

KCAP Financial, Inc.  
Form 10-Q  
November 09, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

**<sup>x</sup> QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the quarterly period ended September 30, 2012**

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

**For the transition period from            to**

**Commission File No. 814-00735**

**KCAP Financial, Inc.**

**(Exact name of Registrant as specified in its charter)**

Delaware

20-5951150

(State or other jurisdiction of    (I.R.S. Employer  
Incorporation or organization) Identification Number)

**295 Madison Avenue, 6th Floor**

**New York, New York 10017**

**(Address of principal executive offices)**

**(212) 455-8300**

**(Registrant's telephone number, including area code)**

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

Indicate by check mark whether the registrant 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 ☐ No ☐

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

Large accelerated filer ☐ Accelerated filer ☒

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

The number of outstanding shares of common stock of the registrant as of November 3, 2012 was 26,464,498.



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**KCAP FINANCIAL, INC.****BALANCE SHEETS**

	As of September 30, 2012 (unaudited)	As of December 31, 2011
<b>ASSETS</b>		
Investments at fair value:		
Time deposits (cost: 2012 - \$501,475; 2011 - \$229,152)	\$ 501,475	\$ 229,152
Money market account (cost: 2012 - \$4,850,220; 2011 - \$31,622,134)	4,850,220	31,622,134
Debt securities (cost: 2012 - \$157,962,430; 2011 - \$134,311,238)	135,477,765	114,673,506
CLO Fund securities managed by non-affiliates (cost: 2012 - \$12,755,413; 2011 - \$12,756,449)	4,564,189	3,110,367
CLO Fund securities managed by affiliates (cost: 2012 - \$72,750,754; 2011 - \$53,772,033)	63,220,258	45,327,950
Equity securities (cost: 2012 - \$17,012,237; 2011 - \$16,559,610)	6,911,736	6,040,895
Asset manager affiliates (cost: 2012 - \$83,203,884; 2011 - \$44,338,301)	73,989,000	40,814,000
Total Investments at fair value (cost: 2012 - \$349,036,413; 2011 - \$293,588,917)	289,514,643	241,818,004
Cash	2,413,104	2,555,259
Restricted cash	6,093,126	—
Interest receivable	1,479,571	522,578
Accounts receivable	1,226,887	859,156
Due from affiliates	—	3,517
Other assets	2,213,921	2,375,147
Total assets	\$ 302,941,252	\$ 248,133,661
<b>LIABILITIES</b>		
Borrowings	\$ 28,000,000	\$ —
Convertible Senior Notes	60,000,000	60,000,000
Payable for open trades	5,955,704	—
Accounts payable and accrued expenses	2,087,299	3,527,682
Dividend payable	—	4,080,037
Total liabilities	\$ 96,043,003	\$ 67,607,719
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, par value \$0.01 per share, 100,000,000 common shares authorized; 26,448,313 and 22,992,211 common shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	\$ 264,412	\$ 226,648
Capital in excess of par value	310,404,794	284,571,466
Accumulated undistributed net investment income	6,536,811	821,904
Accumulated net realized losses	(56,265,235)	(52,802,400)
Net unrealized depreciation on investments	(54,042,533)	(52,291,676)

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Total stockholders' equity	\$ 206,898,249	\$ 180,525,942
Total liabilities and stockholders' equity	\$ 302,941,252	\$ 248,133,661
NET ASSET VALUE PER COMMON SHARE	\$ 7.82	\$ 7.85

See accompanying notes to financial statements.

**KCAP FINANCIAL, INC.****STATEMENTS OF OPERATIONS****(unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Investment Income:				
Interest from investments in debt securities	\$3,570,141	\$2,830,422	\$8,743,045	\$6,853,370
Interest from cash and time deposits	511	4,246	3,919	17,831
Dividends from investments in CLO Fund securities managed by non-affiliates	530,420	491,965	1,408,124	1,481,264
Dividends from investments in CLO Fund securities managed by affiliates	5,258,554	3,435,914	13,901,079	9,103,652
Dividends from affiliate asset managers	925,000	510,000	2,950,000	1,160,000
Capital structuring service fees	69,305	25,642	230,910	55,149
Other Income	—	—	—	2,000,000
Total investment income	10,353,931	7,298,189	27,237,077	20,671,266
Expenses:				
Interest and amortization of debt issuance costs	1,689,908	1,430,520	4,778,546	3,157,750
Compensation	385,323	985,023	2,407,034	3,161,592
Professional fees	713,784	450,156	1,876,115	1,515,247
Insurance	126,761	126,006	399,040	359,241
Administrative and other	305,060	220,781	1,000,145	751,020
Total expenses	3,220,836	3,212,486	10,460,880	8,944,850
Net Investment Income	7,133,095	4,085,703	16,776,197	11,726,416
Realized And Unrealized Gains (Losses) On Investments:				
Net realized gains (losses) from investment transactions	(3,767,256 )	93,068	(3,462,835 )	(13,666,746 )
Net change in unrealized appreciation (depreciation) on:				
Debt securities	2,151,333	(1,766,660 )	(2,846,934 )	11,951,454
Equity securities	(1,260,133 )	(710,600 )	418,214	(1,395,518 )
CLO Fund securities managed by affiliates	2,281,860	(3,118,725 )	4,913,588	(2,603,970 )
CLO Fund securities managed by non-affiliates	1,520,468	(540,719 )	1,454,857	1,651,682
Affiliate asset manager investments	1,309,027	472,676	(5,690,582 )	1,329,889
Net realized and unrealized gains (losses) on investments	2,235,299	(5,570,960 )	(5,213,692 )	(2,733,209 )
Net Increase In Net Assets Resulting From Operations	\$9,368,394	\$(1,485,257 )	\$11,562,505	\$8,993,207
Net Increase In Net Assets Resulting from Operations per Common Share:				
Basic:	\$0.35	\$(0.06 )	\$0.45	\$0.39
Diluted:	\$0.32	\$(0.06 )	\$0.44	\$0.39



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Net Investment Income Per Common Share:

Basic:	\$0.27	\$0.18	\$0.65	\$0.51
Diluted:	\$0.25	\$0.18	\$0.64	\$0.51
Weighted Average Shares of Common Stock Outstanding—Basic	26,668,701	22,872,486	25,860,510	22,830,757
Weighted Average Shares of Common Stock Outstanding—Diluted	33,881,913	22,872,486	25,873,247	22,830,757

See accompanying notes to financial statements.

**KCAP FINANCIAL, INC.**

**STATEMENTS OF CHANGES IN NET ASSETS**

**(unaudited)**

	Nine Months Ended September 30,	
	2012	2011
Operations:		
Net investment income	\$ 16,776,197	\$ 11,726,416
Net realized gains (losses) from investment transactions	(3,462,835 )	(13,666,746 )
Net change in unrealized appreciation (depreciation) on investments	(1,750,857 )	10,933,537
Net increase (decrease) in net assets resulting from operations	11,562,505	8,993,207
Stockholder distributions:		
Dividends from net investment income to common stockholders	(11,046,819 )	(7,645,992 )
Dividends in excess of net investment income to restricted stockholders	(14,470 )	(22,718 )
Net decrease in net assets resulting from stockholder distributions	(11,061,289 )	(7,668,710 )
Capital transactions:		
Issuance of common stock for:		
Acquisition of affiliate asset manager	25,560,000	—
Issuance of common stock under dividend reinvestment plan	413,482	883,385
Vesting of restricted stock	925	961
Stock-based compensation	(103,316 )	599,921
Net increase in net assets resulting from capital transactions	25,871,091	1,484,267
Net assets at beginning of period	180,525,942	186,925,667
Net assets at end of period (including undistributed net investment income of \$6,536,811 in 2012 and \$4,876,370 in 2011)	\$ 206,898,249	\$ 189,734,431
Net asset value per common share	\$ 7.82	\$ 8.29
Common shares outstanding at end of period	26,448,313	22,886,769

See accompanying notes to financial statements.



**KCAP FINANCIAL, INC.****STATEMENTS OF CASH FLOWS****(unaudited)**

	Nine Months Ended September 30,	
	2012	2011
<b>OPERATING ACTIVITIES:</b>		
Net increase in net assets resulting from operations	\$11,562,505	\$8,993,207
Adjustments to reconcile net increase in net assets resulting from operations to net cash provided by (used in) operations:		
Net realized losses on investment transactions	3,462,835	13,666,746
Net change in unrealized (appreciation) depreciation on investments	1,750,857	(10,729,937 )
Net accretion of interest income	(1,171,801 )	(134,662 )
Amortization of debt issuance cost	—	22,908
Amortization of convertible notes offering cost	436,423	257,365
Purchases of investments	(91,356,790)	(106,339,832)
Capital contribution from (to) affiliate asset manager	(305,582 )	193,889
Payment-in-kind interest income	(580,989 )	(378,336 )
Proceeds from sale and redemption of investments	72,020,537	56,483,598
Stock-based compensation expense	(103,316 )	599,923
Changes in operating assets and liabilities:		
Decrease in interest and dividends receivable	(956,993 )	(277,994 )
Decrease in accounts receivable	(367,731 )	(410,906 )
(Increase) decrease in other assets	(275,198 )	44,085
Decrease in due from affiliates	3,517	—
Increase (decrease) in accounts payable and accrued expenses	(1,440,383 )	939,722
Net cash used in operating activities	(7,322,109 )	(37,070,224 )
<b>FINANCING ACTIVITIES:</b>		
Dividends paid in cash	(14,726,920)	(10,597,035 )
Proceeds from issuance of debt	30,000,000	—
Cash paid on repayment of debt	(2,000,000 )	(86,746,582 )
Convertible senior notes offering costs	—	(2,370,454 )
Issuance of Convertible Senior Notes	—	60,000,000
(Increase) Decrease in restricted cash	(6,093,126 )	67,023,170
Net cash provided by (used in) financing activities	7,179,954	27,309,099
<b>CHANGE IN CASH</b>	<b>(142,155 )</b>	<b>(9,761,125 )</b>

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CASH, BEGINNING OF PERIOD	2,555,259	10,175,488
CASH, END OF PERIOD	\$2,413,104	\$414,363
Supplemental Information:		
Interest paid during the period	\$5,624,894	\$2,745,968
Dividends paid during the period under the dividend reinvestment plan	\$414,407	\$884,346
Issuance of common stock in connection with acquisition of affiliate asset manager	\$25,560,000	\$—

See accompanying notes to financial statements.

**KCAP FINANCIAL, INC.****SCHEDULE OF INVESTMENTS****As of September 30, 2012****(unaudited)****Debt Securities Portfolio**

<b>Portfolio Company / Principal Business</b>	<b>Investment</b>	<b>Principal</b>	<b>Cost</b>	<b>Value<sup>2</sup></b>
	<b>Interest Rate<sup>1</sup> / Maturity</b>			
Advanced Lighting Technologies, Inc. <i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Senior Subordinated Bond — 10.5% Cash, Due 6/19	\$3,000,000	\$2,926,516	\$3,000,000
Alaska Communications Systems Holdings, Inc. <i>Telecommunications</i>	Senior Secured Loan — Term Loan 5.5% Cash, Due 10/16	2,947,500	2,961,026	2,700,647
Allison Transmission, Inc. <sup>12</sup> <i>Automobile</i>	Senior Secured Loan — Term B-2 Loan 3.7% Cash, Due 8/17	1,985,000	1,973,698	1,991,948
Aramark Corporation <sup>12</sup> <i>Diversified/Conglomerate Service</i>	Senior Secured Loan — LC-3 Facility 3.5% Cash, Due 7/16	61,707	61,570	61,707
Aramark Corporation <sup>12</sup> <i>Diversified/Conglomerate Service</i>	Senior Secured Loan — U.S. Term C Loan 3.6% Cash, Due 7/16	938,293	936,227	938,313
Asurion, LLC (fka Asurion Corporation) <sup>12</sup> <i>Insurance</i>	Senior Secured Loan — Term Loan (First Lien) 5.5% Cash, Due 5/18	2,000,000	2,022,500	2,015,600
Atlantic Broadband Finance, LLC <sup>12</sup> <i>Broadcasting and Entertainment</i>	Senior Secured Loan — Term Loan (First Lien)	1,995,000	1,985,695	2,003,898

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5.3% Cash, Due 4/19

Avis Budget Car Rental, LLC<sup>12</sup>

Senior Secured Loan — Tranche  
C Term Loan

1,990,000 2,018,875 2,010,726

*Personal Transportation*

4.3% Cash, Due 3/19

Bankruptcy Management Solutions, Inc.

Junior Secured Loan — Loan  
(Second Lien)

1,380,094 1,217,428 44,853

*Diversified/Conglomerate Service*

1.2% Cash, 7.0% PIK, Due  
8/15

Bankruptcy Management Solutions, Inc.

Senior Secured Loan — Term  
Loan B

1,439,003 1,418,274 733,892

*Diversified/Conglomerate Service*

6.5% Cash, 1.0% PIK, Due  
8/14

Portfolio Company / Principal Business	Investment	Principal	Cost	Value <sup>2</sup>
	Interest Rate <sup>1</sup> / Maturity			
Berry Plastics Holding Corporation <sup>12</sup> <i>Containers, Packaging and Glass</i>	Senior Secured Loan — Term C Loan 2.2% Cash, Due 4/15	\$1,984,252	\$1,951,066	\$1,976,811
Blue Coat Systems, Inc. <i>Electronics</i>	Junior Secured Loan — Loan (Second Lien) 11.5% Cash, Due 8/18	2,250,000	2,282,492	2,317,500
Burger King Corporation <sup>12</sup> <i>Personal, Food and Miscellaneous Services</i>	Senior Secured Loan — Tranche B Term Loan (2012) 3.8% Cash, Due 9/19	1,650,000	1,645,875	1,645,875
Caribe Media Inc. (fka Caribe Information Investments Incorporated) <i>Printing and Publishing</i>	Senior Secured Loan — Loan 10.0% Cash, Due 11/14	636,999	636,999	636,999
Catalina Marketing Corporation <sup>12</sup> <i>Diversified/Conglomerate Service</i>	Senior Secured Loan — 2017 Term Loan 5.7% Cash, Due 9/17	1,704,212	1,670,528	1,697,822
Chrysler Group LLC <sup>12</sup> <i>Automobile</i>	Senior Secured Loan — Tranche B Term Loan 6.0% Cash, Due 5/17	1,984,925	1,984,925	2,029,466
CoActive Technologies LLC (fka CoActive Technologies, Inc.) <sup>8</sup> <i>Machinery (Non-Agriculture, Non-Construction, Non-Electronic)</i>	Junior Secured Loan — Term Loan (Second Lien) 7.1% Cash, Due 1/15	2,000,000	1,987,287	1,440,800
Del Monte Foods Company <sup>12</sup> <i>Beverage, Food and Tobacco</i>	Senior Secured Loan — Initial Term Loan 4.5% Cash, Due 3/18	1,927,154	1,906,241	1,930,247
Del Monte Foods Company <i>Beverage, Food and Tobacco</i>	Senior Secured Loan — Initial Term Loan 4.5% Cash, Due 3/18	949,123	950,992	950,647



eInstruction Corporation <sup>8</sup>	Junior Secured Loan — Term Loan (Second Lien)	10,000,000	10,000,000	1,000
<i>Healthcare, Education and Childcare</i>	11.5% Cash, Due 7/14			
ELO Touch Solutions, Inc. <sup>12</sup>	Senior Secured Loan — Term Loan (First Lien)	1,995,000	1,916,788	1,995,000
<i>Electronics</i>	8.0% Cash, Due 6/18			
First Data Corporation <sup>12</sup>	Senior Secured Loan — 2018 Dollar Term Loan	2,000,000	1,797,499	1,907,910
<i>Finance</i>	4.2% Cash, Due 3/18			

Portfolio Company / Principal Business	Investment	Principal	Cost	Value <sup>2</sup>
	Interest Rate <sup>1</sup> / Maturity			
Fram Group Holdings Inc./Prestone Holdings Inc. <sup>12</sup>	Senior Secured Loan — Term Loan (First Lien)	\$992,481	\$999,366	\$988,759
<i>Automobile</i>	6.5% Cash, Due 7/17			
Freescall Semiconductor, Inc.	Senior Subordinated Bond —	1,036,000	1,038,030	1,080,030
<i>Electronics</i>	10.1% Cash, Due 12/16			
Getty Images, Inc. <sup>12</sup>	Senior Secured Loan — Initial Term Loan	1,856,802	1,878,793	1,860,747
<i>Printing and Publishing</i>	5.3% Cash, Due 11/16			
Ginn LA Conduit Lender, Inc. <sup>8</sup>	Senior Secured Loan — First Lien Tranche A Credit-Linked Deposit	1,257,143	1,224,101	36,143
<i>Buildings and Real Estate<sup>4</sup></i>	7.8% Cash, Due 6/11			
Ginn LA Conduit Lender, Inc. <sup>8</sup>	Senior Secured Loan — First Lien Tranche B Term Loan	2,694,857	2,624,028	77,477
<i>Buildings and Real Estate<sup>4</sup></i>	7.8% Cash, Due 6/11			
Ginn LA Conduit Lender, Inc. <sup>8</sup>	Junior Secured Loan — Loan (Second Lien)	3,000,000	2,715,997	30,015
<i>Buildings and Real Estate<sup>4</sup></i>	11.8% Cash, Due 6/12			
Gymboree Corporation., The <sup>12</sup>	Senior Secured Loan — Term Loan	1,467,299	1,396,679	1,434,285
<i>Retail Stores</i>	5.0% Cash, Due 2/18			
HMSC Corporation (aka Swett and Crawford)	Junior Secured Loan — Loan (Second Lien)	5,000,000	4,941,441	3,880,500
<i>Insurance</i>	5.7% Cash, Due 10/14			
Hunter Defense Technologies, Inc.	Junior Secured Loan — Term Loan (Second Lien)	4,074,074	4,022,507	4,037,407
<i>Aerospace and Defense</i>	7.0% Cash, Due 2/15			

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Hunter Fan Company	Junior Secured Loan — Loan (Second Lien)	3,000,000	3,000,000	2,761,500
<i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	7.0% Cash, Due 10/14			
Iasis Healthcare LLC	Senior Subordinated Bond —	3,000,000	2,874,247	2,850,000
<i>Healthcare, Education and Childcare</i>	8.4% Cash, Due 5/19			
International Architectural Products, Inc. <sup>8</sup>	Senior Secured Loan — Term Loan	507,431	480,867	263,864
<i>Mining, Steel, Iron and Non-Precious Metals</i>	12.0% Cash, Due 5/15			

Portfolio Company / Principal Business	Investment	Principal	Cost	Value <sup>2</sup>
	Interest Rate <sup>1</sup> / Maturity			
Jones Stephens Corp. <i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Senior Secured Loan — Term Loan 7.0% Cash, Due 9/15	\$4,315,231	\$4,315,231	\$4,315,231
Kaseman Holdings and Sallyport Holdings <i>Aerospace and Defense</i>	Mezzanine Investment — Mezzanine Notes 14.5% Cash, Due 6/17	8,743,988	8,518,913	9,401,536
KIK Custom Products Inc. <i>Personal and Non Durable Consumer Products (Mfg. Only)</i>	Junior Secured Loan — Loan (Second Lien) 5.2% Cash, Due 12/14	5,000,000	5,000,000	3,833,325
LBREP/L-Suncal Master I LLC <sup>8</sup> <i>Buildings and Real Estate<sup>4</sup></i>	Senior Secured Loan — Term Loan (First Lien) 7.5% Cash, Due 1/10	3,401,921	3,401,921	359,923
Legacy Cabinets, Inc. <i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Senior Secured Loan — Term Loan 1.0% Cash, 6.3% PIK, Due 5/14	516,284	463,380	516,284
Lord & Taylor Holdings LLC (LT Propco LLC) <sup>12</sup> <i>Retail Stores</i>	Senior Secured Loan — Term Loan 5.8% Cash, Due 1/19	430,951	439,957	435,002
Merisant Company <i>Beverage, Food and Tobacco</i>	Senior Secured Loan — Loan 7.5% Cash, Due 1/14	4,558,751	4,548,133	4,558,751
Metropolitan Health Networks, Inc. <i>Healthcare, Education and Childcare</i>	Junior Secured Loan — Term Loan (Second Lien) 13.5% Cash, Due 10/17	5,000,000	4,916,446	5,000,000
Michael Foods Group, Inc. (f/k/a M-Foods Holdings, Inc.) <sup>12</sup> <i>Beverage, Food and Tobacco</i>	Senior Secured Loan — Term B Facility 4.3% Cash, Due 2/18	1,920,993	1,924,263	1,934,200
Neiman Marcus Group Inc., The <sup>12</sup>		2,000,000	1,985,232	2,014,320

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<i>Retail Stores</i>	Senior Secured Loan — Term Loan			
	4.8% Cash, Due 5/18			
Pegasus Solutions, Inc.	Senior Subordinated Bond — Senior Subordinated Second Lien PIK Notes	1,587,800	1,587,800	1,587,800
<i>Leisure, Amusement, Motion Pictures, Entertainment</i>	13.0% PIK, Due 4/14			
Perseus Holding Corp.	Preferred Stock — Preferred Stock			
		400,000	400,000	391,760
<i>Leisure, Amusement, Motion Pictures, Entertainment</i>	14.0% PIK, Due 4/14			

Portfolio Company / Principal Business	Investment	Principal	Cost	Value <sup>2</sup>
	Interest Rate <sup>1</sup> / Maturity			
PetCo Animal Supplies, Inc. <sup>12</sup>	Senior Secured Loan — New Loan	\$2,000,000	\$2,000,000	\$2,012,040
<i>Retail Stores</i>	4.5% Cash, Due 11/17			
Pinnacle Foods Finance LLC <sup>12</sup>	Senior Secured Loan — Extended Initial Term Loan	1,994,987	1,993,577	2,001,232
<i>Beverage, Food and Tobacco</i>	3.7% Cash, Due 10/16			
Pinnacle Foods Finance LLC	Senior Secured Loan — Extended Initial Term Loan	293,752	293,752	294,671
<i>Beverage, Food and Tobacco</i>	3.7% Cash, , Due 10/16			
Potters Holdings, II, L.P.	Junior Secured Loan — Term B Loan (Second Lien)	7,000,000	6,917,576	7,210,000
<i>Diversified/Conglomerate Manufacturing</i>	10.3% Cash, Due 11/17			
TPF Generation Holdings, LLC <sup>12</sup>	Senior Secured Loan — Synthetic LC Deposit (First Lien)	169,532	169,214	169,214
<i>Utilities</i>	2.4% Cash, Due 12/13			
TriZetto Group, Inc. (TZ Merger Sub, Inc.) <sup>12</sup>	Senior Secured Loan — Term Loan	1,964,835	1,955,618	1,960,325
<i>Electronics</i>	4.8% Cash, Due 5/18			
TUI University, LLC	Senior Secured Loan — Term Loan (First Lien)	3,040,242	2,994,776	2,668,420
<i>Healthcare, Education and Childcare</i>	3.2% Cash, Due 10/14			
TWCC Holding Corp. <sup>12</sup>	Senior Secured Loan — Term Loan	1,966,350	1,979,611	1,982,081
<i>Broadcasting and Entertainment</i>	4.3% Cash, Due 2/17			
Twin-Star International, Inc.	Senior Subordinated Bond — Senior Subordinated Note	5,500,000	5,500,000	5,500,000
<i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	13.0% Cash, Due 4/14			

Univar Inc.	Senior Secured Loan — Term B Loan	2,962,312	2,962,312	2,953,469
<i>Chemicals, Plastics and Rubber</i>	5.0% Cash, Due 6/17			
US Foods, Inc. (aka U.S. Foodservice, Inc.) <sup>12</sup>	Senior Secured Loan — Extended Term Loan	1,984,293	1,935,670	1,958,249
<i>Personal, Food and Miscellaneous Services</i>	5.8% Cash, Due 3/17			
Vertafore, Inc. <sup>12</sup>	Senior Secured Loan — Term Loan (First Lien)	1,240,536	1,235,809	1,245,188
<i>Electronics</i>	5.3% Cash, Due 7/16			

