notes to Financial Statements

Derivative contracts are not considered guarantees if these contracts are cash settled and we cannot determine if the derivative counterparty held the contracts' underlying instruments at inception. We have determined these conditions have been met for certain large financial institutions. Accordingly, when these conditions are met, we have not included these derivatives in our guarantee disclosures. At November 30, 2007, the notional value, also the maximum payout value of derivative contracts deemed to be guarantees, was as follows:

In thousands	Notional/ Maximum Payout	Amount of Commitment Expiration per Period					
		2008	2009	2010	2011	2012	2013+
November 30, 2007							
Derivative contracts	\$4,358,584	\$3,364,294	\$176,568	\$113,146	\$74,215	\$75,000	\$555,361

For purposes of determining maximum payout, notional values are used; however, the Company believes the fair value of these contracts is a more relevant measure of these obligations because the Company believes the notional amounts greatly overstate the Company's expected payout. At November 30, 2007, the fair value of these derivative contracts was approximately \$262 million. In addition, all amounts included above are before consideration of hedging transactions. The Company substantially mitigates its risk on these contracts through hedges, such as other derivative contracts and/or cash instruments.

*Other.* Financial instruments sold but not yet purchased represent the Company's obligations to purchase the securities at prevailing market prices. Therefore, the future satisfaction of such obligations may be for an amount greater or less than the amount recorded. The ultimate gain or loss is dependent on the price at which the underlying financial instrument is purchased to settle the Company's obligation under the sale commitment.

In the normal course of business, the Company is exposed to credit and market risk as a result of executing, financing and settling various customer security and commodity transactions. These risks arise from the potential that customers or counterparties may fail to satisfy their obligations and the collateral obtained is insufficient. In such instances, the Company may be required to purchase or sell financial instruments at unfavorable market prices. The Company seeks to control these risks by obtaining margin and other collateral in accordance with regulatory and internal guidelines.

#### Note 7 Regulatory Requirements

The Company is a registered broker-dealer under SEC Rule 17a-12 and is authorized to compute capital charges for market and credit risk pursuant to the Securities Exchange Act Rule 15c3-1 Appendix F ("Appendix F"). Under these rules, the Company is required to maintain net capital of \$20 million and tentative net capital of \$100 million as defined in SEC Rule 15c3-1. As of November 30, 2007 the Company's regulatory net capital, as defined, of \$369 million exceeded the minimum requirement by approximately \$349 million and its tentative net capital of \$423 million exceeded the minimum requirement by \$323 million.

As approved by the SEC, the Company utilizes Value at Risk ("VaR") obtained from its proprietary VaR Model to compute market risk capital charges, multiplying the results obtained by a factor of 4.0. At November 30, 2007, the Company's market risk capital charge was \$49 million. In addition, the Company calculates capital charges for credit risk in accordance with several factors prescribed by the SEC, including, but not limited to the credit rating of the counterparties and the value of the collateral received. At November 30, 2007, the Company's credit risk capital charge was \$5 million. Repayment of subordinated indebtedness and dividend payments by the Company are restricted by the regulations of the SEC.

## Lehman Brothers OTC Derivatives Inc.

### Notes to Financial Statements

---

#### Note 8 Income Taxes

---

Our income is included in the consolidated U.S. federal income tax return of Lehman Brothers. Our tax provision is computed in accordance with the tax sharing agreement between Lehman Brothers and its subsidiaries. In accordance with this agreement, the balance due at November 30, 2007 was \$37.8 million. Our deferred tax liability of \$3.7 million relates to reserves and is included in Income taxes payable in our Statement of Financial Condition.

The provision for income taxes consists of the following (in thousands):

Current taxes:	
U.S. Federal	\$27,615
State and local	10,071
	<u>37,686</u>
Deferred taxes:	
U.S. Federal	5,315
State and local	2,049
	<u>7,364</u>
Provision for income taxes	<u>\$45,050</u>

The provision for income taxes resulted in an effective tax rate of 42.42%, which is higher than the statutory federal income tax rate primarily due to state and local taxes.