Portfolio Company / Principal Business	Investment	Principal	Cost	Value <sup>2</sup>
	Interest Rate <sup>1</sup> / Maturity			
Wesco Aircraft Hardware Corp. <i>Aerospace and Defense</i>	Senior Secured Loan — Tranche B Term Loan  4.3% Cash, Due 4/17	\$2,590,244	\$2,585,370	\$2,601,421
Wholesome Sweeteners, Inc. <i>Beverage, Food and Tobacco</i>	Junior Secured Loan — Subordinated Note (Second Lien)  12.0% Cash, 2.0% PIK Due 10/17	6,614,787	6,569,787	6,680,935
WireCo WorldGroup Inc. <i>Machinery (Non-Agriculture, Non-Construction, Non-Electronic)</i>	Senior Subordinated Bond —  11.8% Cash, Due 5/17	8,000,000	7,919,525	8,560,000
Total Investment in Debt Securities (65% of net asset value at fair value)		\$ 159,902,138	\$ 157,962,430	\$ 135,477,765



**Equity Portfolio**

<b>Portfolio Company / Principal Business</b>	<b>Investment</b>	<b>Percentage Interest/Shares</b>	<b>Cost</b>	<b>Value<sup>2</sup></b>
Aerostructures Holdings L.P. <sup>6</sup> <i>Aerospace and Defense</i>	Partnership Interests	1.2%	\$ 1,000,000	\$ 1,000
Aerostructures Holdings L.P. <sup>6</sup> <i>Aerospace and Defense</i>	Series A Preferred Interests	1.2%	250,962	68,162
Bankruptcy Management Solutions, Inc. <sup>6</sup> <i>Diversified/Conglomerate Service</i>	Common Stock	1.2%	218,592	1,000
Bankruptcy Management Solutions, Inc. <sup>6</sup> <i>Diversified/Conglomerate Service</i>	Warrants	0.1%	-	-
Coastal Concrete Holding II, LLC <sup>6</sup> <i>Buildings and Real Estate<sup>4</sup></i>	Class A Units	10.8%	8,625,626	1,000
eInstruction Acquisition, LLC <sup>6</sup> <i>Healthcare, Education and Childcare</i>	Membership Units	1.1%	1,079,617	1,000
FP WRCA Coinvestment Fund VII, Ltd. <sup>3, 6</sup> <i>Machinery (Non-Agriculture, Non-Construction, Non-Electronic)</i>	Class A Shares	1,500	1,500,000	2,490,167
International Architectural Products, Inc. <sup>6</sup> <i>Mining, Steel, Iron and Non-Precious Metals</i>	Common	2.5%	292,851	1,000
Legacy Cabinets, Inc. <sup>6</sup> <i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Equity	4.0%	115,580	1,000
Perseus Holding Corp. <sup>6</sup>	Common	0.2%	400,000	52,391

*Leisure, Amusement, Motion Pictures, Entertainment*

Plumbing Holdings Corporation<sup>6</sup>

<i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Common	7.8%	-	562,587
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Portfolio Company / Principal Business	Investment	Percentage	Cost	Value <sup>2</sup>
		Interest/Shares		
Plumbing Holdings Corporation				
<i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Preferred Stock	15.5%	\$3,169,244	\$3,169,244
Caribe Media Inc. (fka Caribe Information Investments Incorporated) <sup>6</sup>				
<i>Printing and Publishing</i>	Common	1.3%	359,765	563,185
<b>Total Investment in Equity Securities</b> <b>(3% of net asset value at fair value)</b>			\$17,012,237	\$6,911,736

**CLO Fund Securities****CLO Equity Investments**

Portfolio Company	Investment	Percentage	Cost	Value <sup>2</sup>
		Interest		
Grant Grove CLO, Ltd. <sup>3, 10</sup>	Subordinated Securities	22.2%	\$4,958,483	\$3,063,189
Katonah III, Ltd. <sup>3, 10, 11</sup>	Preferred Shares	23.1%	4,476,930	1,500,000
Katonah V, Ltd. <sup>3, 10, 11</sup>	Preferred Shares	26.7%	3,320,000	1,000
Katonah VII CLO Ltd. <sup>3, 7, 10</sup>	Subordinated Securities	16.4%	4,575,493	2,274,631
Katonah VIII CLO Ltd. <sup>3, 7, 10</sup>	Subordinated Securities	10.3%	3,457,305	2,101,905
Katonah IX CLO Ltd. <sup>3, 7, 10</sup>	Preferred Shares	6.9%	2,075,887	1,511,277
Katonah X CLO Ltd. <sup>3, 7, 10</sup>	Subordinated Securities	33.3%	11,906,371	8,826,471
Katonah 2007-I CLO Ltd. <sup>3, 7, 10</sup>	Preferred Shares	100.0%	31,078,634	27,683,357
Trimaran CLO IV, Ltd. <sup>3, 7, 10</sup>	Preferred Shares	18.9%	5,115,600	3,312,321
Trimaran CLO V, Ltd. <sup>3, 7, 10</sup>	Subordinate Notes	20.8%	5,055,800	3,107,504
Trimaran CLO VI, Ltd. <sup>3, 7, 10</sup>	Income Notes	16.2%	4,200,900	2,715,803
Trimaran CLO VII, Ltd. <sup>3, 7, 10</sup>	Income Notes	10.5%	4,047,400	2,996,989
<b>Total Investment in CLO Equity Securities</b>			\$84,268,803	\$59,094,447

**CLO Rated-Note Investment**

Portfolio Company	Investment	Percentage	Cost	Value <sup>2</sup>
		Interest		
	Class B-2L Notes			
Katonah 2007-I CLO Ltd. <sup>3, 7, 10</sup>	Par Value of \$10,500,000	5.2%	\$1,237,364	\$8,690,000
	5.2%, Due 4/22			
<b>Total Investment in CLO Rated-Note</b>			\$1,237,364	\$8,690,000
<b>Total Investment in CLO Fund Securities</b> <b>(33% of net asset value at fair value)</b>			\$85,506,167	\$67,784,447

**Asset Manager Affiliates**

Portfolio Company / Principal Business	Investment	Percentage	Cost	Value <sup>2</sup>
		Interest		
Asset Manager Affiliates (Katonah Debt Advisors and Trimaran Advisors)	Asset Management Company	100.0%	\$83,203,884	\$73,989,000
<b>Total Investment in Asset Manager Affiliates</b> <b>(36% of net asset value at fair value)</b>			\$83,203,884	\$73,989,000

**Time Deposits and Money Market Account**

Time Deposits and Money Market Account	Investment	Yield	Par / Cost	Value <sup>2</sup>
JP Morgan Asset Account	Time Deposit	0.0%	\$501,475	\$501,475
JP Morgan Business Money Market Account <sup>9</sup>	Money Market Account	0.2%	203,986	203,986
US Bank Money Market Account	Money Market Account	0.4%	4,646,234	4,646,234
<b>Total Investment in Time Deposit and Money Market Accounts</b> <b>(3% of net asset value at fair value)</b>			\$5,351,695	\$5,351,695

**Total Investments<sup>5</sup>**

**(140% of net asset value at fair value)**

\$349,036,413 \$289,514,643

**See accompanying notes to financial statements.**

1 A majority of the variable rate loans to the Company's portfolio companies bear interest at a rate that may be  
determined by reference to either LIBOR or an alternate Base Rate (commonly based on the Federal Funds Rate or  
the Prime Rate), which typically resets semi-annually, quarterly, or monthly. The Company's variable rate loans may  
contain interest rate floors and its variable and fixed rate loans may include payment-in-kind ("PIK") interest. For each  
such loan, the Company has provided the weighted average annual stated interest rate in effect at September 30,  
2012.

2 Reflects the fair market value of all existing investments as of September 30, 2012, as determined by the Company's  
board of directors (the "Board of Directors").

3 Non-U.S. company or principal place of business outside the U.S.

4 Buildings and real estate relate to real estate ownership, builders, managers and developers and excludes mortgage  
debt investments and mortgage lenders or originators.

The aggregate cost of investments for federal income tax purposes is approximately \$349 million. The aggregate  
gross unrealized appreciation is approximately \$12 million, the aggregate gross unrealized depreciation is  
approximately \$71 million and the net unrealized depreciation is approximately \$59 million.

6 Non-income producing.

7 An affiliate CLO Fund managed by an Asset Manager Affiliate (as such term is defined in the notes to the financial  
statements).

8 Loan or debt security is on non-accrual status and therefore is considered non-income producing.

9 Money market account holding restricted cash and security deposits for employee flexible spending and payroll  
related accounts.

10 These securities were acquired in a transaction that was exempt from the registration requirements of the Securities  
Act of 1933, as amended (the "Securities Act"), pursuant to Rule 144A thereunder. These securities may be resold  
only in transactions that are exempt from the registration requirements of the Securities Act, normally to qualified  
institutional buyers.

11 As of September 30, 2012, this CLO Fund security was not providing a dividend distribution.

12 Pledged as collateral for the secured revolving credit facility with Credit Suisse AG (see Note 6 to the financial  
statements).

**KCAP FINANCIAL, INC.****SCHEDULE OF INVESTMENTS****As of December 31, 2011****Debt Securities Portfolio**

<b>Portfolio Company / Principal Business</b>	<b>Investment</b>	<b>Principal</b>	<b>Cost</b>	<b>Value<sup>2</sup></b>
Advanced Lighting Technologies, Inc. <i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	<b>Interest Rate<sup>1</sup> / Maturity</b> Senior Secured Loan — Revolving Loan  .5% Cash, Due 6/13	\$-	\$-	\$-
Advanced Lighting Technologies, Inc. <i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Junior Secured Loan — Second Lien Term Loan Note  6.3% Cash, Due 6/14	5,000,000	4,997,622	4,965,000
Alaska Communications Systems Holdings, Inc. <i>Telecommunications</i>	Senior Secured Loan — Term Loan  5.5% Cash, Due 10/16	2,970,000	2,986,151	2,776,950
Avis Budget Car Rental, LLC <i>Personal Transportation</i>	Senior Secured Loan — Extended Term Loan  5.8% Cash, Due 4/14	2,974,338	2,993,092	2,983,648
Bankruptcy Management Solutions, Inc. <i>Diversified/Conglomerate Service</i>	Junior Secured Loan — Loan (Second Lien)  1.4% Cash, 7.0% PIK, Due 8/15	1,291,447	1,217,438	39,822
Bankruptcy Management Solutions, Inc. <i>Diversified/Conglomerate Service</i>	Senior Secured Loan — Term Loan B  6.5% Cash, 1.0% PIK, Due 8/14	1,442,478	1,434,611	331,777
Bicent Power LLC		4,000,000	4,000,000	137,500

<i>Utilities</i>	Junior Secured Loan — Advance (Second Lien)			
	4.6% Cash, Due 12/14			
Burger King Corporation	Senior Secured Loan — Tranche B Term Loan	2,872,500	2,872,500	2,827,359
<i>Personal, Food and Miscellaneous Services</i>	4.5% Cash, Due 10/16			
Caribe Media Inc. (fka Caribe Information Investments Incorporated)	Senior Secured Loan — Loan	684,774	684,774	684,774
<i>Printing and Publishing</i>	10.0% Cash, Due 11/14			
CoActive Technologies LLC (fka CoActive Technologies, Inc.)	Junior Secured Loan — Term Loan (Second Lien)	2,000,000	1,983,174	1,552,200
<i>Machinery (Non-Agriculture, Non-Construction, Non-Electronic)</i>	7.3% Cash, Due 1/15			



Portfolio Company / Principal Business	Investment	Principal	Cost	Value <sup>2</sup>
	Interest Rate <sup>1</sup> / Maturity			
Del Monte Foods Company	Senior Secured Loan — Initial Term Loan	\$2,985,000	\$2,991,687	\$2,843,212
<i>Beverage, Food and Tobacco</i>	4.5% Cash, Due 3/18			
eInstruction Corporation	Junior Secured Loan — Term Loan (Second Lien)	10,000,000	10,000,000	9,489,000
<i>Healthcare, Education and Childcare</i>	11.5% Cash, Due 7/14			
Freescale Semiconductor, Inc.	Senior Subordinated Bond —	3,000,000	3,007,007	3,135,000
<i>Electronics</i>	10.3% Cash, Due 12/16			
Ginn LA Conduit Lender, Inc. <sup>8</sup>	Senior Secured Loan — First Lien Tranche A Credit-Linked Deposit	1,257,143	1,224,101	91,142
<i>Buildings and Real Estate<sup>4</sup></i>	7.8% Cash, Due 6/11			
Ginn LA Conduit Lender, Inc. <sup>8</sup>	Senior Secured Loan — First Lien Tranche B Term Loan	2,694,857	2,624,028	195,377
<i>Buildings and Real Estate<sup>4</sup></i>	7.8% Cash, Due 6/11			
Ginn LA Conduit Lender, Inc. <sup>8</sup>	Junior Secured Loan — Loan (Second Lien)	3,000,000	2,715,997	15,000
<i>Buildings and Real Estate<sup>4</sup></i>	11.8% Cash, Due 6/12			
HMSC Corporation (aka Swett and Crawford)	Junior Secured Loan — Loan (Second Lien)	5,000,000	4,919,522	3,753,000
<i>Insurance</i>	5.8% Cash, Due 10/14			
Hunter Defense Technologies, Inc.	Junior Secured Loan — Term Loan (Second Lien)	5,000,000	4,916,872	5,000,000
<i>Aerospace and Defense</i>	7.3% Cash, Due 2/15			
Hunter Fan Company	Junior Secured Loan — Loan (Second Lien)	3,000,000	3,000,000	2,724,300
<i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	7.0% Cash, Due 10/14			

International Architectural Products, Inc. <sup>8</sup>	Senior Secured Loan — Term Loan			
<i>Mining, Steel, Iron and Non-Precious Metals</i>	12.0% Cash, 3.3% PIK, Due 5/15	530,803	504,240	437,913
Jones Stephens Corp.	Senior Secured Loan — Term Loan			
<i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	7.0% Cash, Due 9/15	4,889,912	4,889,912	4,889,912

Portfolio Company / Principal Business	Investment	Principal	Cost	Value <sup>2</sup>
	Interest Rate <sup>1</sup> / Maturity			
Kaseman Holdings and Sallyport Holdings <i>Aerospace and Defense</i>	Mezzanine Investment — Mezzanine Notes 14.5% Cash, Due 6/17	11,250,597	10,931,428	11,588,115
KIK Custom Products Inc. <i>Personal and Non Durable Consumer Products (Mfg. Only)</i>	Junior Secured Loan — Loan (Second Lien) 5.3% Cash, Due 12/14	\$5,000,000	5,000,000	3,250,000
LBREP/L-Suncal Master I LLC <sup>8</sup> <i>Buildings and Real Estate<sup>4</sup></i>	Senior Secured Loan — Term Loan (First Lien) 7.5% Cash, Due 1/10	3,401,921	3,401,921	359,923
Legacy Cabinets, Inc. <i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Senior Secured Loan — Term Loan 1.0% Cash, 6.3% PIK, Due 5/14	492,944	463,380	253,817
Merisant Company <i>Beverage, Food and Tobacco</i>	Senior Secured Loan — Loan 7.5% Cash, Due 1/14	5,049,291	5,030,584	5,043,232
Metropolitan Health Networks, Inc. <i>Healthcare, Education and Childcare</i>	Junior Secured Loan — Term Loan (Second Lien) 13.5% Cash, Due 10/17	5,000,000	4,903,929	5,000,000
Michael Foods Group, Inc. (f/k/a M-Foods Holdings, Inc.) <i>Beverage, Food and Tobacco</i>	Senior Secured Loan — Term B Facility 4.3% Cash, Due 2/18	1,925,767	1,870,004	1,910,120
Neiman Marcus Group Inc., The <i>Retail Stores</i>	Senior Secured Loan — Term Loan 4.8% Cash, Due 5/18	2,000,000	1,885,086	1,932,500
Pegasus Solutions, Inc. <i>Leisure, Amusement, Motion Pictures, Entertainment</i>	Senior Subordinated Bond — Senior Subordinated Second Lien PIK Notes , 13.0% PIK, Due 4/14	1,490,892	1,490,892	1,490,892

Perseus Holding Corp. <sup>6</sup>	Preferred Stock — Preferred Stock	400,000	400,000	400,000
<i>Leisure, Amusement, Motion Pictures, Entertainment</i>	, 14.0% PIK			
Potters Holdings, II, L.P.	Junior Secured Loan — Term B Loan (Second Lien)	7,000,000	6,905,447	7,000,000
<i>Diversified/Conglomerate Manufacturing</i>	10.3% Cash, Due 11/17			
Trinseo Materials Operating S.C.A. (fka Styron S.A.R.L) <sup>3</sup>	Senior Secured Loan — Term Loan	1,989,950	1,824,534	1,728,779
<i>Chemicals, Plastics and Rubber</i>	6.0% Cash, Due 8/17			

Portfolio Company / Principal Business	Investment	Principal	Cost	Value <sup>2</sup>
	Interest Rate <sup>1</sup> / Maturity			
TriZetto Group, Inc. (TZ Merger Sub, Inc.)	Senior Secured Loan — Term Loan	1,979,757	1,898,410	1,950,554
<i>Electronics</i>	4.8% Cash, Due 5/18			
TUI University, LLC	Senior Secured Loan — Term Loan (First Lien)	\$3,040,242	2,978,384	2,626,161
<i>Healthcare, Education and Childcare</i>	3.5% Cash, Due 10/14			
Twin-Star International, Inc.	Senior Subordinated Bond — Senior Subordinated Note	5,500,000	5,500,000	5,500,000
<i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	13.0% Cash, Due 4/14			
Univar Inc.	Senior Secured Loan — Term B Loan	2,984,925	2,984,925	2,886,049
<i>Chemicals, Plastics and Rubber</i>	5.0% Cash, Due 6/17			
Vantiv, LLC (fka Fifth Third Processing Solutions, LLC)	Senior Secured Loan — Term B-1 Loan (First Lien)	1,989,975	1,992,299	1,988,482
<i>Electronics</i>	4.5% Cash, Due 11/16			
Vertafore, Inc.	Senior Secured Loan — Term Loan (First Lien)	1,989,956	1,933,723	1,952,147
<i>Electronics</i>	5.3% Cash, Due 7/16			
Walker Group Holdings LLC	Junior Secured Loan — Term Loan B	416,737	416,737	416,737
<i>Cargo Transport</i>	13.3% Cash, Due 12/13			
Walker Group Holdings LLC	Junior Secured Loan — Term Loan B	3,957,614	3,957,614	3,957,614
<i>Cargo Transport</i>	13.3% Cash, Due 12/13			
Warner Chilcott Company, LLC	Senior Secured Loan — Term B-2 Loan	454,851	455,921	449,450
<i>Healthcare, Education and Childcare</i>	4.3% Cash, Due 3/18			

Warner Chilcott Corporation	Senior Secured Loan — Term B-1 Loan	909,703	911,841	898,900
<i>Healthcare, Education and Childcare</i>	4.3% Cash, Due 3/18			
WC Luxco S.A.R.L. (Warner Chilcott) <sup>3</sup>	Senior Secured Loan — Term B-3 Loan	625,421	626,891	617,994
<i>Healthcare, Education and Childcare</i>	4.3% Cash, Due 3/18			
Wesco Aircraft Hardware Corp.	Senior Secured Loan — Tranche B Term Loan	2,590,244	2,584,560	2,599,154
<i>Aerospace and Defense</i>	4.3% Cash, Due 4/17			
<b>Total Investment in Debt Securities</b> <b>(55% of net asset value at fair value)</b>		\$136,034,039	\$134,311,238	\$114,673,506

**Equity Portfolio**

<b>Portfolio Company / Principal Business</b>	<b>Investment</b>	<b>Percentage Interest/Shares</b>	<b>Cost</b>	<b>Value<sup>2</sup></b>
Aerostructures Holdings L.P. <sup>6</sup> <i>Aerospace and Defense</i>	Partnership Interests	1.2%	\$ 1,000,000	\$ 1,000
Aerostructures Holdings L.P. <sup>6</sup> <i>Aerospace and Defense</i>	Series A Preferred Interests	1.2%	250,961	250,961
Bankruptcy Management Solutions, Inc. <sup>6</sup> <i>Diversified/Conglomerate Service</i>	Common Stock	1.2%	218,592	1,005
Bankruptcy Management Solutions, Inc. <sup>6</sup> <i>Diversified/Conglomerate Service</i>	Warrants	0.1%	-	-
Coastal Concrete Holding II, LLC <sup>6</sup> <i>Buildings and Real Estate<sup>4</sup></i>	Class A Units	10.8%	8,625,626	1,000
eInstruction Acquisition, LLC <sup>6</sup> <i>Healthcare, Education and Childcare</i>	Membership Units	1.1%	1,079,617	442,319
FP WRCA Coinvestment Fund VII, Ltd. <sup>3, 6</sup> <i>Machinery (Non-Agriculture, Non-Construction, Non-Electronic)</i>	Class A Shares	1,500	\$ 1,500,000	2,339,700
International Architectural Products, Inc. <sup>6</sup> <i>Mining, Steel, Iron and Non-Precious Metals</i>	Common	2.5%	292,851	1,000
Legacy Cabinets, Inc. <sup>6</sup> <i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Equity	4.0%	115,580	1,000
Perseus Holding Corp. <sup>6</sup> <i>Leisure, Amusement, Motion Pictures, Entertainment</i>	Common	0.2%	400,000	193,120

Plumbing Holdings Corporation<sup>6</sup>

<i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Common	7.8%	-	-
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Plumbing Holdings Corporation<sup>6</sup>

<i>Home and Office Furnishings, Housewares, and Durable Consumer Products</i>	Preferred Stock	15.5%	2,716,618	2,270,821
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Portfolio Company / Principal Business	Investment	Percentage	Cost	Value <sup>2</sup>
		Interest/Shares		
Caribe Media Inc. (fka Caribe Information Investments Incorporated) <sup>6</sup>	Common	1.3%	359,765	538,969
<b>Total Investment in Equity Securities</b> <b>(3% of net asset value at fair value)</b>			\$ 16,559,610	\$ 6,040,895



**CLO Fund Securities****CLO Equity Investments**

Portfolio Company	Investment	Percentage	Cost	Value <sup>2</sup>
		Interest		
Grant Grove CLO, Ltd. <sup>3, 10</sup>	Subordinated Securities	22.2%	\$4,893,552	\$3,042,400
Katonah III, Ltd. <sup>3, 10</sup>	Preferred Shares	23.1%	4,476,930	1,000
Katonah V, Ltd. <sup>3, 10, 11</sup>	Preferred Shares	26.7%	3,320,000	1,000
Katonah VII CLO Ltd. <sup>3, 7, 10</sup>	Subordinated Securities	16.4%	4,614,123	2,358,700
Katonah VIII CLO Ltd. <sup>3, 7, 10</sup>	Subordinated Securities	10.3%	3,450,583	1,888,700
Katonah IX CLO Ltd. <sup>3, 7, 10</sup>	Preferred Shares	6.9%	2,060,697	1,336,800
Katonah X CLO Ltd. <sup>3, 7, 10</sup>	Subordinated Securities	33.3%	11,840,297	8,645,600
Katonah 2007-I CLO Ltd. <sup>3, 7, 10</sup>	Preferred Shares	100.0%	30,659,688	24,488,400
<b>Total Investment in CLO Equity Securities</b>			\$65,315,870	\$41,762,600

**CLO Rated-Note Investment**

Portfolio Company	Investment	Percentage	Cost	Value <sup>2</sup>
		Interest		
	Class B-2L Notes			
Katonah 2007-I CLO Ltd. <sup>3, 7, 10</sup>	Par Value of \$10,500,000	100.0%	\$1,212,612	\$6,675,717
	100.0%, Due 4/22			
<b>Total Investment in CLO Rated-Note</b>			\$1,212,612	\$6,675,717
<b>Total Investment in CLO Fund Securities</b> <b>(23% of net asset value at fair value)</b>			\$66,528,482	\$48,438,317

**Asset Manager Affiliates**

Portfolio Company / Principal Business	Investment	Percentage	Cost	Value <sup>2</sup>
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		<b>Interest</b>		
Asset Manager Affiliates (Katonah Debt Advisors and Trimaran Advisors)	Asset Management Company	100.0%	\$44,338,301	\$40,814,000
<b>Total Investment in Asset Manager Affiliates (20% of net asset value at fair value)</b>			\$44,338,301	\$40,814,000

**Time Deposits and Money Market Account**

<b>Time Deposits and Money Market Account</b>	<b>Investment</b>	<b>Yield</b>	<b>Par / Cost</b>	<b>Value<sup>2</sup></b>
JP Morgan Asset Account	Time Deposit	0.0%	\$ 229,152	\$ 229,152
JP Morgan Business Money Market Account <sup>9</sup>	Money Market Account	0.2%	164,573	164,573
US Bank Money Market Account	Money Market Account	0.4%	31,457,561	31,457,561
<b>Total Investment in Time Deposit and Money Market Accounts</b>			\$ 31,851,286	\$ 31,851,286
<b>(15% of net asset value at fair value)</b>				
<b>Total Investments<sup>5</sup></b>			\$ 293,588,917	\$ 241,818,004
<b>(117% of net asset value at fair value)</b>				

**See accompanying notes to financial statements.**

A majority of the variable rate loans to the Company's portfolio companies bear interest at a rate that may be determined by reference to either LIBOR or an alternate Base Rate (commonly based on the Federal Funds Rate or the Prime Rate), which typically resets semi-annually, quarterly, or monthly. The Company's variable rate loans may contain interest rate floors and its variable and fixed rate loans may include payment-in-kind ("PIK") interest. For each such loan, the Company has provided the weighted average annual stated interest rate in effect at December 31, 2011.

Reflects the fair market value of all existing investments as of December 31, 2011, as determined by the Company's Board of Directors.

Non-U.S. company or principal place of business outside the U.S.

Buildings and real estate relate to real estate ownership, builders, managers and developers and excludes mortgage debt investments and mortgage lenders or originators.

The aggregate cost of investments for federal income tax purposes is approximately \$294 million. The aggregate gross unrealized appreciation is approximately \$8 million, the aggregate gross unrealized depreciation is approximately \$59 million, and the net unrealized depreciation is approximately \$51 million.

Non-income producing.

An affiliate CLO Fund managed by an Asset Manager Affiliate.

Loan or debt security is on non-accrual status and therefore is considered non-income producing.

Money market account holding restricted cash and security deposits for employee flexible spending and payroll related accounts.

These securities were acquired in a transaction that was exempt from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"), pursuant to Rule 144A thereunder. These securities may be resold only in transactions that are exempt from the registration requirements of the Securities Act, normally to qualified institutional buyers.

As of December 31, 2011, this CLO Fund Security was not providing a dividend distribution.

**KCAP FINANCIAL, INC.****FINANCIAL HIGHLIGHTS****(unaudited)**

	Nine Months Ended September 30,			
	2012		2011	
Per Share Data:				
Net asset value, at beginning of period	\$7.85		\$8.21	
Net income (loss)				
Net investment income <sup>1</sup>	0.65		0.52	
Net realized losses <sup>1</sup>	(0.13)	)	(0.60)	)
Net change in unrealized appreciation/depreciation on investments <sup>1</sup>	(0.14)	)	0.43	
Net income (loss)	0.38		0.35	
Net decrease in net assets resulting from distributions From net investment income	(0.42)	)	(0.33)	)
Net decrease in net assets resulting from distributions	(0.42)	)	(0.33)	)
Net increase in net assets relating to stock-based transactions				
Issuance of common stock (not including dividend reinvestment plan)	-		-	
Issuance of common stock under dividend reinvestment plan	0.01		0.04	
Stock based compensation expense	(0.00)	)	0.02	
Net increase in net assets relating to stock-based transactions	0.01		0.06	
Net asset value, end of period	\$7.82		\$8.29	
Total net asset value return <sup>2</sup>	4.9	%	5.1	%
Ratio/Supplemental Data:				
Per share market value at beginning of period	\$6.31		\$6.97	
Per share market value at end of period	\$9.26		\$5.85	
Total market return <sup>3</sup>	53.4	%	(11.3)	)%
Shares outstanding at end of period	26,448,313		22,886,769	
Net assets at end of period	\$206,898,249		\$189,734,433	
Portfolio turnover rate <sup>4</sup>	16.8	%	20.1	%
Average debt outstanding	\$73,655,109		\$51,943,391	
Asset coverage ratio	335	%	416	%
Ratio of net investment income to average net assets <sup>5</sup>	11.1	%	7.9	%
Ratio of total expenses to average net assets <sup>5</sup>	6.9	%	5.9	%
Ratio of interest expense to average net assets <sup>5</sup>	3.2	%	2.1	%
Ratio of non-interest expenses to average net assets <sup>5</sup>	3.8	%	3.8	%

<sup>1</sup> Based on weighted average number of common shares outstanding for the period.

<sup>2</sup> Total net asset value return (not annualized) equals the change in the net asset value per share over the beginning of period net asset value per share plus dividends, divided by the beginning net asset value per share.

<sup>3</sup> Total market return (not annualized) equals the change in the ending market price over the beginning of period price per share plus dividends, divided by the beginning price.

<sup>4</sup> Not annualized. Portfolio turnover rate equals the year-to-date sales and paydowns over the average of the invested assets at fair value.

<sup>5</sup> Annualized

See accompanying notes to financial statements.

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**

**(unaudited)**

**1. ORGANIZATION**

KCAP Financial, Inc. (“KCAP Financial” or the “Company”) is an internally managed, non-diversified closed-end investment company that is regulated as a business development company (“BDC”) under the Investment Company Act of 1940. The Company originates, structures, and invests in senior secured term loans, mezzanine debt and selected equity securities primarily in privately-held middle market companies. The Company defines the middle market as comprising companies with earnings before interest, taxes, depreciation and amortization (“EBITDA”), of \$10 million to \$50 million and/or total debt of \$25 million to \$150 million.

The Company’s investment objective is to generate current income and capital appreciation from investments made in senior secured term loans, mezzanine debt and selected equity investments in privately-held middle market companies.

Katonah Debt Advisors, L.L.C., a registered investment adviser, and its asset manager affiliates (collectively, “Katonah Debt Advisors”) is a wholly-owned portfolio company of the Company. Katonah Debt Advisors manages collateralized loan obligation funds (“CLO Funds”) which invest in broadly syndicated loans, high-yield bonds and other credit instruments. On February 29, 2012, the Company purchased Trimaran Advisors, L.L.C. (“Trimaran Advisors”), a CLO manager similar to Katonah Debt Advisors that had approximately \$1.4 billion of assets under management, for total consideration of \$13.0 million in cash and 3,600,000 shares of the Company’s common stock. Contemporaneously with the acquisition of Trimaran Advisors, the Company acquired from Trimaran Advisors equity interests in certain CLO Funds managed by Trimaran Advisors for an aggregate purchase price of \$12.0 million in cash. As of September 30, 2012, Katonah Debt Advisors and Trimaran Advisors are the Company’s only wholly-owned portfolio companies (collectively, “Asset Manager Affiliates”) and have approximately \$3.3 billion of par value assets under management.

The Company also expects to receive distributions of recurring fee income and to generate capital appreciation from its investments in the asset management businesses of the Asset Manager Affiliates

The Company has elected to be treated as a regulated investment company (“RIC”) under Subchapter M of the Internal Revenue Code of 1986, as amended (the “Code”). To qualify as a RIC, the Company must, among other things, meet certain source-of-income and asset diversification requirements and distribute at least 90% of our net ordinary income and realized short-term capital gains in excess of realized net long-term capital losses, if any. As a RIC, the Company generally will not have to pay corporate-level taxes on any income that it distributes in a timely manner to its stockholders.

## **2. SIGNIFICANT ACCOUNTING POLICIES**

### **Basis of Presentation**

The accompanying unaudited financial statements have been prepared on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information. Accordingly, they do not include all of the information and footnotes required for annual financial statements. The unaudited interim financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto in the Company’s Form 10-K for the year ended December 31, 2011, as filed with the Securities and Exchange Commission (the “Commission” or the “SEC”).

The financial statements reflect all adjustments, both normal and recurring which, in the opinion of management, are necessary for the fair presentation of the Company’s results of operations and financial condition for the periods presented. Furthermore, the preparation of the financial statements requires management to make significant estimates and assumptions. Actual results could differ from those estimates, and the differences could be material. The results of operations for the interim periods presented are not necessarily indicative of the operating results to be expected for the full year.



In accordance with Article 6 of Regulation S-X under the Securities Act of 1933, as amended (the “Securities Act”) and the Securities Exchange Act of 1934, as amended (the “Exchange Act”), the Company does not consolidate portfolio company investments, including those in which it has a controlling interest (the Asset Manager Affiliates are currently the only companies in which the Company has a controlling interest). Effective January 1, 2010, the Asset Manager Affiliates adopted guidance encompassed in Accounting Standards Codification Topic 810, “Consolidation.” Although the Company cannot consolidate portfolio company investments, the adoption of this new guidance affected the required disclosures relating to the Asset Manager Affiliates, as it requires the Asset Manager Affiliates to consolidate their managed CLO Funds that are deemed to be variable interest entities (“VIEs”) and for which the Asset Manager Affiliates are considered to be the primary beneficiaries. As a result of the consolidation of these CLOs into the Asset Manager Affiliates, each Asset Manager Affiliates qualifies as a “significant subsidiary” and, as a result, the Company is required to include additional disclosures regarding the Asset Manager Affiliates in its SEC filings. The additional disclosure is included in Note 5 - Asset Manager Affiliates below.

The Asset Manager Affiliates are valued and presented on a combined basis as they are all asset managers for CLO Funds, economically linked, under common control, dependent on one another for shared resources and represent unconsolidated subsidiaries of the Company.

Beginning in the first quarter of 2012, the Company began recognizing dividend income from its CLO Fund securities based on effective interest, which is determined by using anticipated yield and estimated cash flows as updated quarterly for changes in prepayments, re-investment, credit losses and other items that may impact distributions. Previous cash distributions were previously recognized as dividends based on recent historical distributions and CLO Fund performance and accrued as a dividend receivable. Current accruals are now accrued as an adjustment to the cost basis of the CLO Fund securities. The Company then adjusted such accruals on a quarterly basis to reflect actual distributions. The Company’s financial statements contain reclassifications of prior period amounts to conform with such presentation; the effect of such reclassifications had no impact on the net increase in net assets resulting from operations, total assets or net assets.

### ***Investments***

Investment transactions are recorded on the applicable trade date. Realized gains or losses are determined using the specific identification method.

*Valuation of Portfolio Investments.* The Company’s board of directors (the “Board of Directors”) is ultimately responsible for making a good faith determination of the fair value of portfolio investments on a quarterly basis. Debt and equity securities for which market quotations are readily available are generally valued at such market quotations. Debt and equity securities that are not publicly traded or whose market price is not readily available are valued by the Board of Directors based on detailed analyses prepared by management, the Valuation Committee of the Board of Directors, and, in certain circumstances, third parties with valuation expertise. Valuations are conducted by

management on 100% of the investment portfolio at the end of each quarter. The Company follows the provisions of ASC Fair Value Measurements and Disclosures (“*Fair Value Measurements and Disclosures*”). This standard defines fair value, establishes a framework for measuring fair value, and expands disclosures about assets and liabilities measured at fair value. *Fair Value Measurements and Disclosures* 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. Subsequent to the adoption of *Fair Value Measurements and Disclosures*, the FASB has issued various staff positions clarifying the initial standard as noted below.

In May 2011, the FASB issued additional guidance that clarifies and requires new disclosures about fair value measurements. Information about valuation techniques and unobservable inputs used in Level III fair value measurements and a narrative description of the sensitivity of Level III measurements to changes in unobservable inputs were adopted by the Company in the first quarter of 2012. Note 4 - Investments below reflects the amended disclosure requirements. Since this new guidance only amends the disclosures requirements, it did not impact our balance sheet, statements of operations, or cash flow statement.

*Fair Value Measurements and Disclosures* requires the disclosure in interim and annual periods of the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

Beginning with the period ended June 30, 2011, the Company has engaged an independent valuation firm to provide third party valuation consulting services to the Company’s Board of Directors. Each quarter the independent valuation firm will perform third party valuations on the Company’s investments in illiquid securities such that they are reviewed at least once during a trailing 12 month period. These third party valuation estimates are considered as one of the relevant data inputs in the Company’s determination of fair value. The Board of Directors intends to continue to engage an independent valuation firm in the future to provide certain valuation services, including the review of certain portfolio assets, as part of the quarterly and annual year-end valuation process.

In 2012 and 2011, the Company engaged an independent valuation firm to provide a third-party review of the Company’s CLO fair value model relative to its functionality, model inputs and calculations as a reasonable method to determine the fair value of its CLO Fund investments, in the absence of Level I or Level II trading activity or observable market inputs. The independent valuation firm concluded that the Company’s CLO model appropriately factored in all the necessary inputs required to build a discounted cash flow model in connection with determining the fair value of its CLO Fund investments and that the inputs were being employed correctly.

Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of the Company's investments may differ materially from the values that would have been used had a ready market existed for such investments. Further, such investments may be generally subject to legal and other restrictions on resale or otherwise be less liquid than publicly traded securities. In addition, changes in the market environment and other events may occur over the life of the investments that may cause the value realized on such investments to be different from the currently assigned valuations.

The Company's valuation methodology and procedures are as follows:

Each portfolio company or investment is cross-referenced to an independent pricing service to determine if a current market quote is available. The nature and quality of such quote is reviewed to determine reliability and relevance of the quote. Factors considered in this determination include whether the quote is from a transaction or  
1) is a broker quote, the date and aging of such quote, whether the transaction is arms-length, whether it is of a liquidation or distressed nature and certain other factors judged to be relevant by management within the framework of *Fair Value Measurements and Disclosures*.

If an investment does not have a market quotation on either a broad market exchange or from an independent  
2) pricing service, the investment is initially valued by the Company's investment professionals responsible for the portfolio investment in conjunction with the portfolio management team.

3) Preliminary valuation conclusions are discussed and documented by management.

Illiquid loans, junior and mezzanine securities, equity investments, CLO Fund securities and the investment in the  
4) Asset Manager Affiliates may be selected for review by an independent valuation firm, which is engaged by the Company's Board of Directors. Such independent valuation firm reviews management's preliminary valuations and makes their own independent valuation assessment.

5) The Valuation Committee of the Board of Directors reviews the portfolio valuations, as well as the input and report of such independent valuation firm, as applicable.

Upon approval of the investment valuations by the Valuation Committee of the Board of Directors, the Audit  
6) Committee of the Board of Directors reviews the results for inclusion in the Company's quarterly and annual financial statements, as applicable.

The Board of Directors discusses the valuations and determines in good faith that the fair values of each investment  
7) in the portfolio is reasonable based upon any applicable independent pricing service, input of management, estimates from independent valuation firms (if any) and the recommendations of the Valuation Committee of the Board of Directors.

The majority of the Company's investment portfolio is composed of debt and equity securities with unique contract terms and conditions and/or complexity that requires a valuation of each individual investment that considers multiple levels of market and asset specific inputs, including historical and forecasted financial and operational performance of the individual investment, projected cash flows, market multiples, comparable market transactions, the priority of the

security compared with those of other securities for such issuers, credit risk, interest rates, and independent valuations and reviews.

*Loans and Debt Securities.* To the extent that the Company's investments are exchange traded and are priced or have sufficient price indications from normal course trading at or around the valuation date (financial reporting date), such pricing will determine fair value. Pricing service marks from third party pricing services may be used as an indication of fair value, depending on the volume and reliability of the marks, sufficient and reasonable correlation of bid and ask quotes, and, most importantly, the level of actual trading activity. However, many of the Company's investments are illiquid investments with little or no trading activity. Further, the Company has been unable to identify directly comparable market indices or other market guidance that correlate directly to the types of investments the Company owns. As a result, for most of its assets, the Company determines fair value using alternative methodologies using available market data, as adjusted, to reflect the types of assets the Company owns, their structure, qualitative and credit attributes and other asset specific characteristics.

The Company derives fair value for its illiquid investments that do not have indicative fair values based upon active trades primarily by using a present value technique that discounts the estimated contractual cash flows for the underlying assets with discount rates imputed by broad market indices, bond spreads and yields for comparable issuers relative to the subject assets (the “Market Yield Approach”) and also considers recent loan amendments or other activity specific to the subject asset. Discount rates applied to estimated contractual cash flows for an underlying asset vary by specific investment, industry, priority and nature of the debt security (such as the seniority or security interest of the debt security) and are assessed relative to two indices, a leveraged loan index and a high-yield bond index, at the valuation date. The Company has identified these two indices as benchmarks for broad market information related to its loan and debt investments. Because the Company has not identified any market index that directly correlates to the loan and debt investments held by the Company and therefore uses the two benchmark indices, these market indices may require significant adjustment to better correlate such market data for the calculation of fair value of the investment under the Market Yield Approach. Such adjustments require judgment and may be material to the calculation of fair value. Further adjustments to the discount rate may be applied to reflect other market conditions or the perceived credit risk of the borrower. When broad market indices are used as part of the valuation methodology, their use is subject to adjustment for many factors, including priority, collateral used as security, structure, performance and other quantitative and qualitative attributes of the asset being valued. The resulting present value determination is then weighted along with any quotes from observable transactions and broker/pricing quotes. If such quotes are indicative of actual transactions with reasonable trading volume at or near the valuation date that are not liquidation or distressed sales, relatively more reliance will be put on such quotes to determine fair value. If such quotes are not indicative of market transactions or are insufficient as to volume, reliability, consistency or other relevant factors, such quotes will be compared with other fair value indications and given relatively less weight based on their relevancy. Other significant assumptions, such as coupon and maturity, are asset-specific and are noted for each investment in the Schedules of Investments.

*Equity and Equity-Related Securities.* The Company’s equity and equity-related securities in portfolio companies for which there is no liquid public market are carried at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including EBITDA and cash flows from operations less capital expenditures and other pertinent factors, such as recent offers to purchase a portfolio company’s securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions. The values of the Company’s equity and equity-related securities in public companies for which market quotations are readily available are based upon the closing public market prices on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

The significant inputs used to determine the fair value of equity and equity-related securities include prices, earnings, EBITDA and cash flows after capital expenditures for similar peer comparables and the investment entity itself. Equity and equity related securities are classified as Level III, as described in Note 4 – Investments below, when there is limited activity or less transparency around inputs to the valuation given the lack of information related to such equity investments held in nonpublic companies. Significant assumptions observed for comparable companies are applied to relevant financial data for the specific investment. Such assumptions, such as model discount rates or price/earnings multiples, vary by the specific investment, equity position and industry and incorporate adjustments for risk premiums, liquidity and company specific attributes. Such adjustments require judgment and may be material to the calculation of fair value.

*Asset Manager Affiliates.* The Company's investments in the Asset Manager Affiliates are carried at fair value, which is determined after taking into consideration a percentage of assets under management and a discounted cash flow model incorporating different levels of discount rates depending on the hierarchy of fees earned (including the likelihood of realization of senior, subordinate and incentive fees) and prospective modeled performance. Such valuation includes an analysis of comparable asset management companies. The Asset Manager Affiliates are classified as a Level III investment (as described below). Any change in value from period to period is recognized as net change in unrealized appreciation or depreciation.

*CLO Fund Securities.* The Company typically makes a minority investment in the most junior class of securities of CLO Funds raised and managed by the Asset Manager Affiliates and may selectively invest in securities issued by funds managed by other asset management companies (collectively, "CLO Fund securities").

The Company's investments in CLO Fund securities are carried at fair value, which is based either on (i) the present value of the net expected cash inflows for interest income and principal repayments from underlying assets and cash outflows for interest expense, debt paydown and other fund costs for the CLO Funds that are approaching or past the end of their reinvestment period and therefore are selling assets and/or using principal repayments to pay down CLO Fund debt (or will begin to do so shortly), and for which there continue to be net cash distributions to the class of securities owned by the Company, or (ii) a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar securities or preferred shares to those in which the Company has invested. The Company recognizes unrealized appreciation or depreciation on the Company's investments in CLO Fund securities as comparable yields in the market change and/or based on changes in net asset values or estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each investment in CLO Fund securities ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool are updated and the revised cash flows are used in determining the fair value of the CLO Fund investment. The Company determines the fair value of its investments in CLO Fund securities on a security-by-security basis.

Due to the individual attributes of each CLO Fund security, they are classified as a Level III investment unless specific trading activity can be identified at or near the valuation date. When available, observable market information will be identified, evaluated and weighted accordingly in the application of such data to the present value models and fair value determination. Significant assumptions to the present value calculations include default rates, recovery rates, prepayment rates, investment/reinvestment rates and spreads and the discount rate by which to value the resulting underlying cash flows. Such assumptions can vary significantly, depending on market data sources which often vary in depth and level of analysis, understanding of the CLO market, detailed or broad characterization of the CLO market and the application of such data to an appropriate framework for analysis. The application of data points are based on the specific attributes of each individual CLO Fund security's underlying assets, historic, current and prospective performance, vintage, and other quantitative and qualitative factors that would be evaluated by market participants. The Company evaluates the source of market data for reliability as an indicative market input, consistency amongst other inputs and results and also the context in which such data is presented.

For rated note tranches of CLO Fund securities (those above the junior class) without transactions to support a fair value for the specific CLO Fund and tranche, fair value is based on discounting estimated bond payments at current market yields, which may reflect the adjusted yield on the leveraged loan index for similarly rated tranches, as well as prices for similar tranches for other CLO Funds and also other factors such as the default and recovery rates of underlying assets in the CLO Fund, as may be applicable. Such model assumptions may vary and incorporate adjustments for risk premiums and CLO Fund specific attributes. Such adjustments require judgment and may be material to the calculation of fair value.

**Cash.** The Company defines cash as demand deposits. The Company places its cash with financial institutions and, at times, cash held in checking accounts may exceed the Federal Deposit Insurance Corporation insured limit.

**Restricted Cash.** Restricted cash consisted of cash held in an operating account pursuant to the Company's secured credit facility agreement with Credit Suisse AG.

**Time Deposits and Money Market Accounts.** Time deposits primarily represent investments of cash held in non-demand deposit accounts. Money market accounts primarily represent short term interest-bearing deposit accounts including an account that contains restricted cash held for employee flexible spending accounts.

**Interest Income.** Interest income, including the amortization of premium and accretion of discount, is recorded on the accrual basis to the extent that such amounts are expected to be collected. The Company generally places a loan or security on non-accrual status and ceases recognizing cash interest income on such loan or security when a loan or security becomes 90 days or more past due or if the Company otherwise does not expect the debtor to be able to service its debt obligations. Non-accrual loans remain in such status until the borrower has demonstrated the ability and intent to pay contractual amounts due or such loans become current. As of September 30, 2012, five issuers representing less than 1% of total investments at fair value were considered in default and on non-accrual.

***Dividends from Asset Manager Affiliates.*** The Company records dividend income from the Asset Manager Affiliates on the declaration date, which represents the ex-dividend date.

***Dividend Income from CLO Fund Securities.*** The Company generates dividend income from its investments in the most junior class of securities of CLO Funds (typically preferred shares or subordinated securities) managed by the Asset Manager Affiliates and selective investments in securities issued by funds managed by other asset management companies using the effective interest method based on anticipated yield and estimated cash flows as updated quarterly for changes in prepayments, re-investment, credit losses and other items that may impact distributions. The Company's CLO Fund junior class securities are subordinated to senior note holders who typically receive a rate of return on their investment at a fixed spread relative to the LIBOR index. The CLO Funds are leveraged funds and any excess cash flow or "excess spread" (interest earned by the underlying securities in the fund less payments made to senior note holders and less fund expenses and management fees) is paid to the holders of the CLO Fund's subordinated securities or preferred shares.



For non-junior class CLO Fund securities, such as the Company's investment in the Class B-2L Notes of the Katonah 2007-1 CLO, interest is earned at a fixed spread relative to the LIBOR index.

**Capital Structuring Service Fees.** The Company may earn ancillary structuring and other fees related to the origination, investment, disposition or liquidation of debt and investment securities. Generally, the Company will capitalize loan origination fees, then amortize these fees into interest income over the term of the loan using the effective interest rate method, recognize prepayment and liquidation fees upon receipt and equity structuring fees as earned, which generally occurs when an investment transaction closes.

**Debt Issuance Costs.** Debt issuance costs represent fees and other direct costs incurred in connection with the Company's borrowings. These amounts are capitalized and amortized ratably over the contractual term of the borrowing. In January 31, 2011, the Company fully repaid its outstanding secured credit borrowing facility which had a balance of \$86.7 million as of December 31, 2010 and, at repayment, all related debt issuance costs were fully amortized.