---

#### Note 9 Related Party Transactions

---

In the normal course of business the Company engages in various securities trading and financing activities with Holdings, LBI and certain of their subsidiaries (the "Related Parties"). Various charges, such as compensation and benefits, occupancy, administration and computer processing are allocated among the Related Parties based on specific identification and other allocation methods.

Related Parties have allocated to the Company the cost of certain employees and space in various New York City and surrounding locations. The aggregate of these amounts are classified in the Statement of Income as Compensation and benefits and Occupancy and other, respectively.

At November 30, 2007 the Company had approximately \$68.4 million and \$20.1 million of Securities purchased under agreements to resell, with LBI and Lehman Brothers International Europe ("LBIE"), respectively. For the year ended November 30, 2007, the Company earned interest revenue of \$48.0 million from affiliates. The Company had \$5.4 million and \$18.4 million of Securities sold under agreements to repurchase with LBI and LBIE at November 30, 2007, respectively.

Receivables from an affiliated broker dealer are approximately \$3.6 billion at November 30, 2007.

Advances from Holdings and other affiliates totaling approximately \$306.8 million at November 30, 2007, are generally payable on demand. The average interest rate charged on these advances is primarily based on Holdings' average daily cost of funds, which was 5.25% at November 30, 2007. The Company also had borrowings from Holdings classified as subordinated indebtedness of \$250 million at November 30, 2007. For the year ended, the Company incurred interest expense of \$69.5 million to affiliates.

## **Supplemental Information**

**FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT  
PART IIB**

Lehman Brothers OTC Derivatives, Inc.	11/30/2007
Name of Dealer	As of ( MM/DD/YYYY)

**COMPUTATION OF NET CAPITAL AND NET CAPITAL REQUIRED  
(Electing 15c3-1 Appendix F)**

CAPITAL

1. Total ownership equity	\$ 180,846,000	3480
2. Deduct: Ownership Equity not Allowable for Net Capital	0	3490
3 Total Ownership Equity Qualified for Net Capital	180,846,000	3500
4. Add: Subordinated Liabilities Approved for Net Capital	250,000,000	3520
5. Other Allowable Credit or Deductions	0	3525
6. Total Capital and Approved Subordinations	430,846,000	3530
7. Non- Allowable Assets	\$ 8,331,000	3540
8. Secured Demand Note Deficiency	0	3590
9. Other deductions and charges	0	3610
10. Total Non-Allowable Assets, Other Deductions and Charges	8,331,000	3620
11. Tentative Net Capital ( must equal or exceed \$100,000,000)	\$ 422,515,000	3640

Computation of Net Capital Requirements and Excess Net Capital

12. Market Risk Exposure		
A. Total Value At Risk	12,183,000	3635
1. Fixed Income ( VAR )	1,973,000	3636
2. Currency ( VAR )	0	3637
3. Commodities ( VAR )	0	3638
4 Equities ( VAR )	15,716,000	3639
<u>Note: The sum of the value at risk components may not equal total value at risk.</u>		
B. Multiplication factor	4	3645
C. Subtotal ( If Line 12A is positive, multiply Line 12A by 12B )	48,732,000	3655
D. Alternative Method for Equities under Appendix A of Rule 15c3-1 ( if applicable )	0	3665
E. Non - Marketable Securities	0	3675
F. Residual Positions	0	3676
13. Subtotal Market Risk Exposure ( add lines 12C and 12D)	\$ 48,732,000	3677
14. Credit Risk Exposure:		
A. Credit Risk Charge ( Counterparty )	4,660,000	3678
B. Concentration Charge	501,000	3650
15. Subtotal Credit Risk Exposure ( add Lines 14A and 14B )	\$ 5,161,000	3679
16. Net Capital ( Line 11 less Lines 13 and 15 )	368,622,000	3750
17. Minimum Capital Requirement	20,000,000	3758
18. Excess Net Capital ( Line 16 less Line 17 )	\$ 348,622,000	3770

**Lehman Brothers Inc.**

**Statement of Assets Deemed Non-allowable**

**In Computing Net Capital Under Rule 15c3-1, Appendix F**

**as of November 30, 2007**

<b>In thousands</b>	<b>Amount</b>
<i>Description of Asset:</i>	
Receivables from customers	\$2,469
Affiliate receivable	1,498
Other assets	4,364
	<b>\$8,331</b>

**Statement Pursuant to Paragraph (b) (4) of Rule 17a-12**

There are no material differences between the audited Computation of Net Capital under Rule 15c3-1, Appendix F included in this report and the corresponding schedules included in the Company's unaudited November 30, 2007 Part II FOCUS filing.