During March 2011, the Company issued \$60 million of convertible senior notes (the "Convertible Senior Notes") and incurred debt issuance costs of approximately \$2.4 million which will be amortized over a five-year period. At September 30, 2012, there was an unamortized debt issuance cost of approximately \$1.6 million included in other assets in the accompanying balance sheet. Amortization expense for the nine months ended September 30, 2012 and 2011 was approximately \$354,000 and \$257,000, respectively.

On February 24, 2012, the Company entered into a three year financing arrangement under which the Company may obtain up to \$30 million in financing. In connection with the Facility, the Company incurred approximately \$444,000 of debt origination costs which are being amortized over the term of the Facility on a straight-line basis of which approximately \$360,000 remains to be amortized.

**Expenses.** The Company is internally managed and expenses costs, as incurred, with regard to the running of its operations. Primary operating expenses include employee salaries and benefits, the costs of identifying, evaluating, negotiating, closing, monitoring and servicing the Company's investments and related overhead charges and expenses, including rental expense, and any interest expense incurred in connection with borrowings. The Company and the Asset Manager Affiliates share office space and certain other operating expenses. The Company has entered into an Overhead Allocation Agreement with the Asset Manager Affiliates which provides for the sharing of such expenses based on an equal sharing of office lease costs and the ratable usage of other shared resources. The aggregate net payments of such expenses under the Overhead Allocation Agreement are not material.

**Dividends.** Dividends and distributions to common stockholders are recorded on the ex-dividend date. The amount to be paid out as a dividend is determined by the Board of Directors each quarter and is generally based upon the earnings estimated by management for the period and year.

The Company has adopted a dividend reinvestment plan that provides for reinvestment of its distributions on behalf of its stockholders, unless a stockholder “opts out” of the plan to receive cash in lieu of having their cash dividends automatically reinvested in additional shares of the Company’s common stock.

### ***Recent Accounting Pronouncements***

***Improved Disclosures Regarding Fair Value Measurements.*** In January 2010, the FASB issued Accounting Standards Update No. 2010-06, *Fair Value Measurements and Improving Disclosures About Fair Value Measurements (Topic 820)*, which provides for improving disclosures about fair value measurements, primarily significant transfers in and out of Levels I and II, and activity in Level III fair value measurements. The new disclosures and clarifications of existing disclosures are effective for the interim and annual reporting periods beginning after December 15, 2009, while the disclosures about the purchases, sales, issuances, and settlements in the roll forward activity in Level 3 fair value measurements are effective for fiscal years beginning after December 15, 2010 and for the interim periods within those fiscal years. Except for certain detailed Level III disclosures, which are effective for fiscal years beginning after December 15, 2010 and interim periods within those years, the new guidance became effective for the Company’s fiscal 2010 second quarter. The adoption of this disclosure-only guidance is included in Note 4 “— Investments” and did not have a material impact on the Company’s financial results.

In May 2011, the FASB issued FASB Accounting Standards Update (“ASU”) 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. The amendments in this ASU generally represent clarifications of Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This ASU results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRS. The amendments in this ASU are applied prospectively and are effective during interim and annual periods beginning after December 15, 2011. The adoption of this ASU did not have a material impact on the Company’s operating results, financial position or cash flows.

### 3. EARNINGS PER SHARE

The following information sets forth the computation of basic and diluted net increase in net assets from operations per share for the three and nine months ended September 30, 2012 and 2011 (unaudited):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net increase in net assets from operations	\$ 9,368,394	\$ (1,485,257 )	\$ 11,562,505	\$ 8,993,207
Net decrease in net assets allocated to unvested share awards	—	—	(136,546 )	—
Add: Interest on Senior Convertible Notes	1,312,500	—	—	—
Add: Amortization of Capitalized Costs on Senior Convertible Notes	118,020	—	—	—
Net increase in net assets available to common stockholders	10,798,914	(1,485,257 )	11,425,959	8,993,207
Weighted average number of common shares outstanding for basic shares computation	26,668,701	22,872,486	25,860,510	22,830,757
Effect of dilutive securities - stock options	—	—	12,737	—
Effect of dilutive Senior Convertible Notes	7,213,212	—	—	—
Weighted average number of common and common stock equivalent shares outstanding for diluted shares computation	33,881,913	22,872,486	25,873,247	22,830,757
Net increase in net assets per basic common shares:				
Net increase in net assets from operations	0.35	(0.06 )	0.45	0.39
Net decrease in net assets allocated to unvested share awards	—	—	(0.01 )	—
Net increase in net assets per diluted shares:				
Net increase in net assets from operations	0.32	(0.06 )	0.44	0.39
Net decrease in net assets allocated to unvested share awards	—	—	(0.01 )	—

Share-based awards that contain nonforfeitable rights to dividends or dividend equivalents, whether paid or unpaid, are participating securities and included in the computation of both basic and diluted earnings per share. Grants of restricted stock awards to our employees and directors are considered participating securities when there are earnings in the period and the earnings per share calculations include outstanding unvested restricted stock awards in the basic weighted average shares outstanding calculation.

Options to purchase 60,000 shares were not included in the computation of diluted earnings per share for the three months ended September 30, 2012 because the effect was not materially dilutive. Options to purchase 60,000 shares

were included in the computation of diluted earnings per share for the nine months ended September 30, 2012, with a dilutive effect of 12,737 shares. For the three and nine months ended September 30, 2011, options to purchase 60,000 shares were not included in the computation of diluted earnings per share because the effect would be antidilutive as the exercise prices exceeded the average market price of the common shares.

The Company's Convertible Senior Notes are included in the computation of the diluted net increase or decrease in net assets resulting from operations per share in accordance with ASC 261-10-45-40-b by application of the "if-converted method." Under the if-converted method, interest charges applicable to the convertible debt for the period are added to the reported net increase or decrease in net assets resulting from operations and the full amount of shares (pro-rata if not outstanding for the full period) that would be issued are added to weighted average basic shares. Convertible debt is considered anti-dilutive only when its interest per share upon conversion exceeds the basic net increase or decrease in net assets resulting from operations per share. For the three months ended September 30, 2012, the effect of the convertible debt was dilutive. For the nine months ended September 30, 2012, the effect of the convertible debt was antidilutive.

The if-converted method of computing the dilutive effects on convertible debt assumes a conversion even if the contracted conversion price exceeds the market value of the shares. The Company's Convertible Senior Notes had a conversion price of \$8.44 per share which was above the Company's net asset value per share at the time of issuance. The conversion rate is subject to customary anti-dilution adjustments, including for any cash dividends or distributions paid on shares of our common stock in excess of a quarterly dividend of \$0.17 per share, but will not be adjusted for any accrued and unpaid interest. In addition, if certain corporate events occur prior to the maturity date of the Convertible Senior Notes, the conversion rate will be increased for converting holders. Upon conversion, the Company would issue the full amount of common stock upon conversion and retire the full amount of debt outstanding.

#### 4. INVESTMENTS

The Company invests in senior secured loans and mezzanine debt and, to a lesser extent, equity capital of middle market companies in a variety of industries. However, the Company may invest in industries in which it currently has little or no investment if it is presented with attractive opportunities. The Company generally targets companies that generate positive cash flows because the Company looks to cash flows as the primary source for servicing debt.

The following table shows the Company's portfolio by security type at September 30, 2012 and December 31, 2011:

Security Type	September 30, 2012 (unaudited)			December 31, 2011			
	Cost	Fair Value	% <sup>1</sup>	Cost	Fair Value	% <sup>1</sup>	
Time Deposits	\$501,475	\$501,475	-	% \$229,152	\$229,152	-	%
Money Market Account	4,850,220	4,850,220	2	31,622,134	31,622,134	18	
Senior Secured Loan	73,626,439	65,868,804	32	54,045,184	45,259,328	25	
Junior Secured Loan	53,570,960	37,237,835	18	58,936,728	47,300,172	26	
Mezzanine Investment	8,518,913	9,401,536	5	10,931,428	11,588,115	6	
Senior Subordinated Bond	21,846,118	22,577,830	11	9,997,898	10,125,891	6	
CLO Fund Securities	85,506,168	67,784,447	33	66,528,482	48,438,317	27	
Equity Securities	17,012,236	6,911,736	3	16,559,610	6,040,895	3	
Preferred	400,000	391,760	-	400,000	400,000	-	
Asset Manager Affiliates	83,203,884	73,989,000	36	44,338,301	40,814,000	23	
Total	\$349,036,413	\$289,514,643	140%	\$293,588,917	\$241,818,004	134%	

<sup>1</sup> Calculated as a percentage of net asset value.

The industry concentrations of the Company's investment portfolio based on the fair value of the investments as of September 30, 2012 and December 31, 2011, were as follows:

Industry Classification	September 30, 2012 (unaudited)			December 31, 2011		
	Cost	Fair Value	% <sup>1</sup>	Cost	Fair Value	% <sup>1</sup>
Aerospace and Defense	\$16,377,751	\$16,109,525	8	% \$19,683,821	\$19,439,230	11
Asset Management Companies <sup>2</sup>	83,203,884	73,989,000	36	44,338,301	40,814,000	23
Automobile	4,957,988	5,010,173	2	-	-	-
Beverage, Food and Tobacco	18,186,743	18,350,683	9	9,892,275	9,796,565	5
Broadcasting and Entertainment	3,965,305	3,985,979	2	-	-	-
Buildings and Real Estate <sup>3</sup>	18,591,674	504,558	-	18,591,674	662,443	-
Cargo Transport	-	-	-	4,374,351	4,374,351	2
Chemicals, Plastics and Rubber	2,962,312	2,953,469	1	4,809,459	4,614,828	3
CLO Fund Securities	85,506,167	67,784,447	33	66,528,482	48,438,317	27
Containers, Packaging and Glass	1,951,066	1,976,811	1	-	-	-
Diversified/Conglomerate	6,917,576	7,210,000	3	6,905,447	7,000,000	4
Manufacturing	5,522,623	3,477,588	2	2,870,642	372,599	-
Diversified/Conglomerate Service	8,428,737	8,598,043	4	8,831,441	9,026,186	5
Electronics	1,797,499	1,907,910	1	-	-	-
Finance	21,865,085	10,520,420	5	20,956,582	19,523,824	11
Healthcare, Education and Childcare	19,489,951	19,825,846	10	21,683,112	20,604,850	11
Home and Office Furnishings, Housewares, and Durable Consumer Products	6,963,941	5,896,100	3	4,919,522	3,753,000	2
Insurance	2,387,800	2,031,951	1	2,290,892	2,084,012	1
Leisure, Amusement, Motion Pictures, Entertainment	11,406,812	12,490,967	6	3,483,174	3,891,900	2
Machinery (Non-Agriculture, Non-Construction, Non-Electronic)	773,718	264,864	-	797,091	438,913	-
Mining, Steel, Iron and Non-Precious Metals	5,000,000	3,833,325	2	5,000,000	3,250,000	2
Personal and Non Durable Consumer Products (Mfg. Only)	3,581,545	3,604,124	2	2,872,500	2,827,359	2
Personal, Food and Miscellaneous Services	2,018,875	2,010,726	1	2,993,092	2,983,648	2
Personal Transportation	2,875,557	3,060,931	1	1,044,539	1,223,743	1
Printing and Publishing	5,821,868	5,895,647	3	1,885,086	1,932,500	1
Retail Stores	2,961,026	2,700,647	1	2,986,151	2,776,950	2
Telecommunications	5,351,696	5,351,695	3	31,851,287	31,851,286	18
Time Deposit and Money Market Accounts	169,214	169,214	-	4,000,000	137,500	-
Utilities	\$349,036,413	\$289,514,643	140%	\$293,588,921	\$241,818,004	135%
Total						

<sup>1</sup>Calculated as a percentage of net asset value.

<sup>2</sup>Represents the Asset Manager Affiliates.

<sup>3</sup>Buildings and real estate relate to real estate ownership, builders, managers and developers and excludes mortgage debt investments and mortgage lenders or originators.

The Company may invest up to 30% of the investment portfolio in opportunistic investments in high-yield bonds, debt and equity securities of CLO Funds, distressed debt or equity securities of public companies. The Company expects that these public companies generally will have debt that is non-investment grade. The Company also may invest in debt of middle market companies located outside of the United States, these investments (excluding the Company's investments in CLO Funds) are generally not anticipated to be in excess of 10% of the investment portfolio at the time such investments are made.

At September 30, 2012 and December 31, 2011, approximately 23% and 21% of the Company's total assets were foreign assets (including the Company's investments in CLO Funds, which are typically domiciled outside the U.S.)

At September 30, 2012 and December 31, 2011, the Company's ten largest portfolio companies represented approximately 56% and 62%, respectively, of the total fair value of its investments. The Company's largest investment, the Asset Manager Affiliates represented 26% and 17% of the total fair value of the Company's investments at September 30, 2012 and December 31, 2011, respectively. Excluding Asset Manager Affiliates and CLO Fund securities, the Company's ten largest portfolio companies represented approximately 20% and 26% of the total fair value of the Company's investments at September 30, 2012 and December 31, 2011, respectively.

### **Investment in CLO Fund Securities**

The Company typically makes a minority investment in the most junior class of securities of CLO Funds (typically preferred shares or subordinated securities) managed by the Asset Manager Affiliates and may selectively invest in securities issued by funds managed by other asset management companies. CLO Funds managed by the Asset Manager Affiliates ("CLO Fund securities managed by affiliate") invest primarily in broadly syndicated non-investment grade loans, high-yield bonds and other credit instruments of corporate issuers. The underlying assets in each of the CLO Funds in which the Company has an investment are generally diversified secured or unsecured corporate debt.

As of September 30, 2012 and December 31, 2011, the Company had approximately \$68 million and \$48 million, respectively, of CLO Fund securities at fair value. The cost basis of the Company's investment in CLO Fund securities as of September 30, 2012 was approximately \$86 million and aggregate unrealized depreciation on the CLO Fund securities totaled approximately \$18 million. The cost basis of the Company's investment in CLO Fund securities as of December 31, 2011, was approximately \$67 million and aggregate unrealized depreciation on the CLO Fund securities totaled approximately \$18 million.

All CLO Funds managed by the Asset Manager Affiliates are currently making quarterly dividend distributions to the Company and are paying all senior and subordinate management fees to the Asset Manager Affiliates. With the exception of the Katonah III, Ltd. and the Katonah V, Ltd. CLO Funds, all third-party managed CLO Funds held as



investments are making quarterly dividend distributions to the Company.

## **Fair Value Measurements**

The Company follows the provisions of *Fair Value Measurements and Disclosures*, which among other things, requires enhanced disclosures about investments that are measured and reported at fair value. This standard defines fair value and establishes a hierarchical disclosure framework which prioritizes and ranks the level of market price observability used in measuring investments at fair value and expands disclosures about assets and liabilities measured at fair value. *Fair Value Measurements and Disclosures* 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. This fair value definition focuses on an exit price in the principal, or most advantageous market, and prioritizes, within a measurement of fair value, the use of market-based inputs (which may be weighted or adjusted for relevance, reliability and specific attributes relative to the subject investment) over entity-specific inputs. Market price observability is affected by a number of factors, including the type of investment and the characteristics specific to the investment. Investments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of market price observability and a lesser degree of judgment used in measuring fair value. Subsequent to the adoption of *Fair Value Measurements and Disclosures*, the FASB has issued various staff positions clarifying the initial standard (see Note 2. “Significant Accounting Policies—Investments”).

*Fair Value Measurements and Disclosures* establishes the following three-level hierarchy, based upon the transparency of inputs to the fair value measurement of an asset or liability as of the measurement date:

Level I – Unadjusted quoted prices are available in active markets for identical investments as of the reporting date. The type of investments included in Level I include listed equities and listed securities. As required by *Fair Value Measurements and Disclosures*, the Company does not adjust the quoted price for these investments, even in situations where the Company holds a large position and a sale could reasonably affect the quoted price.

Level II – Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date. Such inputs may be quoted prices for similar assets or liabilities, quoted markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full character of the financial instrument, or inputs that are derived principally from, or corroborated by, observable market information. Investments which are generally included in this category include illiquid corporate loans and bonds and less liquid, privately held or restricted equity securities for which some level of recent trading activity has been observed.

Level III – Pricing inputs are unobservable for the investment and includes situations where there is little, if any, market activity for the investment. The inputs may be based on the Company's own assumptions about how market participants would price the asset or liability or may use Level II inputs, as adjusted, to reflect specific investment attributes relative to a broader market assumption. The use of these inputs in determining the fair value of an asset or liability may require significant management judgment or estimation. Even if observable market data for comparable performance or valuation measures (earnings multiples, discount rates, other financial/valuation ratios, etc.) are available, such investments are grouped as Level III if any significant data point that is not also market observable (private company earnings, cash flows, etc.) is used in the valuation methodology.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an investment's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and the Company considers factors specific to the investment. The Company evaluates the source of inputs, including any markets in which its investments are trading, in determining fair value. Inputs that are backed by actual transactions, those that are highly correlated to the specific investment being valued and those derived from reliable or knowledgeable sources will tend to have a higher weighting in determining fair value. The determination of the fair value of the Company's investments is based on an assessment of each underlying investment, the current and prospective operating and financial performance of the portfolio company, consideration of financing and sale transactions with third parties, expected cash flows and market-based information, including comparable transactions, performance factors, and other investment or industry specific market data, among other factors.

The following table summarizes the fair value of investments by the above *Fair Value Measurements and Disclosures* fair value hierarchy levels as of September 30, 2012 (unaudited) and December 31, 2011, respectively:

As of September 30, 2012 (unaudited)

	Level I	Level II	Level III	Total
Time deposit and money market account	\$ —	\$5,351,695	\$—	\$5,351,695
Debt securities	—	88,851,575	46,626,190	135,477,765
CLO Fund securities	—	—	67,784,447	67,784,447
Equity securities	—	—	6,911,736	6,911,736
Asset Manager Affiliates	—	—	73,989,000	73,989,000

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Total	—	94,203,270	195,311,373	289,514,643
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As of December 31, 2011

	Level I	Level II	Level III	Total
Time deposit and money market account	\$ —	\$31,851,286	\$—	\$31,851,286
Debt securities	—	31,578,832	83,094,674	114,673,506
CLO Fund securities	—	—	46,412,000	46,412,000
Equity securities	—	—	6,040,895	6,040,895
Asset Manager Affiliates	—	—	40,814,000	40,814,000
Total	—	63,430,118	176,361,569	239,791,687

As a BDC, it is required that the Company invest primarily in the debt and equity of non-public or thinly traded public companies for which there is little, if any, market-observable information. As a result a significant portion of the Company's investments at any given time will likely be deemed Level III investments. The Company believes that investments classified as Level III for *Fair Value Measurements and Disclosures* have a further hierarchal framework which prioritizes and ranks such valuations based on the degree of independent and observable inputs, objectivity of data and models and the level of judgment required to adjust comparable data. The investments listed in the above table are presented in descending order from the highest to lowest degree of independent and observable inputs and are discussed in such order below.

When possible, the Company will obtain investment value indications from third party pricing services. Generally, such value indications represent a trading or broker quote on an asset that is infrequently traded. If the quotes are deemed reliable and current, such quotes are deemed Level II assets. If the quotes are not deemed reliable and current, Level III inputs and assessments may be relied upon and the value will be deemed a Level III asset (consistent with a fair value hierarchy based on the lowest level of input that is significant to the fair value measurement).

The Asset Manager Affiliates may also receive incentive fees from CLO Funds upon exceeding specified relative and/or absolute return thresholds. Such fees are recorded upon completion of the measurement period which varies by CLO Fund. If incentive fees are paid upon reaching such investment return thresholds, they are not subject to claw-back provisions.

The Company derives fair value for its illiquid investments that do not have indicative fair values based upon active trades primarily by using the Market Yield Approach and also considers recent loan amendments or other activity specific to the subject asset. Discount rates applied to estimated contractual cash flows for an underlying asset vary by specific investment, industry, priority and nature of the debt security (such as the seniority or security interest of the debt security) and are assessed relative to two indices, a leveraged loan index and a high-yield bond index, at the valuation date. The Company has identified these two indices as benchmarks for broad market information related to its loan and debt investments. Because the Company has not identified any market index that directly correlates to the loan and debt investments held by the Company and therefore uses the two benchmark indices, these market indices may require significant adjustment to better correlate such market data for the calculation of fair value of the investment under the Market Yield Approach. Such adjustments require judgment and may be material to the calculation of fair value. Further adjustments to the discount rate may be applied to reflect other market conditions or the perceived credit risk of the borrower. When broad market indices are used as part of the valuation methodology, their use is subject to adjustment for many factors, including priority, collateral used as security, structure, performance and other quantitative and qualitative attributes of the asset being valued. The resulting present value determination is then weighted along with any quotes from observable transactions and broker/pricing quotes. If such quotes are indicative of actual transactions with reasonable trading volume at or near the valuation date that are not liquidation or distressed sales, relatively more reliance will be put on such quotes to determine fair value. If such quotes are not indicative of market transactions or are insufficient as to volume, reliability, consistency or other relevant factors, such quotes will be compared with other fair value indications and given relatively less weight based on their relevancy. The appropriateness of specific valuation methods and techniques may change as market conditions and available data change.

In 2012 and 2011, the Company engaged an independent valuation firm to provide a third-party review of the Company's CLO fair value model relative to its functionality, model inputs, and calculations as a reasonable method to determine the fair value of its CLO Fund investments in the absence of Level I or Level II trading activity or observable market inputs. The independent valuation firm concluded that the Company's CLO model appropriately factored in all the necessary inputs required to build a discounted cash flow model in connection with determining the fair value of its CLO Fund investments and that the inputs were being employed correctly.

Beginning with the period ending June 30, 2011, the Company has engaged an independent valuation firm to provide third party valuation consulting services to the Company's Board of Directors. Each quarter the independent valuation firm will perform third party valuations on the Company's investments on illiquid securities such that they are reviewed at least once during a trailing 12 month period. These third party valuation estimates are considered as one of the relevant data inputs in the Company's determination of fair value. The Board of Directors intends to continue to engage an independent valuation firm in the future to provide certain valuation services, including the review of certain portfolio assets, as part of the quarterly and annual year-end valuation process.

Values derived for debt securities using public/private company comparables generally utilize market-observable data from such comparables and specific, non-public and non-observable financial measures (such as earnings or cash flows) for the private, underlying company/issuer. Such non-observable company/issuer data is typically provided on a monthly basis, is certified as correct by the management of the company/issuer and/or audited by an independent accounting firm on an annual basis. Since such private company/issuer data is not publicly available it is not deemed market-observable data and, as a result, such investment values are grouped as Level III assets.

Values derived for the Asset Manager Affiliates using public/private company comparables generally utilize market-observable data from such comparables and specific, non-public and non-observable financial measures (such as assets under management, historical and prospective earnings) for the Asset Manager Affiliates. The Company recognizes that comparable asset managers may not be fully comparable to the Asset Manager Affiliates and typically identifies a range of performance measures and/or adjustments within the comparable population with which to determine value. Since any such ranges and adjustments are entity specific, they are not considered market-observable data and thus require a Level III grouping. Illiquid investments that have values derived through the use of discounted cash flow models and residual enterprise value models are grouped as Level III assets.

The Company's policy for determining transfers between levels is based solely on the previously defined three-level hierarchy for fair value measurement. Transfers between the levels of the fair value hierarchy are separately noted in the tables below and the reason for such transfer described in each table's respective footnotes. The changes in investments measured at fair value for which the Company has used unobservable inputs to determine fair value are as follows:

	Nine Months Ended September 30, 2012 (unaudited)				
	Debt Securities	CLO Fund Securities	Equity Securities	Asset Manager Affiliates	Total
Balance, December 31, 2011	\$83,094,677	\$46,412,000	\$6,040,895	\$40,814,000	\$176,361,572
Transfers out of Level III <sup>1</sup>	(21,524,891 )	—	—	—	(21,524,891 )
Transfers into of Level III <sup>1</sup>	263,864	—	—	—	263,864
Net accretion of interest	44,677	3,004,002	—	—	3,048,679
Purchases	8,453,959	12,000,000	452,627	13,305,582	34,212,168
Issuance of Common Stock	—	—	—	25,560,000	25,560,000
Sales	(2,067,294 )	—	—	—	(2,067,294 )
Total realized and unrealized gains (losses) included in earnings	(21,638,802 )	6,368,445	418,214	(5,690,582 )	(20,542,725 )
Balance, September 30, 2012	\$46,626,190	\$67,784,447	\$6,911,736	\$73,989,000	\$195,311,373
Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date	\$(9,209,711 )	\$7,363,170	\$418,214	\$(6,175,555 )	\$(7,603,882 )

<sup>1</sup> The transfers to Level II from Level III in the nine months ended September 30, 2012 were primarily due to the availability of observable market inputs and multiple quotes from pricing vendors and/or broker dealers as a result of the return of liquidity in the credit markets. The transfers into Level III during the nine months ended September 30, 2012 were primarily due to additional valuation modeling data becoming available during the period. There were no transfers between Level I and Level II during the nine months ended September 30, 2012.

Nine Months Ended September 30, 2011 (unaudited)	
Debt Securities	Total

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		CLO Fund Securities	Equity Securities	Asset Manager Affiliates	
Balance, December 31, 2010	\$91,042,928	\$53,031,000	\$4,688,832	\$ 41,493,000	\$ 190,255,760
Transfers in/out of Level III <sup>1</sup>	—	—	—	—	—
Net accretion of discount	98,775	61,023	—	—	159,798
Purchases	76,691,361	—	2,858,387	—	79,549,748
Sales	(46,725,296 )	(1,935,000 )	(141,769 )	(193,889 )	(48,995,954 )
Total realized and unrealized gains (losses) included in earnings	(500,292 )	(2,396,023 )	(1,395,518 )	1,329,889	(2,961,944 )
Balance, September 30, 2011	\$120,607,476	\$48,761,000	\$6,009,932	\$ 42,629,000	\$218,007,408
Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date	\$(7,849,468 )	\$(2,371,023 )	\$(684,921 )	\$ 1,329,889	\$(9,575,523 )

<sup>1</sup> For the nine months ended September 30, 2011, the Company had no transfers into or out of Level III during the period. There were no transfers between Level I and Level II during the nine months ended September 30, 2011.

As of September 30, 2012, the Company's Level II portfolio investments were valued by a third party pricing service for which the prices are not adjusted and for which inputs are observable or can be corroborated by observable market data for substantially the full character of the financial instrument, or inputs that are derived principally from, or corroborated by, observable market information. The fair value of the Company's Level II portfolio investments was \$94,203,270 as of September 30, 2012.

As of September 30, 2012, the Company's Level III portfolio investments had the following valuation techniques and significant inputs:

Asset Type	Fair Value	Valuation Technique	Unobservable Inputs	Range of Inputs
Debt securities	\$40,787,606	Income Approach Enterprise value	Market yield	5.7% - 17.2%
	\$5,838,584		Average EBITDA multiple	3.8x - 8.8x
			Weighted average cost of capital	10.0% - 12.7%
Equity securities	\$6,911,736	Enterprise value	Average EBITDA multiple	3.8x - 7.4x
			Weighted average cost of capital	9.5% - 13.4%
CLO Fund securities	\$67,784,447	Discounted cash flow	Discount rate	12.4% - 16.0%
			Probability of default	1.2% - 4.0%
			Loss severity	25% - 40%
			Recovery rate	60% - 75%
			Prepayment rate	10% - 20%
Asset Manager Affiliates	\$73,989,000	Discounted cash flow		1.4% - 13.0% (weighted average 8.57%)
			Discount rate	

The significant unobservable inputs used in the fair value measurement of the Company's debt securities include the comparable yields of similar investments in similar industries, effective discount rates, average EBITDA multiples, and weighted average cost of capital. Significant increases or decreases in such comparable yields would result in a significantly lower or higher fair value measurement.

The significant unobservable inputs used in the fair value measurement of the Company's equity securities include the EBITDA multiple of similar investments in similar industries and the weighted average cost of capital. Significant increases or decreases in such inputs would result in a significantly lower or higher fair value measurement.

Significant unobservable inputs used in the fair value measurement of the Company's CLO Fund securities include default rates, recovery rates, prepayment rates, and spreads and the discount rate by which to value the resulting underlying cash flows. Such assumptions can vary significantly, depending on market data sources which often vary in depth and level of analysis, understanding of the CLO market, detailed or broad characterization of the CLO market



and the application of such data to an appropriate framework for analysis. The application of data points are based on the specific attributes of each individual CLO Fund security's underlying assets, historic, current and prospective performance, vintage, and other quantitative and qualitative factors that would be evaluated by market participants. The Company evaluates the source of market data for reliability as an indicative market input, consistency amongst other inputs and results and also the context in which such data is presented. Significant increases or decreases in probability of default and loss severity inputs in isolation would result in a significantly lower or higher fair value measurement. In general, a change in the assumption of the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity in an event of default. Significant increases or decreases in the discount rate in isolation would result in a significantly lower or higher fair value measurement.

The significant unobservable inputs used in the fair value measurement of the Company's Asset Manager Affiliates is the discount rate used to present value prospective cash flows. Prospective revenues are generally based on a fixed percentage of the par value of CLO Fund assets under management and are recurring in nature for the term of the CLO Fund so long as the Asset Manager Affiliates manage the fund. As a result, the annual management fees earned by the Asset Manager Affiliates are not subject to market value fluctuations in the underlying collateral. The discounted cash flow model incorporates different levels of discount rates depending on the hierarchy of fees earned (including the likelihood of realization of senior, subordinate and incentive fees) and prospective modeled performance. Significant increases or decreases in such discount rate would result in a significantly lower or higher fair value measurement.

## 5. ASSET MANAGER AFFILIATES

The Asset Manager Affiliates are wholly-owned portfolio companies of the Company. The Asset Manager Affiliates manage CLO Funds primarily for third party investors that invest in broadly syndicated loans, high yield bonds and other credit instruments issued by corporations. At September 30, 2012, Asset Manager Affiliates had approximately \$3.3 billion of par value of assets under management, and the Company's 100% equity interest in the Asset Manager Affiliates was valued at approximately \$74 million.

As a manager of the CLO Funds, the Asset Manager Affiliates receive contractual and recurring management fees and may receive a one-time structuring fee from the CLO Funds for their management and advisory services. The annual fees which the Asset Manager Affiliates receive are generally based on a fixed percentage of assets under management (at par value and not subject to changes in market value), and the Asset Manager Affiliates generate annual operating income equal to the amount by which their fee income exceeds their operating expenses. The annual management fees the Asset Manager Affiliates receive have two components - a senior management fee and a subordinated management fee. Currently, all CLO Funds managed by the Asset Manager Affiliates are paying both their senior and subordinated management fees on a current basis.

The revenue that the Asset Manager Affiliates generate through the fees they receive for managing CLO Funds and after paying the expenses associated with their operations, including compensation of their employees, may be distributed to the Company. Any distributions of the Asset Manager Affiliates' net income are recorded as "dividends from affiliate asset managers" in its financial statements. For the nine months ended September 30, 2012, the Asset Manager Affiliates made distributions of \$2,950,000 to the Company. For the nine months ended September 30, 2011, the Asset Manager Affiliates made distributions of \$1,160,000 to the Company; dividends are recorded as declared (where declaration date represents ex-dividend date) by the Asset Manager Affiliates as income on our statement of operations.

As with all other investments, the Asset Manager Affiliates' fair value is determined quarterly. The valuation is primarily based on an analysis of both a percentage of its assets under management and the Asset Manager Affiliates'

estimated operating income. Any change in value from period to period is recognized as unrealized gain or loss. See Note 2, “Significant Accounting Policies” and Note 4, “Investments” for further information relating to the Company’s valuation methodology.

Effective January 1, 2010, the Asset Manager Affiliates adopted guidance encompassed in Accounting Standards Codification Topic 810, "Consolidation." The adoption of this new guidance had an impact on the disclosures relating to the Asset Manager Affiliates which had previously not been required, as its provisions require the Asset Manager Affiliates to consolidate certain of their managed CLO Funds that were not previously consolidated. As a result of the consolidation of these CLO Funds into the Asset Manager Affiliates, the financial results of the Asset Manager Affiliates indicate that they qualify as a "significant subsidiary" of the Company requiring the following additional disclosures. These disclosures regarding the Asset Manager Affiliates do not directly impact the financial position, results of operations or cash flows of the Company.

### Asset Manager Affiliates

#### Summarized Balance Sheet Information (unaudited)

	As of September 30, 2012	As of December 31, 2011
Investments of CLO Funds, at fair value	\$3,233,471,387	\$ 1,768,088,977
Restricted cash of CLO Funds	238,854,945	71,888,141
Total assets	3,527,130,894	1,855,513,431
CLO Fund liabilities, at fair value	3,067,672,661	1,727,560,760
Total liabilities	3,146,465,272	1,753,442,181
Appropriated retained earnings of consolidated VIEs	338,085,016	95,845,268

### Asset Manager Affiliates

#### Summarized Statements of Operations Information (unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Interest income - CLO Fund investments	\$33,444,575	\$17,402,439	\$96,512,395	\$49,887,143
Total income	34,396,116	17,970,940	99,969,090	53,755,607
Interest expense of CLO Fund liabilities	29,092,478	14,606,712	84,953,300	40,833,809
Total expenses	33,314,268	16,705,841	97,500,175	47,736,201
Net realized and unrealized gains (losses)	(28,525,250)	(60,261,531)	132,794,725	(54,669,019)
Net income (loss) attributable to consolidated VIEs	(28,122,928)	(59,568,871)	134,419,700	(49,317,403)
Net income (loss) attributable to Asset Manager Affiliates	494,936	864,789	439,289	1,567,194

All of the consolidated VIEs' investment balances are CLO Fund-related. The assets of the CLO Funds are held solely to satisfy the obligations of the CLO Funds. The Asset Manager Affiliates have no right to the benefits from, nor do they bear the risks associated with, the collateral assets held by the CLO Funds, beyond the management fees generated from the CLO Funds. If the Asset Manager Affiliates were to liquidate, the collateral assets would not be available to the general creditors of the Asset Manager Affiliates. Additionally, the investors in the CLO Funds have no recourse to the general credit of the Asset Manager Affiliates for the securities issued by the CLO Funds.

The consolidation of the VIEs' investment products in the Asset Manager Affiliates' financial statements is not reflective of the underlying financial position, results of operations or cash flows of the Asset Manager Affiliates as stand-alone entities. Furthermore, the financial operations of the Asset Manager Affiliates, whether consolidated with the CLO funds they manage or on a stand-alone basis, are not reflective of the fair value of the Asset Manager Affiliates as reported on the Company's balance sheet and schedule of investments as the Company is required under GAAP to report the Asset Manager Affiliates as a portfolio company at fair value.

As separately regarded entities for tax purposes, the Asset Manager Affiliates are taxed at normal corporate rates. For tax purposes, any distributions of taxable net income earned by the Asset Manager Affiliates to the Company would generally need to be distributed to the Company's shareholders. Generally, such distributions of the Asset Manager Affiliates' income to the Company's shareholders will be considered as qualified dividends for tax purposes. The Asset Manager Affiliates' taxable net income will differ from GAAP net income because of deferred tax timing adjustments and permanent tax adjustments. Deferred tax timing adjustments may include differences for the recognition and timing of depreciation, bonuses to employees and stock option expense. Permanent differences may include adjustments, limitations or disallowances for meals and entertainment expenses, penalties, tax goodwill amortization and net operating loss carryforward.

Goodwill amortization for tax purposes was created upon the purchase of 100% of the equity interests in Katonah Debt Advisors prior to the Company's initial public offering in 2006 and in the February 2012 purchase of 100% of the equity interests in Trimaran Advisors. These transactions were considered an asset purchase under Section 351(a) of the Code. Katonah Debt Advisors has approximately \$32 million being amortized for tax purposes on a straight-line basis over 15 years, which accounts for an annual difference between GAAP income and taxable income by approximately \$2 million per year over such period. Trimaran Advisors has approximately \$16 million being amortized on a straight-line basis over 5 years, which accounts for an annual difference between GAAP income and taxable income by approximately \$3.5 million per year over such period.

At September 30, 2012 there were no intercompany balances with our affiliates. At December 31, 2011 there was an intercompany balance of \$3,517 due from our affiliates.

## 6. BORROWINGS

The Company's debt obligations consist of the following:

	As of September 30, 2012 (unaudited)	As of December 31, 2011
Convertible Senior Notes, due March 15, 2016	60,000,000	60,000,000
Secured credit facility, due December 20, 2014	28,000,000	-

*Secured Credit Facility*

At December 31, 2010, the Company had a secured credit facility with an outstanding balance of \$86,746,582. On January 31, 2011, the Company repaid in full the outstanding balance under this facility, resulting in the lenders' release to the Company of approximately \$73 million of collateral previously securing the facility and their payment of a \$2 million cash settlement to the Company. This facility was terminated in connection with such repayment.

On February 24, 2012, the Company entered into a Note Purchase Agreement with Credit Suisse AG, Cayman Islands Branch ("CS"), Credit Suisse Securities (USA) LLC, as arranger, The Bank of New York Mellon Trust Company, National Association, as collateral administrator and collateral agent, and KCAP Funding, a special-purpose bankruptcy remote wholly-owned subsidiary of the Company ("KCAP Funding"), under which the Company may obtain up to \$30 million in financing (the "Facility"). The scheduled maturity date for the Facility is December 20, 2014. Interest on the Facility is LIBOR + 300 basis points and payable quarterly.

Advances under the Facility are used by the Company primarily to make additional investments. The Facility is secured by loans that it currently owns and a security interest in the Company's right to receive certain management fees. The Company's borrowings under the Facility are effected through KCAP Funding.

As of September 30, 2012, there was an outstanding balance of \$28,000,000 under the Facility and the Company was in compliance with all its debt covenants. As of September 30, 2012, the Company had restricted cash balances of approximately \$6.1 million which it maintained in accordance with the terms of the Facility. As of September 30, 2012 the Company has pledged assets with a fair value of approximately \$42 million as collateral in accordance with the terms of the Facility.

In connection with the Facility, the Company incurred approximately \$444,000 of debt origination costs which are being amortized over the term of the Facility on a straight-line basis of which approximately \$350,000 remains to be amortized.

### *Convertible Senior Notes*

On March 16, 2011, the Company issued \$55 million in aggregate principal amount of unsecured 8.75% convertible senior notes due March 15, 2016 (“Convertible Senior Notes”). On March 23, 2011, pursuant to an over-allotment option, the Company issued an additional \$5 million of such Convertible Senior Notes for a total of \$60 million in aggregate principal amount. The net proceeds from the sale of the Convertible Senior Notes, following underwriting expenses, were approximately \$57.7 million. Interest on the Convertible Senior Notes is paid semi-annually in arrears on March 15 and September 15, at a rate of 8.75%, commencing September 15, 2011. The Notes mature on March 15, 2016 unless converted earlier. The Convertible Senior Notes are senior unsecured obligations of the Company.

The Convertible Senior Notes are convertible into shares of Company’s common stock based on a conversion rate of 120.2202 shares of common stock per \$1,000 principal amount of Convertible Senior Notes, which is equivalent to an initial conversion price of approximately \$8.3181 per share of common stock. The conversion rate is subject to customary anti-dilution adjustments, including for any cash dividends or distributions paid on shares of our common stock in excess of a quarterly dividend of \$0.17 per share, but will not be adjusted for any accrued and unpaid interest. In addition, if certain corporate events occur prior to the maturity date of the Convertible Senior Notes, the conversion rate will be increased for converting holders.

Upon conversion, unless a holder converts after a record date for an interest payment but prior to the corresponding interest payment date, the holder will receive a separate cash payment with respect to the Convertible Senior Notes surrendered for conversion representing accrued and unpaid interest to, but not including the conversion date. Any such payment will be made on the settlement date applicable to the relevant conversion on the Convertible Senior Notes.

No holder of Convertible Senior Notes will be entitled to receive shares of the Company’s common stock upon conversion to the extent (but only to the extent) that such receipt would cause such converting holder to become, directly or indirectly, a beneficial owner (within the meaning of Section 13(d) of the Securities Exchange Act of 1934 and the rules and regulations promulgated thereunder) of more than 5.0% of the shares of the Company’s common stock outstanding at such time. The 5.0% limitation shall no longer apply following the effective date of any fundamental change. The Company will not issue any shares in connection with the conversion or redemption of the Convertible Senior Notes which would equal or exceed 20% of the shares outstanding at the time of the transaction in accordance with NASDAQ rules.

Subject to certain exceptions, holders may require us to repurchase, for cash, all or part of their Convertible Senior Notes upon a fundamental change at a price equal to 100% of the principal amount of the Convertible Senior Notes being repurchased plus any accrued and unpaid interest up to, but excluding, the fundamental change repurchase date. In addition, in the case of certain fundamental changes and without duplication of the foregoing amount, the Company will also pay holders an amount in cash (or, in certain circumstances, shares of the Company’s common stock) equal to



the present value of the remaining interest payments on such notes through, and including, the maturity date.

In connection with the issuance of the Convertible Senior Notes, the Company incurred approximately \$2.4 million of debt offering costs which are being amortized over the term of the facility on a straight-line basis, which approximates the effective yield method, of which approximately \$1.6 million remains to be amortized.

The Convertible Senior Notes have been analyzed for any features that would require its accounting to be bifurcated. There are no features that require accounting to be bifurcated, and as a result, they are recorded as a liability at their contractual amounts.

*Fair Value of Convertible Senior Notes.* The Company carries the Convertible Senior Notes at cost. The Convertible Senior Notes were issued in a private placement and there is no active trading of these notes. The fair value of the Company's outstanding Convertible Senior Notes was approximately \$67.7 million at September 30, 2012. The fair value was determined based on the average of indicative bid and offer pricing for the Convertible Senior Notes.

**7. DISTRIBUTABLE TAXABLE INCOME**

Effective December 11, 2006, the Company elected to be treated as a RIC under the Code and adopted a December 31 calendar year end. As a RIC, the Company is not subject to federal income tax on the portion of its taxable income and gains distributed currently to its stockholders as a dividend. The Company's quarterly dividends, if any, are determined by the Board of Directors. The Company anticipates distributing at least 90% of its taxable income and gains, within the Subchapter M rules, and thus the Company anticipates that it will not incur any federal or state income tax at the RIC level. As a RIC, the Company is also subject to a federal excise tax based on distributive requirements of its taxable income on a calendar year basis (e.g., calendar year 2012). Depending on the level of taxable income earned in a tax year, the Company may choose to carry forward taxable income in excess of current year distributions into the next tax year and pay a 4% excise tax on such income, to the extent required. The Company anticipates timely distribution of its taxable income within the tax rules, and the Company anticipates that it will not incur a US federal excise tax for the calendar year 2012.

The following reconciles net increase in net assets resulting from operations to taxable income for the nine months ended September 30, 2012:

	Nine Months Ended September 30, 2012 (unaudited)
Net increase in net assets resulting from operations	\$ 11,562,505
Net change in unrealized (appreciation) depreciation from investments	1,750,857
Excess capital losses over capital gains	3,462,836
Income not on GAAP books currently taxable	33,670
Income not currently taxable	(52,640 )
Expenses not currently deductible	(655,196 )
Taxable income before deductions for distributions	\$ 16,102,032
Taxable income before deductions for distributions per weighted average shares for the period	\$ 0.62

For the quarter ended September 30, 2012, the Company declared a dividend on September 17, 2012 of \$0.24 per share for a total of approximately \$6.3 million. The record date was October 10, 2012 and the dividend was distributed on October 29, 2012.

Taxable income differs from net increase (decrease) in net assets resulting from operations primarily due to: (1) unrealized appreciation (depreciation) on investments, as investment gains and losses are not included in taxable income until they are realized; (2) amortization of discount on CLO Fund securities; (3) amortization of organizational costs; (4) non-deductible expenses; (5) stock compensation expense that is not currently deductible for tax purposes;

(6) excess of capital losses over capital gains; and (7) recognition of interest income on certain loans.

At September 30, 2012, the Company had a net capital loss carryforward of approximately \$54 million to offset net capital gains, to the extent provided by federal tax law. The capital loss carryforward will begin to expire in the tax year ending December 31, 2015.

The Company adopted Financial Accounting Standards Board ASC Topic 740 Accounting for Uncertainty in Income Taxes ("ASC 740") as of January 1, 2007. ASC 740 provides guidance for how uncertain tax positions should be recognized, measured, presented, and disclosed in the financial statements. ASC 740 requires the evaluation of tax positions taken or expected to be taken in the course of preparing the Company's tax returns to determine whether the tax positions are "more-likely-than-not" of being sustained by the applicable tax authority. The Company recognizes the tax benefits of uncertain tax positions only where the position is "more likely than not" to be sustained assuming examination by tax authorities. Management has analyzed the Company's tax positions, and has concluded that no liability for unrecognized tax benefits should be recorded related to uncertain tax positions taken on returns filed for open tax years (the last three fiscal years) or expected to be taken in the Company's current year tax return. The Company identifies its major tax jurisdictions as U.S. Federal and New York State, and the Company is not aware of any tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will change materially in the next 12 months. The adoption of ASC 740 did not have an effect on the financial position or results of operations of the Company as there was no liability for unrecognized tax benefits and no change to the beginning capital of the Company. Management's determinations regarding ASC 740 may be subject to review and adjustment at a later date based upon factors including, but not limited to, an ongoing analysis of tax laws, regulations and interpretations thereof.

## 8. COMMITMENTS AND CONTINGENCIES

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the needs of the Company's investment in portfolio companies. Such instruments include commitments to extend credit and may involve, in varying degrees, elements of credit risk in excess of amounts recognized on the Company's balance sheet. Prior to extending such credit, the Company attempts to limit its credit risk by conducting extensive due diligence, obtaining collateral where necessary and negotiating appropriate financial covenants. As of December 31, 2011 the Company had commitments to make a total of approximately \$2 million of investments in various revolving senior secured loans, of which none had been funded as of December 31, 2011. As of September 30, 2012 the Company had no commitments to make investments in various revolving senior secured loans.

On January 11, 2010, the staff of the SEC's Division of Enforcement informed the Company that it was conducting an informal inquiry. The focus of the inquiry concerns the valuation methodology and procedures used by the Company to value its investments. On April 30, 2010, the SEC Staff advised the Company that a formal order of private investigation had been issued and that the informal inquiry was now a formal investigation. A subpoena has been issued to the Company in connection with the formal investigation. The subpoena requests that the Company produce documents that primarily relate to the valuation methodology and procedures used by the Company to value its investments. Since January 2010, the Company has been providing documents in response to the informal inquiry and the subpoena, and the SEC Staff has taken testimony from Company representatives. The Company is cooperating fully with the SEC Staff's investigation.

In connection with the investigation described above, on April 19, 2012, the SEC Staff issued a "Wells Notice" to Michael I. Wirth, the Company's former Chief Financial Officer, indicating that the SEC Staff is considering recommending that the SEC institute proceedings against Mr. Wirth alleging that Mr. Wirth violated certain provisions of the federal securities laws. The Wells Notice does not constitute a determination that Mr. Wirth violated any law. Under the process established by the SEC, Mr. Wirth will have the opportunity to make a Wells Submission before the SEC Staff makes a formal recommendation to the SEC regarding what action, if any, should be brought by the SEC. Mr. Wirth has informed the Company that he has made such a submission.

Neither the Company nor any other person employed by the Company has received a Wells Notice. The Company and the other officers involved in this matter, including Dayl W. Pearson, the Company's President and Chief Executive Officer, are engaged in settlement negotiations in an effort to resolve the matter and believe that discussions to date with the SEC Staff will lead to a settlement. Any settlement remains subject to approval by the SEC.

The Company cannot at this time predict with certainty the outcome of the above matter, including whether the SEC will approve any settlement or whether the SEC will ultimately determine to issue a Wells Notice to the Company or any other person involved in this matter. The Company does not anticipate that the Wells Notice referenced above or the terms of any settlement involving the Company and the other officers involved in the matter will have a material

adverse impact on its business, financial condition or results of operations.

## **9. STOCKHOLDERS' EQUITY**

During the nine months ended September 30, 2012 and the year ended December 31, 2011, the Company issued 60,023 and 141,278 shares, respectively, of common stock under its dividend reinvestment plan. During the nine months ended September 30, 2012 the Company issued 3,600,000 shares in connection with the acquisition of Trimaran Advisors. For the nine months ended September 30, 2012, the Company issued 28,847 shares of restricted stock, 232,768 shares were forfeited and 97,071 shares of restricted stock were converted to common stock due to vesting. For the year ended December 31, 2011, the Company issued 90,805 shares of restricted stock for which 3,668 shares were forfeited and 96,122 shares vested. The total number of shares of the Company's common stock issued and outstanding as of September 30, 2012 and December 31, 2011 was 26,448,313 and 22,992,211, respectively.