**Lehman Brothers OTC Derivatives Inc.**  
**Reconciliation of Assets, Liabilities and Stockholder's Equity to the Regulatory Report**

The financial statements have been prepared on the basis of generally accepted accounting principles and differ in certain respects from accounting practices prescribed by the Securities and Exchange Commission's general instructions to Form X-17A-5.

A reconciliation of amounts reported by the Company at November 30, 2007 on Form X-17A-5 to the financial statements is as follows:

<b>In thousands</b>	<b>Unaudited</b>		<b>Financial</b>
<b>November 30, 2007</b>	<b>Form</b>	<b>Reclassifications</b>	<b>Statements</b>
	<b>X-17A-5</b>		
<b>Assets</b>			
Cash and cash equivalents	\$ 3,382	\$ -	\$ 3,382
Financial instruments owned	1,637,160	3,284	1,640,444
Securities purchased under agreements to resell	88,459	(6)	88,453
Securities borrowed	169,335	-	169,335
Receivables:			
Affiliated broker dealer	3,607,274	(1,786)	3,605,488
Customer receivables	25,528	-	25,528
Other receivables	124,170	6,803	130,973
Investments in and receivables from affiliates	1,498	(1,498)	-
Other assets	11,161	(6,797)	4,364
	<b>\$5,667,967</b>	<b>\$ -</b>	<b>\$5,667,967</b>
<b>Liabilities and stockholder's equity</b>			
Financial instruments sold but not yet purchased	\$4,140,276	\$ -	\$4,140,276
Securities sold under agreements to repurchase	23,749	-	23,749
Securities loaned	32,997	(4,721)	28,276
Advances from Holdings and other affiliates	-	306,810	306,810
Payables to customers	204,433	1	204,434
Short-term borrowings	-	382,660	382,660
Subordinated indebtedness	250,000	-	250,000
Compensation payable	-	104,051	104,051
Income taxes payable	-	41,526	41,526
Accrued liabilities and other payables	835,666	(830,327)	5,339
Stockholder's equity	180,846	-	180,846
	<b>\$5,667,967</b>	<b>\$ -</b>	<b>\$5,667,967</b>

**SUPPLEMENTAL REPORT**

**OF**

**INDEPENDENT REGISTERED PUBLIC  
ACCOUNTING FIRM**

## Supplemental Report of Independent Registered Public Accounting Firm on Internal Control Required by Securities Exchange Commission Rule 17a-12

The Board of Directors and Stockholder of  
Lehman Brothers OTC Derivatives Inc.

In planning and performing our audit of the financial statements of Lehman Brothers OTC Derivatives Inc. (the "Company"), as of and for the year ended November 30, 2007, in accordance with auditing standards generally accepted in the United States, we considered its internal control over financial reporting ("internal control"), as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by rule 17a-12(h)(1) of the Securities and Exchange Commission ("SEC"), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities.

The management of the Company is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in internal control, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

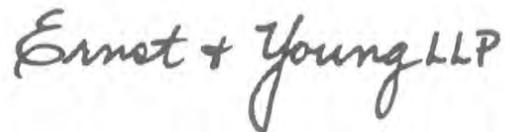
A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. A

material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses as defined above.

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second paragraph of this report, were adequate at November 30, 2007, to meet the SEC's objectives.

This report is intended solely for the information and use of the Board of Directors, management, and the SEC under the Securities Exchange Act of 1934 in their regulation of OTC derivatives dealers, and is not intended to be and should not be used by anyone other than these specified parties.



January 28, 2008