## 10. EQUITY INCENTIVE PLAN

During 2006, the Company established the 2006 Equity Incentive Plan, which plan was amended in 2008 (as amended, the “Plan”). 2,000,000 shares of common stock are reserved for issuance under the Plan. The purpose of the Plan is to provide officers and prospective employees of the Company with additional incentives and align the interests of its employees with those of its shareholders. Options granted under the Plan are exercisable at a price equal to the fair market value (market closing price) of the shares on the day the option is granted. Restricted stock granted under the Plan is granted at a price equal to the fair market value (market closing price) of the shares on the day such restricted stock is granted.

During 2008, the Company established a non-employee director plan, which plan was amended in 2008 (as amended, the “Amended and Restated Non-Employee Director Plan”). Pursuant to such amendment, the Company is permitted to issue restricted stock, and is no longer permitted to issue any options for common stock, of the Company to non-employee directors. Options granted to non-employee directors prior to the effectiveness of the Amended and Restated Non-Employee Director Plan remained outstanding in accordance with the terms of the Amended and Restated Non-Employee Director Plan as in place prior to such amendment.

### *Stock Options*

During the years ended December 31, 2009 and December 31, 2010, 20,000 options per year were granted to non-employee directors as partial annual compensation for their services as director. Each of these annual options grants have a vesting period by which 50% of such options vest on the grant date and 50% vest on the first grant date anniversary. The exercise price of these grants and other characteristics of these grants are as follows:

Options granted for the year ended:	Exercise Price	Exercise Period (years)	Risk Free Rate	Volatility Rate	Weighted Average Grant Date Fair Value per Share
December 31, 2009	\$ 4.93	10	4.3	% 41	% \$ 0.90
December 31, 2010	\$ 4.83	10	3.1	% 59	% \$ 1.46

On June 10, 2011, the Company’s shareholders approved the Amended and Restated Non-Employee Director Plan. Accordingly, the previous annual grant of 20,000 options to non-employee directors was discontinued and replaced with an annual grant of 4,000 shares of restricted stock as partial annual compensation for the services of the non-employee directors.

Information with respect to options granted, exercised and forfeited under the Plan for the period January 1, 2011 through September 30, 2012 is as follows:

	Shares	Weighted Average Exercise Price per Share	Weighted Average Contractual Remaining Term (years)	<b>Aggregate Intrinsic Value<sup>1</sup></b>
Options outstanding at January 1, 2011	60,000	\$ 7.24		
Granted	—	\$ —		
Exercised	—	\$ —		
Forfeited	—	\$ —		
Options outstanding at December 31, 2011	60,000	\$ 7.24		
Granted	—	\$ —		
Exercised	—	\$ —		
Forfeited	—	\$ —		
Outstanding at September 30, 2012	60,000	\$ 7.24	6.7	\$ 175,200
Total vested at September 30, 2012	60,000	\$ 7.24	6.7	

<sup>1</sup> Represents the difference between the market value of shares of the Company upon exercise of the options at September 30, 2012 and the cost for the option holders to exercise the options.

The Company uses a Binary Option Pricing Model (American, call option) as its valuation model to establish the expected value of all stock option grants. For the nine months ended September 30, 2012, the Company recognized no non-cash compensation expense related to stock options. For the nine months ended September 30, 2011, the Company recognized non-cash compensation expense related to stock options of approximately \$8,000. At September 30, 2012, the Company had no remaining compensation cost related to unvested stock option-based awards.

### *Restricted Stock*

On June 13, 2008, the Company's shareholders approved the Plan, as amended, and the Board of Directors approved the grant of awards of 100,250 shares of restricted stock to certain executive officers of the Company. On July 22, 2010 and August 5, 2009, the Board of Directors approved the grant of an additional 103,519 and 84,889 shares of restricted stock, respectively, to a certain executive officer of the Company. Such awards of restricted stock will vest as to 50% of the shares on the third anniversary of the grant date and the remaining 50% of the shares on the fourth anniversary of the grant date.

On June 13, 2008, the Company's Board of Directors authorized the Company to allow employees who agree to cancel options that they hold to receive shares of the Company's common stock to receive 1 share of restricted stock for every 5 options so cancelled. The shares of restricted stock received by employees through any such transaction will vest annually generally over the remaining vesting schedule as was applicable to the cancelled options. Subsequently, employees holding options to purchase 1,295,000 shares individually entered into agreements to cancel such options and to receive 259,000 shares of restricted stock. As of September 30, 2012, 233,998 of such shares were vested. The remaining 25,002 shares have been forfeited.

On June 10, 2011, the Company's shareholders approved the Amended and Restated Non-Employee Director Plan, and the Board of Directors approved the grant of awards of 4,000 shares of restricted stock to the non-employee directors of the Company as partial annual compensation for their services as director. Such awards of restricted stock will vest as to 50% of the shares on the grant date and the remaining 50% of the shares on the first anniversary of the grant date.

During the nine months ended September 30, 2012, 97,071 shares of restricted stock had vested. As of September 30, 2012, there were options to purchase 60,000 shares of common stock outstanding and there were 26,347 shares of restricted stock outstanding. Information with respect to restricted stock granted, exercised and forfeited under the Plan for the period January 1, 2011 through September 30, 2012 is as follows:

Unvested	<b>Weighted Average</b>
Restricted	



	Shares	Exercise Price per Share
Unvested shares outstanding at December 31, 2010	336,324	\$ 9.63
Granted	90,805	\$ 4.83
Vested	(96,122 )	\$ 10.39
Forfeited	(3,668 )	\$ 9.82
Unvested shares outstanding at December 31, 2011	327,339	\$ 6.46
Granted	28,847	\$ 6.29
Vested	(97,071 )	\$ 9.08
Forfeited	(232,768 )	\$ 5.37
Outstanding at September 30, 2012	26,347	\$ 6.29
Total unvested shares at September 30, 2012	26,347	\$ 6.29

For the nine months ended September 30, 2012, non-cash compensation expense related to restricted stock was approximately \$418,000; of this amount approximately \$404,000 was expensed at the Company, offset by a credit of approximately \$287,000 for a final non-cash compensation expense of approximately \$117,000 at the Company; and approximately \$14,000 was a reimbursable expense allocated to the Asset Manager Affiliates. For the nine months ended September 30, 2011, non-cash compensation expense related to restricted stock was approximately \$593,000; of this amount approximately \$508,000 was expensed at the Company and approximately \$85,000 was a reimbursable expense allocated to the Asset Manager Affiliates.

Dividends are paid on all outstanding shares of restricted stock, whether or not vested. In general, shares of unvested restricted stock are forfeited upon the recipient's termination of employment. As of September 30, 2012, there was approximately \$158,000 of total unrecognized compensation cost related to unvested share-based awards. That cost is expected to be recognized over a weighted average period of 3 years.

## **11. OTHER EMPLOYEE COMPENSATION**

The Company adopted a 401(k) plan ("401K Plan") effective January 1, 2007. The 401K Plan is open to all full time employees. The 401K Plan permits an employee to defer a portion of their total annual compensation up to the Internal Revenue Service annual maximum based on age and eligibility. The Company makes contributions to the 401K Plan of up to 2.67% of the employee's first 74.9% of maximum eligible compensation, which fully vest at the time of contribution. For the nine months ended September 30, 2012 and 2011, the Company made contributions to the 401K Plan of approximately \$34,000 and \$18,000, respectively.

The Company has also adopted a deferred compensation plan ("Pension Plan") effective January 1, 2007. Employees are eligible for the Pension Plan provided that they are employed and working with the Company to participate in at least 100 days during the year and remain employed as of the last day of the year. Employees do not make contributions to the Pension Plan. On behalf of the employee, the Company may contribute to the Pension Plan 1) up to 8.0% of all compensation up to the Internal Revenue Service annual maximum and 2) up to 5.7% excess contributions on any incremental amounts above the social security wage base limitation and up to the Internal Revenue Service annual maximum. Employees vest 100% in the Pension Plan after five years of service. For the nine months ended September 30, 2012, the Company made a contribution of approximately \$104,000 to the Pension Plan and a contribution of \$112,000 to the Pension Plan for the nine months ended September 30, 2011.

## **12. SUBSEQUENT EVENTS**

On October 4, 2012 The Company announced that it has priced an underwritten public offering of \$36 million in aggregate principal amount of 7.375% senior unsecured notes due 2019. The notes will mature on September 30,

2019, and may be redeemed in whole or in part at any time or from time to time at KCAP Financial, Inc.'s option on or after September 30, 2015. The notes will bear interest at a rate of 7.375% per year payable quarterly on March 30, June 30, September 30 and December 30 of each year, beginning December 30, 2012.

Stifel, Nicolaus & Company, Incorporated and Barclays Capital Inc. are acting as joint book-running managers of this offering. Janney Montgomery Scott LLC and JMP Securities LLC are acting as co-lead managers and Ladenburg Thalmann & Co. Inc., Sandler O'Neill & Partners, L.P. and Wunderlich Securities, Inc. are acting as co-managers for this offering. The offering closed on October 10, 2012. The Company had granted the underwriters an option to purchase up to an additional \$5.4 million in aggregate principal amount of notes which was executed, bringing the aggregate principal amount of the notes to \$41.4 million.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

In this Quarterly Report on Form 10-Q, "KCAP Financial," "Company," "we," "us," and "our" refer to KCAP Financial, Inc., and its wholly-owned subsidiary.

The information contained in this section should be read in conjunction with our financial statements and notes thereto appearing elsewhere in this Quarterly Report. In addition, some of the statements in this report constitute forward-looking statements. The matters discussed in this Quarterly Report, as well as in future oral and written statements by management of KCAP Financial, that are forward-looking statements are based on current management expectations that involve substantial risks and uncertainties which could cause actual results to differ materially from the results expressed in, or implied by, these forward-looking statements. Forward-looking statements relate to future events or our future financial performance. We generally identify forward-looking statements by terminology such as "may," "will," "should," "expects," "plans," "anticipates," "could," "intends," "target," "projects," "believes," "estimates," "proceeds," "continue" or the negative of these terms or other similar words. Important assumptions include our ability to originate new investments, achieve certain margins and levels of profitability, the availability of funds under our credit facility, the availability of additional capital, and the ability to maintain certain debt to asset ratios. In light of these and other uncertainties, the inclusion of a projection or forward-looking statement in this Quarterly Report should not be regarded as a representation by us that our plans or objectives will be achieved. The forward-looking statements contained in this Quarterly Report include statements as to:

- our future operating results;
- our business prospects and the prospects of our existing and prospective portfolio companies;
- the return or impact of current and future investments;
- our contractual arrangements and other relationships with third parties;
- the dependence of our future success on the general economy and its impact on the industries in which we invest;
- the financial condition and ability of our existing and prospective portfolio companies to achieve their objectives;
- our expected financings and investments;
- our regulatory structure and tax treatment;

our ability to operate as a business development company and a registered investment company, including the impact of changes in laws or regulations governing our operations, or the operations of our portfolio companies;

- the adequacy of our cash resources and working capital;
- the timing of cash flows, if any, from the operations of our portfolio companies;
- the impact of a protracted decline in the liquidity of credit markets on our business;
- the impact of fluctuations in interest rates on our business;
- the valuation of our investments in portfolio companies, particularly those having no liquid trading market;
- our ability to recover unrealized losses;
- market conditions and our ability to access additional capital; and
- the timing, form and amount of any dividend distributions.

There are a number of important risks and uncertainties that could cause our actual results to differ materially from those indicated by such forward-looking statements. For a discussion of factors that could cause our actual results to differ from forward-looking statements contained in this Quarterly Report, please see the discussion in Part II, “Item 1A. Risk Factors”, and in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. You should not place undue reliance on these forward-looking statements. The forward-looking statements made in this Quarterly Report relate only to events as of the date on which the statements are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances occurring after the date this Quarterly Report is filed with the SEC.

## GENERAL

We are an internally managed, non-diversified closed-end investment company that is regulated as a business development company (“BDC”) under the Investment Company Act of 1940. We originate, structure, and invest in senior secured term loans, mezzanine debt and selected equity securities primarily in privately-held middle market companies. We define the middle market as comprising companies with earnings before interest, taxes, depreciation and amortization (“EBITDA”) of \$10 million to \$50 million and/or total debt of \$25 million to \$150 million.

Our investment objective is to generate current income and capital appreciation from investments made in senior secured term loans, mezzanine debt and selected equity investments in privately-held middle market companies.

Katonah Debt Advisors, L.L.C., a registered investment adviser, and its asset manager affiliates (collectively, “Katonah Debt Advisors”) is a wholly-owned portfolio company. Katonah Debt Advisors manages collateralized loan obligation funds (“CLO Funds”) which invest in broadly syndicated loans, high-yield bonds and other credit instruments. On February 29, 2012, we purchased Trimaran Advisors, L.L.C. (“Trimaran Advisors”), a registered investment adviser and CLO manager similar to Katonah Debt Advisors that had assets under management of approximately \$1.4 billion, for total consideration of \$13.0 million in cash and 3,600,000 shares of our common stock. Contemporaneously with the acquisition of Trimaran Advisors, we acquired from Trimaran Advisors equity interests in certain CLO Funds managed by Trimaran Advisors for an aggregate purchase price of \$12.0 million in cash. As of September 30, 2012, Katonah Debt Advisors and Trimaran Advisors are our only wholly-owned portfolio companies (collectively, “Asset Manager Affiliates”) and have approximately \$3.3 billion of par value assets under management.

The Company also expects to receive distributions of recurring fee income and to generate capital appreciation from its investments in the asset management businesses of the Asset Manager Affiliates.

The Company has elected to be treated as a regulated investment company (“RIC”) under Subchapter M of the Internal Revenue Code of 1986, as amended (the “Code”). To qualify as a RIC, the Company must, among other things, meet certain source-of-income and asset diversification requirements and distribute at least 90% of our net ordinary income and realized short-term capital gains in excess of realized net long-term capital losses, if any. As a RIC, the Company generally will not have to pay corporate-level taxes on any income that it distributes in a timely manner to its stockholders.

Our common stock is traded on The NASDAQ Global Select Market under the symbol “KCAP.” The net asset value per share of our common stock at September 30, 2012 was \$7.82. On September 30, 2012, the last reported sale price of a share of our common stock on The NASDAQ Global Select Market was \$9.26.

**KEY QUANTITATIVE AND QUALITATIVE FINANCIAL MEASURES AND INDICATORS****Net Asset Value**

Our net asset value per share was \$7.82 and \$7.85 as of September 30, 2012 and December 31, 2011, respectively. As we must report our assets at fair value for each reporting period, net asset value also represents the amount of stockholder's equity per share for the reporting period. Our net asset value is comprised mostly of investment assets less debt and other liabilities. The table below sets forth information relating to our net asset value and net asset value per share.

	September 30, 2012 (unaudited)		December 31, 2011	
	Fair Value <sup>1</sup>	Per Share <sup>1</sup>	Fair Value <sup>1</sup>	Per Share <sup>1</sup>
Investments at fair value:				
Investments in time deposits	\$ 501,475	\$ 0.02	\$ 229,152	\$ 0.01
Investments in money market accounts	4,850,220	0.18	31,622,134	1.38
Investments in debt securities	135,477,765	5.12	114,673,506	4.99
Investments in CLO Fund securities	67,784,447	2.56	48,438,317	2.11
Investments in equity securities	6,911,736	0.26	6,040,895	0.26
Investments in Asset Manager Affiliates	73,989,000	2.80	40,814,000	1.78
Cash	2,413,104	0.09	2,555,259	0.11
Restricted Cash	6,093,126	0.23	—	-
Other assets	4,920,379	0.19	3,760,398	0.16
Total Assets	\$ 302,941,252	\$ 11.45	\$ 248,133,661	\$ 10.79
Borrowings	\$ 28,000,000	\$ 1.06	\$ —	\$ -
Other liabilities	8,043,003	0.30	7,607,719	0.33
Convertible Senior Notes	60,000,000	2.27	60,000,000	2.61
Total Liabilities	\$ 96,043,003	\$ 3.63	\$ 67,607,719	\$ 2.94
NET ASSET VALUE	\$ 206,898,249	\$ 7.82	\$ 180,525,942	\$ 7.85

<sup>1</sup> Our balance sheet at fair value and resultant net asset value are calculated on a basis consistent with accounting principles generally accepted in the United States of America ("GAAP"). Our per share presentation of such amounts (other than net asset value per share) is an internally derived non-GAAP performance measure calculated by dividing the applicable balance sheet amount by outstanding shares. We believe that the per share amounts for such balance sheet items are helpful in analyzing our balance sheet both quantitatively and qualitatively in that our shares may trade based on a percentage of net asset value and individual investors may weight certain balance sheet items differently in performing an analysis of the Company.

## Leverage

We use borrowed funds, known as leverage, to make investments and to attempt to increase returns to our shareholders by reducing our overall cost of capital. As a BDC, we are limited in the amount of leverage we can incur under the 1940 Act. We are only allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% immediately after such borrowing. As of September 30, 2012, we had approximately \$88 million of outstanding borrowings and our asset coverage ratio of total assets to total borrowings was 335%, compliant with the minimum asset coverage level of 200% generally required for a BDC by the 1940 Act. We may also borrow amounts of up to 5% of the value of our total assets for temporary purposes.

At December 31, 2010, we had approximately \$87 million of outstanding indebtedness through a secured credit facility. On January 31, 2011, we repaid in full the outstanding balance under this facility and the facility was terminated. As a result, approximately \$73 million of collateral previously securing the facility was released to us and we also received a \$2 million cash settlement from the lenders to settle litigation previously initiated by us against the lenders. In order to pay off this facility, we utilized proceeds received from the paydown, amortization or sale of portfolio loan investments totaling approximately \$133 million together with available cash.

On March 16, 2011, we issued \$55 million in aggregate principal amount of unsecured 8.75% convertible senior notes due March 15, 2016 ("Convertible Senior Notes"). On March 23, 2011, pursuant to an over-allotment option, we issued an additional \$5 million of such Convertible Senior Notes for a total of \$60 million in aggregate principal amount. The net proceeds for the Convertible Senior Notes, following underwriting expenses, were approximately \$57.7 million. Interest on the Convertible Senior Notes is paid semi-annually in arrears on March 15 and September 15, at a rate of 8.75%, commencing September 15, 2011. The Notes mature on March 15, 2016 unless converted earlier. The Convertible Senior Notes are senior unsecured obligations of the Company.

The Convertible Senior Notes are convertible into shares of Company's common stock based on an initial conversion rate of 120.2202 shares of common stock per \$1,000 principal amount of Convertible Senior Notes, which is equivalent to an initial conversion price of approximately \$8.3181 per share of common stock. The conversion rate is subject to customary anti-dilution adjustments, including for any cash dividends or distributions paid on shares of our common stock in excess of a quarterly dividend of \$0.17 per share, but will not be adjusted for any accrued and



unpaid interest. In addition, if certain corporate events occur prior to the maturity date of the Convertible Senior Notes, the conversion rate will be increased for converting holders.

On February 24, 2012, we entered into a Note Purchase Agreement with Credit Suisse AG, Cayman Islands Branch (“CS”), Credit Suisse Securities (USA) LLC, as arranger, The Bank of New York Mellon Trust Company, National Association, as collateral administrator and collateral agent, and KCAP Funding, a special-purpose bankruptcy remote wholly-owned subsidiary of ours, under which we may obtain up to \$30 million in financing (the “Facility”). The scheduled maturity date for the Facility is December 20, 2014. Interest on the Facility is LIBOR + 300 basis points and payable quarterly.

Advances under the Facility are used by us primarily to make additional investments. The Facility is secured by loans that the Company currently owns and a security interest in our right to receive certain management fees. Our borrowings under the Facility are effected through KCAP Funding.

As of September 30, 2012, there was an outstanding balance under the Facility of \$28,000,000 and we are in compliance with all its debt covenants. As of September 30, 2012, we had restricted cash balances of approximately \$6.1 million which we maintained in accordance with the terms of the Facility.

Subject to prevailing market conditions, we intend to grow our portfolio of assets by raising additional capital, including through the prudent use of leverage available to us. As a result, we may seek to enter into new agreements with other lenders or into other financing arrangements as market conditions permit.

### **Investment Portfolio Summary Attributes as of and for the Nine Months ended September 30, 2012**

Our investment portfolio generates net investment income which is generally used to pay principal and interest on our borrowings and to fund our dividend. Our investment portfolio consists of three primary components: debt securities, CLO Fund securities and our investments in the Asset Manager Affiliates. We also have investments in equity securities of approximately \$7 million, which comprises approximately 2% of our investment portfolio. Below are summary attributes for each of our primary investment portfolio components (see “—Investment Securities” for a more detailed description) as of and for the nine months ended September 30, 2012:

#### *Debt Securities*

- represent approximately 45% of total assets;
- represent credit instruments issued by corporate borrowers;
- primarily senior secured and junior secured loans (49% and 27% of debt securities, respectively);
- spread across 24 different industries and 53 different entities;
- average balance per investment of approximately \$3 million;
- all but five issuers (representing less than 1% of total investments at fair value) are current on their debt service obligations; and
- weighted average interest rate of 8.1% on income producing debt investments.

*CLO Fund Securities* (as of the last monthly trustee report prior to September 30, 2012 unless otherwise specified)

represent approximately 22% of total assets at September 30, 2012;

87% of CLO Fund securities represent investments in subordinated securities or equity securities issued by CLO Funds and 13% of CLO Fund securities are rated notes;

all CLO Funds invest primarily in credit instruments issued by corporate borrowers;

13 different CLO Fund securities; 10 of such CLO Fund securities are managed by our Asset Manager Affiliates; and

two CLO Fund securities, not managed by our Asset Manager Affiliates, representing a fair value of \$1.5 million, are not currently providing a dividend payment to the Company.

#### *Asset Manager Affiliates*

represent approximately 24% of fair value of total assets;

represent our 100% ownership of the equity interest of two profitable CLO Fund managers focused on corporate credit investing;

have approximately \$3.3 billion of assets under management;

receive contractual and recurring asset management fees based on par value of managed investments;

may receive an incentive fee provided that the CLO Fund achieves a minimum designated return on investment;

dividends paid by our Asset Manager Affiliates are recognized as dividend income from affiliate asset manager on our statement of operations and are an additional source of income to pay our dividend;

for the nine months ended September 30, 2012, our Asset Manager Affiliates had EBITDA of approximately \$3 million; and

for the nine months ended September 30, 2012, our Asset Manager Affiliates made a distribution of \$2,950,000 to the Company in the form of a dividend which is recognized as current earnings to the Company.

#### **Revenue**

Revenues consist primarily of investment income from interest and dividends on our investment portfolio and various ancillary fees related to our investment holdings.

*Interest from Investments in Debt Securities.* We generate interest income from our investments in debt securities which consist primarily of senior and junior secured loans. Our debt securities portfolio is spread across multiple industries and geographic locations, and as such, we are broadly exposed to market conditions and business environments. As a result, although our investments are exposed to market risks, we continuously seek to limit concentration of exposure in any particular sector or issuer.

*Dividends from Investments in CLO Fund Securities.* We generate dividend income from our investments in the securities of CLO Funds (typically preferred shares or subordinated securities) managed by our Asset Manager Affiliates and selective investments in securities issued by funds managed by other asset management companies. CLO Funds managed by our Asset Manager Affiliates invest primarily in broadly syndicated non-investment grade loans, high-yield bonds and other credit instruments of corporate issuers. The Company distinguishes CLO Funds managed by its Asset Manager Affiliates as “CLO Fund securities managed by affiliates.” in its financial statements. The underlying assets in each of the CLO Funds in which we have an investment are generally diversified secured or unsecured corporate debt. Our CLO Fund securities that are subordinated securities or preferred shares (“junior securities”) are subordinated to senior note holders who typically receive a return on their investment at a fixed spread relative to the LIBOR index. The CLO Funds are leveraged funds and any excess cash flow or “excess spread” (interest earned by the underlying securities in the fund less payments made to senior bond holders and less fund expenses and management fees) is paid to the holders of the CLO Fund’s subordinated securities or preferred shares. The level of excess spread from CLO Fund securities can be impacted from the timing and level of the resetting of the benchmark interest rate for the underlying assets (which reset at various times throughout the quarter) in the CLO Fund and the related CLO Fund note liabilities (which reset at each quarterly distribution date); in periods of short-term and volatile changes in the benchmark interest rate, the levels of excess spread and distributions to us can vary significantly. In addition, the failure of CLO Funds in which we invest to comply with certain financial covenants may lead to the temporary suspension or deferral of cash distributions to us.

For non-junior class CLO Fund securities, such as our investment in the class B-2L notes of the Katonah 2007-1 CLO, interest is earned at a fixed spread relative to the LIBOR index.

*Dividends from Asset Manager Affiliates.* We generate dividend income from our investment in our Asset Manager Affiliates, which are wholly-owned and manage CLO Funds that invest primarily in broadly syndicated non-investment grade loans, high yield bonds and other credit instruments issued by corporations. As managers of CLO Funds, our Asset Manager Affiliates receive contractual and recurring management fees as well as an expected one-time structuring fee from the CLO Funds for their management and advisory services. In addition, our Asset Manager Affiliates may also earn income related to net interest on assets accumulated for future CLO issuances on which they have provided a first loss guaranty in connection with loan warehouse arrangements for their CLO Funds. Our Asset Manager Affiliates generate annual operating income equal to the amount by which their fee income exceeds their operating expenses. The annual management fees which our Asset Manager Affiliates receive are generally based on a fixed percentage of the par value of assets under management and are recurring in nature for the term of the CLO Fund so long as the Asset Manager Affiliates manage the fund. As a result, the annual management fees earned by our Asset Manager Affiliates generally are not subject to market value fluctuations in the underlying collateral. Our Asset Manager Affiliates may receive incentive fees provided such CLO Funds have achieved a minimum investment return to holders of their subordinated securities or preferred shares.

*Capital Structuring Service Fees.* We may earn ancillary structuring and other fees related to the origination, investment, disposition or liquidation of debt and investment securities.

## **Expenses**

We are internally managed and directly incur the cost of management and operations; as a result, we incur no management fees or other fees to an external investment adviser. Our expenses consist primarily of interest expense on outstanding borrowings, compensation expense and general and administrative expenses, including professional fees.

*Interest and Amortization of Debt Issuance Costs.* Interest expense is dependent on the average outstanding balance on our borrowings and the base index rate for the period. Debt issuance costs represent fees and other direct costs incurred in connection with the Company's borrowings. These amounts are capitalized and amortized ratably over the contractual term of the borrowing.

*Compensation Expense.* Compensation expense includes base salaries, bonuses, stock compensation, employee benefits and employer-related payroll costs. The largest components of total compensation costs are base salaries and bonuses; generally, base salaries are expensed as incurred and annual bonus expenses are estimated and accrued. Our compensation arrangements with our employees contain a significant profit sharing and/or performance based bonus component. Therefore, as our net revenues increase, our compensation costs may also rise. In addition, our compensation expenses may also increase to reflect increased investment in personnel as we grow our products and businesses.

*Professional Fees and General and Administrative Expenses.* The balance of our expenses include professional fees (primarily legal, accounting, valuation and other professional services), occupancy costs and general administrative and other costs.

### **Net Change in Unrealized Appreciation (Depreciation) on Investments**

During the three months ended September 30, 2012, the Company's investments had a net increase in unrealized appreciation of approximately \$6.0 million. During the nine months ended September 30, 2012, the Company's investments had a net increase in unrealized depreciation of approximately \$1.8 million. During the three months ended September 30, 2011, the Company's investments had a net increase in unrealized depreciation of approximately \$6.0 million. During the nine months ended September 30, 2011, the Company's investments had a net increase in unrealized appreciation of approximately \$11 million.

The net increase in unrealized appreciation of approximately \$6.0 million for the three months ended September 30, 2012 is primarily due to (i) an approximate \$900,000 net increase in the unrealized appreciation of certain loans and equity positions as a result of credit considerations and current market conditions; (ii) a net increase of approximately \$3.8 million in the unrealized appreciation of CLO Fund securities; and (iii) an approximate increase of \$1.3 million in the unrealized depreciation of our Asset Manager Affiliates.

The net increase in unrealized depreciation of approximately \$1.8 million for the nine months ended September 30, 2012 is primarily due to (i) an approximate \$2.4 million net increase in the unrealized depreciation of certain loans and equity positions as a result of credit considerations and current market conditions; (ii) a net increase of approximately \$6.4 million in the unrealized appreciation of CLO Fund securities; and (iii) an approximate increase of \$5.7 million in the unrealized depreciation of our Asset Manager Affiliates.

### **Net Change in Net Assets Resulting From Operations**

The net change in net assets resulting from operations for the three months ended September 30, 2012 and 2011 was an increase of approximately \$9 million and a decrease of \$1 million, respectively, or \$0.35 and \$0.06 per share, respectively. The net change in net assets resulting from operations for the nine months ended September 30, 2012 and 2011 was an increase of approximately \$12 million and \$9 million, respectively, or \$0.45 and \$0.39 per share, respectively.

### **Net Investment Income and Net Realized Gains (Losses)**

Net investment income and net realized gains (losses) represents the net change in net assets resulting from operations before net unrealized appreciation or depreciation on investments. For the three months ended September 30, 2012, net investment income and net realized gains were approximately \$3 million, or \$0.13 per share. For the three months ended September 30, 2011, net investment income and net realized gains were approximately \$4 million or \$0.18 per share. For the nine months ended September 30, 2012, net investment income and net realized gains were approximately \$13 million, or \$0.51 per share. For the nine months ended September 30, 2011, net investment income and net realized losses were approximately \$2 million or \$0.08 per share.

## Dividends

For the three months ended September 30, 2012, we declared a \$0.24 dividend per share. As a result, there was a dividend distribution of approximately \$6.3 million for the third quarter declaration, which was booked in the fourth quarter. We intend to continue to distribute quarterly dividends to our stockholders. To avoid certain excise taxes imposed on RICs, we currently intend to distribute during each calendar year an amount at least equal to the sum of:

- 98% of our ordinary net taxable income for the calendar year;

• 98.2% of our capital gains, if any, in excess of capital losses for the one-year period ending on October 31 of the calendar year; and

- any net ordinary income and net capital gains for the preceding year that were not distributed during such year.

The amount of our declared dividends, as evaluated by management and approved by our Board of Directors, is based on our evaluation of both distributable income for tax purposes and GAAP net investment income (which excludes unrealized gains and losses). Generally, we seek to fund our dividends from GAAP current earnings, primarily from net interest and dividend income generated by our investment portfolio and without a return of capital or a high reliance on realized capital gains. The following table sets forth the quarterly dividends declared by us since the most recent completed calendar year, which represent an amount equal to our estimated net investment income for the specified quarter, including income distributed from the Asset Manager Affiliates received by the Company, if any, plus a portion of any prior year undistributed amounts of net investment income distributed in subsequent years:



	Dividend	Declaration Date	Record Date	Pay Date
2012:				
Third quarter	\$ 0.24	9/17/2012	10/10/2012	10/29/2012
Second quarter	0.24	6/18/2012	7/6/2012	7/27/2012
First quarter	0.18	3/16/2012	4/6/2012	4/27/2012

Total declared in 2012 \$ 0.66

2011:				
Fourth quarter	\$ 0.18	12/12/2011	12/23/2011	1/27/2012
Third quarter	0.18	9/15/2011	10/10/2011	10/28/2011
Second quarter	0.17	6/13/2011	7/8/2011	7/29/2011
First quarter	0.17	3/21/2011	4/8/2011	4/29/2011

Total declared in 2011 \$ 0.70

Due to our ownership of our Asset Manager Affiliates and certain timing, structural and tax considerations, our dividend distributions may include a return of capital for tax purposes. For the nine months ended September 30, 2012, our Asset Manager Affiliates had approximately \$3.0 million of EBITDA and made a distribution of \$2,950,000 to us. For the nine months ended September 30, 2011, our Katonah Debt Advisors earned approximately \$1 million of pre-tax net income and made no distributions to us. We did not acquire Trimaran Advisors until February 2012. Dividends are recorded as declared (where declaration date represents ex-dividend date) by our Asset Manager Affiliates as income on our statement of operations. It is anticipated that our Asset Manager Affiliates may make further dividend distributions to us during 2012.

## INVESTMENT PORTFOLIO

### Investment Objective

Our investment objective is to generate current income and capital appreciation from the investments made by our middle market business in senior secured term loans, mezzanine debt and selected equity investments in privately-held middle market companies. The Company also expects to receive distributions of recurring fee income and to generate capital appreciation from its investments in the asset management businesses of the Asset Manager Affiliates. We intend to grow our portfolio of assets by raising additional capital, including through the prudent use of leverage available to us. We primarily invest in first and second lien term loans which, because of their priority in a company's capital structure, we expect will have lower default rates and higher rates of recovery of principal if there is a default and which we expect will create a stable stream of interest income. While our primary investment focus is on making loans to, and selected equity investments in, privately-held middle market companies, we may also invest in other investments such as loans to larger, publicly-traded companies, high-yield bonds and distressed debt securities. We may also receive warrants or options to purchase common stock in connection with our debt investments. In addition,

we may also invest in debt and equity securities issued by CLO Funds managed by our Asset Manager Affiliates or by other asset managers.

The following table shows the Company's portfolio by security type at September 30, 2012 and December 31, 2011:

Security Type	September 30, 2012 (unaudited)			December 31, 2011			
	Cost	Fair Value	% <sup>1</sup>	Cost	Fair Value	% <sup>1</sup>	
Time Deposits	\$501,475	\$501,475	-	\$229,152	\$229,152	-	%
Money Market Account	4,850,220	4,850,220	2	31,622,134	31,622,134	18	
Senior Secured Loan	73,626,439	65,868,804	32	54,045,184	45,259,328	25	
Junior Secured Loan	53,570,960	37,237,835	18	58,936,728	47,300,172	26	
Mezzanine Investment	8,518,913	9,401,536	5	10,931,428	11,588,115	6	
Senior Subordinated Bond	21,846,118	22,577,830	11	9,997,898	10,125,891	6	
CLO Fund Securities	85,506,168	67,784,447	33	66,528,482	48,438,317	27	
Equity Securities	17,012,236	6,911,736	3	16,559,610	6,040,895	3	
Preferred	400,000	391,760	-	400,000	400,000	-	
Asset Manager Affiliates	83,203,884	73,989,000	36	44,338,301	40,814,000	23	
Total	\$349,036,413	\$289,514,643	140%	\$293,588,917	\$241,818,004	134%	

<sup>1</sup> Calculated as a percentage of net asset value.

## Investment Securities

We invest in senior secured loans, mezzanine debt and, to a lesser extent, equity of middle market companies in a variety of industries. However, we may invest in other industries if we are presented with attractive opportunities. We generally target companies that generate positive cash flows because we look to cash flows as the primary source for servicing debt.

We employ a disciplined approach in the selection and monitoring of our investments. Generally, we target investments that will provide a current return through interest income to provide for stability in our net income and place less reliance on realized capital gains from our investments. Our investment philosophy is focused on preserving capital with an appropriate return profile relative to risk. Our investment due diligence and selection generally focuses on an underlying issuer's net cash flow after capital expenditures to service its debt rather than on multiples of net income, valuations or other broad benchmarks which frequently miss the nuances of an issuer's business and prospective financial performance. We also generally avoid concentrations in any one industry or issuer. We manage risk through a rigorous credit and investment underwriting process and an active portfolio monitoring program.

Our Board of Directors is ultimately and solely responsible for making a good faith determination of the fair value of portfolio investments on a quarterly basis. Debt and equity securities for which market quotations are readily available are generally valued at such market quotations. Debt and equity securities that are not publicly traded or whose market price is not readily available are valued by the Board of Directors based on detailed analyses prepared by management, the Valuation Committee of the Board of Directors, and, in certain circumstances, third parties with valuation expertise. Valuations are conducted by management on 100% of the investment portfolio at the end of each quarter. Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments may differ materially from the values that would have existed had a ready market existed for such investments. Further, such investments may be generally subject to legal and other restrictions on resale or otherwise less liquid than publicly traded securities. In addition, changes in the market environment and other events may occur over the life of the investments that may cause the value realized on such investments to be different from the currently assigned valuations.

We derive fair value for our illiquid investments that do not have indicative fair values based upon active trades primarily by using a present value technique that discounts the estimated contractual cash flows for the underlying assets with discount rates imputed by broad market indices, bond spreads and yields for comparable issuers relative to the subject assets (the "Market Yield Approach") and also consider recent loan amendments or other activity specific to the subject asset. Discount rates applied to estimated contractual cash flows for an underlying asset vary by specific investment, industry, priority and nature of the debt security (such as the seniority or security interest of the debt security) and are assessed relative to two indices, a leveraged loan index and a high-yield bond index, at the valuation date. We have identified these two indices as benchmarks for broad market information related to our loan and debt investments. Because we have not identified any market index that directly correlates to the loan and debt investments held by us and therefore use the two benchmark indices, these market indices may require significant adjustment to better correlate such market data for the calculation of fair value of the investment under the Market Yield Approach.

Such adjustments require judgment and may be material to the calculation of fair value. Further adjustments to the discount rate may be applied to reflect other market conditions or the perceived credit risk of the borrower. When broad market indices are used as part of the valuation methodology, their use is subject to adjustment for many factors, including priority, collateral used as security, structure, performance and other quantitative and qualitative attributes of the asset being valued. The resulting present value determination is then weighted along with any quotes from observable transactions and broker/pricing quotes. If such quotes are indicative of actual transactions with reasonable trading volume at or near the valuation date that are not liquidation or distressed sales, relatively more reliance will be put on such quotes to determine fair value. If such quotes are not indicative of market transactions or are insufficient as to volume, reliability, consistency or other relevant factors, such quotes will be compared with other fair value indications and given relatively less weight based on their relevancy. The appropriateness of specific valuation methods and techniques may change as market conditions and available data change.

The majority of our investment portfolio is composed of debt and equity securities with unique contract terms and conditions and/or complexity that requires a valuation of each individual investment that considers multiple levels of market and asset specific inputs, including historical and forecasted financial and operational performance of the individual investment, projected cash flows, market multiples, comparable market transactions, the priority of the security compared with those of other securities for such issuers, credit risk, interest rates and independent valuations and reviews.

#### ***Loans and Debt Securities.***

To the extent that our investments are exchange traded and are priced or have sufficient price indications from normal course trading at or around the valuation date (financial reporting date), such pricing will determine fair value. Pricing service marks from third party pricing services may be used as an indication of fair value, depending on the volume and reliability of the marks, sufficient and reasonable correlation of bid and ask quotes, and, most importantly, the level of actual trading activity. However, most of our investments are illiquid investments with little or no trading activity. Further, we have been unable to identify directly comparable market indices or other market guidance that correlate directly to the types of investments we own. As a result, for most of our assets, we determine fair value using alternative methodologies and models using available market data, as adjusted, to reflect the types of assets we own, their structure, qualitative and credit attributes and other asset specific characteristics.

We derive fair value for our illiquid investments that do not have indicative fair values based upon active trades primarily by using the Market Yield Approach and also consider recent loan amendments or other activity specific to the subject asset. Discount rates applied to estimated contractual cash flows for an underlying asset vary by specific investment, industry, priority and nature of the debt security (such as the seniority or security interest of the debt security) and are assessed relative to two indices, a leveraged loan index and a high-yield bond index, at the valuation date. We have identified these two indices as benchmarks for broad market information related to our loan and debt investments. Because we have not identified any market index that directly correlates to the loan and debt investments held by us and therefore use the two benchmark indices, these market indices may require significant adjustment to better correlate such market data for the calculation of fair value of the investment under the Market Yield Approach. Such adjustments require judgment and may be material to the calculation of fair value. Further adjustments to the discount rate may be applied to reflect other market conditions or the perceived credit risk of the borrower. When broad market indices are used as part of the valuation methodology, their use is subject to adjustment for many factors, including priority, collateral used as security, structure, performance and other quantitative and qualitative attributes of the asset being valued. The resulting present value determination is then weighted along with any quotes from observable transactions and broker/pricing quotes. If such quotes are indicative of actual transactions with reasonable trading volume at or near the valuation date that are not liquidation or distressed sales, relatively more reliance will be put on such quotes to determine fair value. If such quotes are not indicative of market transactions or are insufficient as to volume, reliability, consistency or other relevant factors, such quotes will be compared with other fair value indications and given relatively less weight based on their relevancy.

#### ***Equity and Equity-Related Securities.***

Our equity and equity-related securities in portfolio companies for which there is no liquid public market are carried at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including EBITDA, cash flows from operations less capital expenditures and other pertinent factors, such as recent offers to purchase a portfolio company's securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions. The values of our equity and equity-related securities in public companies for which market quotations are readily available are based upon the closing public market price on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

The significant inputs used to determine the fair value of equity and equity-related securities include prices, earnings, EBITDA and cash flows after capital expenditures for similar peer comparables and the investment entity itself. Equity and equity-related securities are classified as Level III as described in—"Critical Accounting Policies—Valuation of Portfolio Investments" below), when there is limited activity or less transparency around inputs to the valuation given the lack of information related to such equity investments held in nonpublic companies. Significant assumptions observed for comparable companies as applied to relevant financial data for the specific investment. Such assumptions, such as model discount rates or price/earnings multiples, vary by the specific investment, equity position and industry and incorporate adjustments for risk premiums, liquidity and company specific attributes. Such adjustments require judgment and may be material to the calculation of fair value.

At September 30, 2012 and December 31, 2011, our investments in income producing loans and debt securities, excluding CLO Fund securities, had a weighted average interest rate of approximately 8.1% and 8.4%, respectively.

The investment portfolio (excluding the Company's investments in its Asset Manager Affiliates and CLO Funds) at September 30, 2012 was spread across 24 different industries and 53 different entities with an average balance per entity of approximately \$3 million. As of September 30, 2012, all but five of our portfolio companies (representing less than 1% of total investments at fair value) were current on their debt service obligations. Our portfolio, including the CLO Funds in which it invests, and the CLO Funds managed by our Asset Manager Affiliates consist almost exclusively of credit instruments issued by corporations.

We may invest up to 30% of our investment portfolio in opportunistic investments in high-yield bonds, debt and equity securities of CLO Funds, distressed debt or equity securities of public companies. At September 30, 2012, approximately 23% of our total assets were foreign assets (including our investments in CLO Funds, which are typically domiciled outside the U.S.).

At September 30, 2012, our ten largest portfolio companies represented approximately 56% of the total fair value of our investments. Our largest investment is comprised of our wholly-owned Asset Manager Affiliates and represented 26% of the total fair value of our investments. Excluding our Asset Manager Affiliates and CLO Fund securities, our ten largest portfolio companies represent approximately 20% of the total fair value of our investments.

### ***CLO Fund Securities***

We typically make a minority investment in the subordinated securities or preferred stock of CLO Funds raised and managed by our Asset Manager Affiliates and may selectively invest in securities issued by CLO Funds managed by other asset management companies. As of September 30, 2012, we had approximately \$68 million invested in CLO Fund securities, including those issued by funds managed by our Asset Manager Affiliates.

The CLO Funds managed by our Asset Manager Affiliates invest primarily in broadly syndicated non-investment grade loans, high-yield bonds and other credit instruments of corporate issuers. The underlying assets in each of the CLO Funds in which we have an investment are generally diversified secured or unsecured corporate debt.

Our CLO Fund investments as of September 30, 2012 and December 31, 2011 are as follows:

<b>CLO Fund Securities</b>	<b>Investment</b>	<b>%<sup>1</sup></b>	<b>September 30, 2012 (unaudited)</b>		<b>December 31, 2011</b>	
			<b>Cost</b>	<b>Fair Value</b>	<b>Cost</b>	<b>Fair Value</b>
Grant Grove CLO, Ltd.	Subordinated Securities	22.2	% \$4,958,483	\$3,063,189	\$4,893,552	\$3,042,400
Katonah III, Ltd. <sup>3</sup>	Preferred Shares	23.1	4,476,930	1,500,000	4,476,930	1,000
Katonah V, Ltd. <sup>3</sup>	Preferred Shares	26.7	3,320,000	1,000	3,320,000	1,000
Katonah VII CLO Ltd. <sup>2</sup>	Subordinated Securities	16.4	4,575,493	2,274,631	4,614,123	2,358,700

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Katonah VIII CLO Ltd. <sup>2</sup>	Subordinated Securities	10.3	3,457,305	2,101,905	3,450,583	1,888,700
Katonah IX CLO Ltd. <sup>2</sup>	Preferred Shares	6.9	2,075,887	1,511,277	2,060,697	1,336,800
Katonah X CLO Ltd. <sup>2</sup>	Subordinated Securities	33.3	11,906,371	8,826,471	11,840,297	8,645,600
Katonah 2007-1 CLO Ltd. <sup>2</sup>	Preferred Shares	100.0	31,078,634	27,683,357	30,659,688	24,488,400
Katonah 2007-1 CLO Ltd. <sup>2</sup>	Class B-2L Notes	100.0	1,237,364	8,690,000	1,212,612	6,675,717
Trimaran CLO IV, Ltd. <sup>2</sup>	Preferred Shares	18.9	5,115,600	3,312,321	—	—
Trimaran CLO V, Ltd. <sup>2</sup>	Subordinate Notes	20.8	5,055,800	3,107,504	—	—
Trimaran CLO VI, Ltd. <sup>2</sup>	Income Notes	16.2	4,200,900	2,715,803	—	—
Trimaran CLO VII, Ltd. <sup>2</sup>	Income Notes	10.5	4,047,400	2,996,989	—	—
Total			\$85,506,167	\$67,784,447	\$66,528,482	\$48,438,317

<sup>1</sup> Represents percentage of class held.

<sup>2</sup> An affiliate CLO Fund managed by an Asset Manager Affiliate.

<sup>3</sup> As of September 30, 2012, this CLO Fund security was not providing a dividend distribution.



Our investments in CLO Fund securities are carried at fair value, which is based either on (i) the present value of the net expected cash inflows for interest income and principal repayments from underlying assets and cash outflows for interest expense, debt paydown and other fund costs for the CLO Funds that are approaching or past the end of their reinvestment period and therefore are selling assets and/or using principal repayments to pay down CLO Fund debt (or will begin to do so shortly), and for which there continue to be net cash distributions to the class of securities owned by us, or (ii) a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar securities or preferred shares to those in which we have invested. We recognize unrealized appreciation or depreciation on our investments in CLO Fund securities as comparable yields in the market change and/or based on changes in net asset values or estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each investment in CLO Fund securities ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool are updated and the revised cash flows are used in determining the fair value of the CLO Fund investments. We determine the fair value of our investments in CLO Fund securities on a security-by-security basis.

Due to the individual attributes of each CLO Fund security, they are classified as a Level III (as described in—“Critical Accounting Policies—Valuation of Portfolio Investments” below) investment unless specific trading activity can be identified at or near the valuation date. When available, Level II (as described in “—Critical Accounting Policies—Valuation of Portfolio Investments” below) market information will be identified, evaluated and weighted accordingly in the application of such data to the present value models and fair value determination. Significant assumptions to the present value calculations include default rates, recovery rates, prepayment rates, investment/reinvestment rates and spreads and the discount rate by which to value the resulting underlying cash flows. Such assumptions can vary significantly, depending on market data sources which often vary in depth and level of analysis, understanding of the CLO market, detailed or broad characterizations of the CLO market and the application of such data to an appropriate framework for analysis. The application of data points are based on the specific attributes of each individual CLO Fund security’s underlying assets, historic, current and prospective performance, vintage, and other quantitative and qualitative factors that would be evaluated by market participants. We evaluate the source of market data for reliability as an indicative market input, consistency amongst other inputs and results and also the context in which such data is presented.

For rated note tranches of CLO Fund securities (those above the junior class) without transactions to support a fair value for the specific CLO Fund and tranche, fair value is based on discounting estimated bond payments at current market yields, which may reflect the adjusted yield on the leveraged loan index for similarly rated tranches, as well as prices for similar tranches for other CLO Funds, and also considers other factors such as the default and recovery rates of underlying assets in the CLO Fund, as may be applicable. Such model assumptions may vary and incorporate adjustments for risk premiums and CLO Fund specific attributes. Such adjustments require judgment and may be material to the calculation of fair value.

The unaudited table below summarizes certain attributes of each CLO Fund as per their most recent trustee reports as of September 30, 2012:

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<b>CLO Fund Securities<sup>1</sup></b>	<b>Number of Securities</b>	<b>Number of Issuers</b>	<b>Number of Industries</b>	<b>Average Security Position Size</b>	<b>Average Issuer Position Size</b>
Grant Grove CLO, Ltd. <sup>2</sup>	295	234	32	\$ 942,963	\$ 1,188,778
Katonah III, Ltd. <sup>2</sup>	81	43	19	1,257,104	2,368,033
Katonah V, Ltd. <sup>2</sup>	104	61	27	456,489	778,277
Katonah VII CLO Ltd.	159	133	30	1,648,367	1,970,604
Katonah VIII CLO Ltd.	194	158	31	1,827,296	2,243,642
Katonah IX CLO Ltd.	224	185	30	1,787,487	2,164,309
Katonah X CLO Ltd.	240	202	29	1,942,848	2,308,335
Katonah 2007-1 CLO Ltd.	195	167	28	1,525,100	1,780,805
Trimaran CLO IV, Ltd.	122	99	22	2,390,645	2,946,047
Trimaran CLO V, Ltd.	146	116	23	1,927,047	2,425,421
Trimaran CLO VI, Ltd.	168	130	25	1,736,073	2,243,540
Trimaran CLO VII, Ltd.	186	147	28	2,542,219	3,216,685

<sup>1</sup> All data from most recent Trustee reports as of September 30, 2012.

<sup>2</sup> Managed by non-affiliates as of September 30, 2012.

In May 2009, we purchased the class B-2L notes of the Katonah 2007-1 CLO investment managed by Katonah Debt Advisors (“Katonah 2007-1 B-2L”). We purchased Katonah 2007-1 B-2L for 10% of the par value. The fair value, cost basis, and aggregate unrealized appreciation of the Katonah 2007-1 B-2L investment as of September 30, 2012 were approximately \$8.7 million, \$1.2 million, and \$7.5 million, respectively, and at December 31, 2011, the fair value, cost basis, and aggregate unrealized appreciation of the Katonah 2007-1 B-2L investment were \$6.7 million, \$1.2 million, and \$5.5 million, respectively. Both the B-2L notes and preferred shares of Katonah 2007-1 are owned 100% by us and Katonah 2007-1 is current in the payment of all quarterly distributions in respect of the B-2L notes and the preferred shares.

All CLO Funds managed by Asset Manager Affiliates are currently making quarterly dividend distributions to us and are paying all senior and subordinate management fees to our Asset Manager Affiliates. With the exception of the Katonah III, Ltd. CLO Fund and the Katonah V, Ltd. CLO Fund, all third-party managed CLO Funds held as investments are making quarterly dividend distributions to us.

### **Asset Manager Affiliates**

Our Asset Manager Affiliates are our wholly-owned asset management companies that manage CLO Funds that invest in broadly syndicated loans, high yield bonds and other credit instruments. The CLO Funds managed by our Asset Manager Affiliates consist exclusively of credit instruments issued by corporations. As of September 30, 2012, our Asset Manager Affiliates had approximately \$3.3 billion of par value of assets under management on which they earn management fees, and were valued at approximately \$74 million.

As a manager of the CLO Funds, our Asset Manager Affiliates receive contractual and recurring management fees as well as an expected one-time structuring fee from the CLO Funds for its management and advisory services. In addition, our Asset Manager Affiliates may also earn income related to net interest on assets accumulated for future CLO issuances on which it has provided a first loss guaranty in connection with loan warehouse arrangements for its CLO Funds. Our Asset Manager Affiliates generate annual operating income equal to the amount by which its fee income exceeds its operating expenses.

The annual management fees which our Asset Manager Affiliates receive are generally based on a fixed percentage of the par value of assets under management and are recurring in nature for the term of the CLO Fund so long as the Asset Manager Affiliates manage the fund. As a result, the annual management fees earned by our Asset Manager Affiliates are not subject to market value fluctuations in the underlying collateral. The annual management fees our Asset Manager Affiliates receive have two components: a senior management fee and a subordinated management fee. Currently, all CLO Funds managed by Asset Manager Affiliates are paying both their senior and subordinated management fees on a current basis.

Our Asset Manager Affiliates may receive incentive fees from CLO Funds they manage provided such CLO Funds have achieved a minimum investment return to holders of their subordinated securities or preferred shares.

Subject to market conditions, we expect to continue to make investments in CLO Funds managed by our Asset Manager Affiliates, which we believe will provide us with a current cash investment return. We believe that these investments will provide our Asset Manager Affiliates with greater opportunities to access new sources of capital which will ultimately increase our Asset Manager Affiliates' assets under management and resulting management fee income.

The revenue that our Asset Manager Affiliates generate through the fees they receive for managing CLO Funds and after paying the expenses pursuant to an overhead allocation agreement with the Company associated with its operations, including compensation of its employees, may be distributed to us. Cash distributions of our Asset Manager Affiliates' net income are recorded as "dividends from an affiliate asset managers" in our financial statements when declared. As with all other investments, the fair value for Asset Manager Affiliates is determined quarterly. Our investment in our Asset Manager Affiliates is carried at fair value, which is determined after taking into consideration a percentage of assets under management and a discounted cash flow model incorporating different levels of discount rates depending on the hierarchy of fees earned (including the likelihood of realization of senior, subordinate and incentive fees) and prospective modeled performance. Such valuation includes an analysis of comparable asset management companies. The Asset Manager Affiliates are classified as a Level III investment as described in—"Critical Accounting Policies—Valuation of Portfolio Investments" below). Any change in value from period to period is recognized as net change in unrealized appreciation or depreciation.

**PORTFOLIO AND INVESTMENT ACTIVITY**

Total portfolio investment activity (excluding activity in time deposit and money market investments) for the nine months ended September 30, 2012 (unaudited) and for the year ended December 31, 2011 was as follows:

	Debt Securities	CLO Fund Securities	Equity Securities	Asset Manager Affiliates	Total Portfolio
Fair Value at December 31, 2010	\$ 91,042,928	\$ 53,031,000	\$ 4,688,832	\$ 41,493,000	\$ 190,255,760
2011 Activity:					
Purchases / originations / draws	\$ 81,815,921	\$—	\$ 3,218,151	\$ (194,027 )	\$ 84,840,045
Pay-downs / pay-offs / sales	(56,944,765 )	(1,935,000 )	(141,769 )	—	(59,021,534 )
Net accretion of interest	156,180	1,398,283	—	—	1,554,463
Net realized losses	(17,261,608 )	(1,215,000 )	—	—	(18,476,608 )
Increase (decrease) in fair value	15,864,850	(2,840,966 )	(1,724,319 )	(484,973 )	10,814,592
Fair Value at December 31, 2011	114,673,506	48,438,317	6,040,895	40,814,000	209,966,718
Year to Date 2012 Activity:					
Purchases / originations / draws	72,168,533	12,000,000	452,627	38,865,582	123,486,742
Pay-downs / pay-offs / sales	(45,248,621 )	—	—	—	(45,248,621 )
Net accretion of interest	194,116	977,685	—	—	1,171,801
Net realized losses	(3,462,835 )	—	—	—	(3,462,835 )
Increase (decrease) in fair value	(2,846,934 )	6,368,445	418,214	(5,690,582 )	(1,750,857 )
Fair Value at September 30, 2012	\$ 135,477,765	\$ 67,784,447	\$ 6,911,736	\$ 73,989,000	\$ 284,162,948

The level of investment activity for investments funded and principal repayments for our investments can vary substantially from period to period depending on the number and size of investments that we invest in or divest of, and many other factors, including the amount and competition for the debt and equity securities available to middle market companies, the level of merger and acquisition activity for such companies and the general economic environment.

**RESULTS OF OPERATIONS**

The principal measure of our financial performance is the net increase (decrease) in net assets resulting from operations which includes net investment income (loss) and net realized and unrealized appreciation (depreciation). Net investment income (loss) is the difference between our income from interest, dividends, fees, and other investment income and our operating expenses. Net realized gain (loss) on investments, is the difference between the proceeds received from dispositions of portfolio investments and their amortized cost. Net change in unrealized appreciation (depreciation) on investments is the net change in the fair value of our investment portfolio.

Set forth below is a discussion of our results of operations for the three and nine months ended September 30, 2012 and 2011.

### **Investment Income**

Investment income is primarily dependent on the composition and credit quality of our investment portfolio. Generally, our debt securities portfolio is expected to generate predictable, recurring interest income in accordance with the contractual terms of each loan. Corporate equity securities may pay a dividend and may increase in value for which a gain may be recognized; generally such dividend payments and gains are less predictable than interest income on our loan portfolio.

Dividends from CLO Fund securities are dependent on the performance of the underlying assets in each CLO Fund; interest payments, principal amortization and prepayments of the underlying loans in each CLO Fund are primary factors which determine the level of income on our CLO Fund securities. The level of excess spread from CLO Fund securities can be impacted by the timing and level of the resetting of the benchmark interest rate for the underlying assets (which reset at various times throughout the quarter) in the CLO Fund and the related CLO Fund note liabilities (which reset at each quarterly distribution date); in periods of short-term and volatile changes in the benchmark interest rate, the levels of excess spread and distributions to us can vary significantly.

Investment income for the three months ended September 30, 2012 and 2011 was approximately \$10 million and \$7 million, respectively. Of these amounts, approximately \$4 million and \$3 million was attributable to interest income on our loan and bond investments, respectively. For the three months ended September 30, 2012 and 2011, approximately \$6 million and \$4 million of investment income is attributable to dividends earned on CLO equity investments, respectively.

Investment income for the nine months ended September 30, 2012 and 2011 was approximately \$27 million and \$21 million, respectively. Of these amounts, approximately \$9 million and \$7 million was attributable to interest income on our loan and bond investments, respectively. For the nine months ended September 30, 2012 and 2011, approximately \$15 million and \$11 million of investment income is attributable to dividends earned on CLO equity investments, respectively.

The increase in our interest income for the three and nine months ended September 30, 2012 as compared to the three and nine months ended September 30, 2011 was primarily attributable to a higher average level of outstanding debt securities.

The increase in investment income from CLO Fund securities for the three and nine months ended September 30, 2012 as compared to the three and nine months ended September 30, 2011 was largely attributable to our acquisition of equity interests in CLO Funds managed by Trimaran Advisors in connection with our acquisition of Trimaran Advisors in February 2012.

During the nine months ended September 30, 2011, we received a \$2 million cash settlement to settle litigation previously initiated by us against the lenders related to our secured credit facility which we fully repaid on January 31, 2011. Upon receipt, this settlement was recognized as other income during the nine months ended September 30, 2011.

#### **Dividends from Asset Manager Affiliates**

Distributions of net income from our Asset Manager Affiliates are recorded as “dividends from affiliate asset managers” in our financial statements. The Company intends to distribute to its shareholders the accumulated undistributed net income of the Asset Manager Affiliates in the future. For purposes of calculating distributable tax income for required quarterly dividends as a RIC, the Asset Manager Affiliates’ net income is further reduced by approximately \$5.5 million per annum for tax goodwill amortization resulting from the acquisition of Katonah Debt Advisors by us prior to our initial public offering and our recent acquisition of Trimaran Advisors. As a result, the amount of our declared dividends, as evaluated by management and approved by our Board of Directors, is based on our evaluation of both distributable income for tax purposes and GAAP net investment income (which excludes unrealized gains and losses).

As of September 30, 2012, our investment in the Asset Manager Affiliates was valued at approximately \$74 million. For the three months ended September 30, 2012 and 2011, our Asset Manager Affiliates had EBITDA of approximately \$2 million and \$570,000, respectively. For the nine months ended September 30, 2012 and 2011, our Asset Manager Affiliates had pre-tax net income before net capital losses of approximately \$2.9 million and \$1 million, respectively. For the three months ended September 30, 2012 and 2011, our Asset Manager Affiliates made distributions of net income of \$925,000 and \$510,000, respectively. For the nine months ended September 30, 2012 and 2011, our Asset Manager Affiliates made distributions of net income of \$2,950,000 and \$1,160,000, respectively. The distributions from our Asset Manager Affiliates in 2012 represent a portion of the expected net income for our Asset Manager Affiliates for the year ending December 31, 2012.

The increase in distributions from our Asset Manager Affiliates for the three and nine months ended September 30, 2012 as compared to the three and nine months ended September 30, 2011 was largely attributable to our acquisition of Trimaran Advisors in February 2012.

## Expenses

Total expenses for the three months ended September 30, 2012 and 2011 were approximately \$3 million and \$3 million, respectively. Interest expense and amortization on debt issuance costs for the period, which includes facility and program fees on the unused loan balance, were approximately \$2 million and \$1 million, respectively, on average debt outstanding of \$86 million and \$60 million, respectively. Approximately \$385,000 and \$985,000, respectively, of expenses were attributable to employment compensation, including salaries, bonuses and stock option expense for the three months ended September 30, 2012 and 2011. For the three months ended September 30, 2012, other expenses included approximately \$1 million for professional fees, insurance, administrative and other. For the three months ended September 30, 2011, other expenses included approximately \$797,000 for professional fees, insurance, administrative and other. For the three months ended September 30, 2012 and 2011, administrative and other costs (including occupancy expense, insurance, technology and other office expenses) totaled approximately \$305,000 and \$221,000, respectively.



Total expenses for the nine months ended September 30, 2012 and 2011 were approximately \$10 million and \$9 million, respectively. Interest expense and amortization on debt issuance costs for the period, which includes facility and program fees on the unused loan balance, were approximately \$5 million and \$3 million, respectively, on average debt outstanding of \$74 million and \$52 million, respectively. Approximately \$2 million and \$3 million, respectively, of expenses were attributable to employment compensation, including salaries, bonuses and stock option expense for the nine months ended September 30, 2012 and 2011. For the nine months ended September 30, 2012, other expenses included approximately \$3 million for professional fees, insurance, administrative and other. For the nine months ended September 30, 2011, other expenses included approximately \$3 million for professional fees, insurance, administrative and other. For the nine months ended September 30, 2012 and 2011, administrative and other costs (including occupancy expense, insurance, technology and other office expenses) totaled approximately \$1 million and \$751,000, respectively.

Interest and compensation expense are generally expected to be our largest expenses each period. Interest expense is dependent on the average outstanding principal balance on our borrowings and the related interest rate for the period. Compensation expense includes base salaries, bonuses, stock compensation, employee benefits and employer related payroll costs. The largest components of total compensation costs are base salaries and bonuses; generally, base salaries are expensed as incurred and bonus expenses are estimated and accrued since bonuses are generally paid annually.

Professional fee expenses for the nine months ended September 30, 2012 are higher by approximately \$360,000 relative to the same prior year period primarily due to an increase in professional fees related to additional legal, accounting, and valuation costs connected to our acquisition of Trimaran Advisors.

#### **Net Unrealized (Depreciation) Appreciation on Investments**

During the three months ended September 30, 2012, our total investments had a increase in net unrealized appreciation of approximately \$6.0 million. During the three months ended September 30, 2011, our total investments had an increase in net unrealized depreciation of approximately \$5.7 million. For the three months ended September 30, 2012, our Asset Manager Affiliates had an increase in net unrealized appreciation of approximately \$1.3 million. For the three months ended September 30, 2011, our Asset Manager Affiliates had an increase in net unrealized appreciation of approximately \$470,000. For the three months ended September 30, 2012, our middle market portfolio of debt securities, equity securities, and CLO Fund securities had a net increase in unrealized appreciation due to fair value adjustments of approximately \$4.7 million. For the three months ended September 30, 2011, our middle market portfolio of debt securities, equity securities, and CLO Fund securities had a net increase in unrealized depreciation due to fair value adjustments of approximately \$6.1 million.

During the nine months ended September 30, 2012, our total investments had an increase in net unrealized depreciation of approximately \$1.7 million. During the nine months ended September 30, 2011, our total investments

had an increase in net unrealized appreciation of approximately \$10.9 million. For the nine months ended September 30, 2012, our Asset Manager Affiliates had an increase in net unrealized depreciation of approximately \$5.7 million. For the nine months ended September 30, 2011, our Asset Manager Affiliates had an increase in net unrealized appreciation of approximately \$1.3 million. For the nine months ended September 30, 2012, our middle market portfolio of debt securities, equity securities, and CLO Fund securities had a net increase in unrealized appreciation due to fair value adjustments of approximately \$4.0 million. For the nine months ended September 30, 2011, our middle market portfolio of debt securities, equity securities, and CLO Fund securities had a net increase in unrealized appreciation due to fair value adjustments of approximately \$9.6 million.

#### **Net Increase (Decrease) in Net Assets Resulting From Operations**

For the three and nine months ended September 30, 2012 the net change in net assets resulting from operations was an approximate increase of \$9 million and \$12 million, or \$0.35 and \$0.45 per share, respectively. The net change in net assets resulting from operations for the three and nine months ended September 30, 2011 was an approximate decrease of \$1 million, or \$0.06 per share, and an approximate increase of \$9 million, or \$0.39 per share, respectively.

**FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES**

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain investments, pay dividends to our stockholders and other general business needs. We recognize the need to have funds available for operating our business and to make investments. We seek to have adequate liquidity at all times to cover normal cyclical swings in funding availability and to allow us to meet abnormal and unexpected funding requirements. We plan to satisfy our liquidity needs through normal operations with the goal of avoiding unplanned sales of assets or emergency borrowing of funds.

As of September 30, 2012 and December 31, 2011 the fair value of investments and cash were as follows:

Security Type	Investments at Fair Value	
	September 30, 2012 (unaudited)	December 31, 2011
Cash	\$2,413,104	\$ 2,555,259
Time Deposits	501,475	229,152
Money Market Accounts	4,850,220	31,622,134
Senior Secured Loan	65,868,804	45,259,328
Junior Secured Loan	37,237,835	47,300,172
Mezzanine Investment	9,401,536	11,588,115
Senior Subordinated Bond	22,577,830	10,125,891
CLO Fund Securities	67,784,447	48,438,317
Equity Securities	6,911,736	6,040,895
Preferred	391,760	400,000
Affiliate Asset Managers	73,989,000	40,814,000
Total	\$291,927,747	\$ 244,373,263

We use borrowed funds, known as “leverage,” to make investments and to attempt to increase returns to our shareholders by reducing our overall cost of capital. As a BDC, we are limited in the amount of leverage we can incur under the 1940 Act. We are only allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% immediately after such borrowing. As of September 30, 2012, we had approximately \$88 million of outstanding borrowings and our asset coverage ratio of total assets to total borrowings was 335%, compliant with the minimum asset coverage level of 200% generally required for a BDC by the 1940 Act. We may also borrow amounts of up to 5% of the value of our total assets for temporary purposes.

At December 31, 2010, we had approximately \$87 million of outstanding indebtedness through a secured credit facility. On January 31, 2011, we repaid in full the outstanding balance under this facility and terminated this facility. On March 16, 2011, we issued \$55 million in aggregate principal amount of unsecured 8.75% convertible senior notes due March 15, 2016 (“Convertible Senior Notes”). On March 23, 2011, pursuant to an over-allotment option, we issued an additional \$5 million of such Convertible Senior Notes for a total of \$60 million in aggregate principal amount.

On February 24, 2012, we entered into a Note Purchase Agreement with Credit Suisse AG, Cayman Islands Branch (“CS”), Credit Suisse Securities (USA) LLC, as arranger, The Bank of New York Mellon Trust Company, National Association, as collateral administrator and collateral agent, and KCAP Funding, a special-purpose bankruptcy remote wholly-owned subsidiary of the Company, under which we may obtain up to \$30 million in financing (the “Facility”). The scheduled maturity date for the Facility is December 20, 2014. Interest on the Facility is LIBOR + 300 basis points and payable quarterly.

Advances under the Facility are used by us primarily to make additional investments. The Facility is secured by loans that it currently owns and a security interest in our right to receive certain management fees. Our borrowings under the Facility are effected through KCAP Funding.

As of September 30, 2012, there was an outstanding balance of \$28,000,000 under the Facility and we are in compliance with all its debt covenants. As of September 30, 2012, we had restricted cash balances of approximately \$6.1 million which we maintained in accordance with the terms of the Facility.

As of September 30, 2012, we had total outstanding indebtedness of approximately \$88 million. As of September 30, 2012, we had cash, time deposits, and money market accounts of approximately \$5 million which will fund future investments and operational needs.

Subject to prevailing market conditions, we intend to grow our portfolio of assets by raising additional capital, including through the prudent use of leverage available to us. As a result, we may seek to enter into new agreements with other lenders or into other financing arrangements as market conditions permit. Such financing arrangements may include a new secured and/or unsecured credit facility, the issuance of preferred securities or debt guaranteed by the Small Business Administration.

If our common stock trades below our net asset value per share, we will generally not be able to issue additional common stock at the market price unless our shareholders approve such a sale and our Board of Directors makes certain determinations. A proposal, approved by our shareholders at our June 2012 annual meeting of stockholders, authorizes us to sell shares of our common stock below the then current net asset value per share of our common stock in one or more offerings for the period ending on the earlier of (i) June 15, 2013, the one year anniversary of our 2012 annual meeting of shareholders, or (ii) the date of our 2013 annual meeting of shareholders. We would need similar future approval from our shareholders to issue shares below the then current net asset value per share any time after the expiration of the current approval.

## **COMMITMENTS AND OFF-BALANCE SHEET ARRANGEMENTS**

We are a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the needs of our investment in portfolio companies. Such instruments include commitments to extend credit and may involve, in varying degrees, elements of credit risk in excess of amounts recognized on our balance sheet. Prior to extending such credit, we attempt to limit our credit risk by conducting extensive due diligence, obtaining collateral where necessary and negotiating appropriate financial covenants. As of September 30, 2012 and December 31, 2011, we had committed to make a total of approximately \$0 and \$2 million, respectively, of investments.

## **CRITICAL ACCOUNTING POLICIES**

The financial statements are based on the selection and application of critical accounting policies, which require management to make significant estimates and assumptions. Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management's most difficult, complex, or subjective judgments. Our critical accounting policies are those applicable to the basis of presentation, valuation of investments, and certain revenue recognition matters as discussed below.

### ***Basis of Presentation***

The accompanying unaudited financial statements have been prepared on the accrual basis of accounting in conformity with GAAP for interim financial information. Accordingly, they do not include all of the information and footnotes required for annual financial statements. The unaudited interim financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto in the Company's Form 10-K for the fiscal year ended December 31, 2011, as filed with the Commission.

### ***Valuation of Portfolio Investments***

The most significant estimate inherent in the preparation of our financial statements is the valuation of investments and the related amounts of unrealized appreciation and depreciation of investments recorded.

Value, as defined in Section 2(a)(41) of 1940 Act, is (1) the market price for those securities for which a market quotation is readily available and (2) for all other securities and assets, fair value as determined in good faith by our Board of Directors pursuant to procedures approved by our Board of Directors. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio based on the nature of the security, the market for the security and other considerations including the financial performance and enterprise value of the portfolio company. Because of the inherent uncertainty of valuation, the Board of Directors' determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

We are, for GAAP purposes, an investment company under the AICPA Audit and Accounting Guide for Investment Companies. As a result, we reflect our investments on our balance sheet at their estimated fair value with unrealized gains and losses resulting from changes in fair value reflected as a component of unrealized gains or losses on our statements of operations. Fair value is the amount that would be received to sell the investments in an orderly transaction between market participants at the measurement date (i.e., the exit price). Additionally, we do not consolidate majority or wholly-owned and controlled investments.

Effective January 1, 2008 we adopted *Fair Value Measurements and Disclosures*, which among other things, requires enhanced disclosures about financial instruments carried at fair value. See Note 4 to the financial statements for the additional information about the level of market observability associated with investments carried at fair value.

We have valued our investments, in the absence of observable market prices, using the valuation methodologies described below applied on a consistent basis. For some investments little market activity may exist; management's determination of fair value is then based on the best information available in the circumstances, and may incorporate management's own assumptions and involves a significant degree of management's judgment.

Our investments in CLO Fund securities are carried at fair value, which is based either on (i) the present value of the net expected cash inflows for interest income and principal repayments from underlying assets and the cash outflows for interest expense, debt paydown and other fund costs for the CLO Funds which are approaching or past the end of their reinvestment period and therefore begin to sell assets and/or use principal repayments to pay-down CLO Fund debt, and for which there continue to be net cash distributions to the class of we securities own, or (ii) a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar securities or preferred shares to those in which the Company has invested. We recognize unrealized appreciation or depreciation on our investments in CLO Fund securities as comparable yields in the market change and/or based on changes in net asset values or estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each investment in CLO Fund securities ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool are updated and the revised cash flows are used in determining the fair value of the CLO Investment. We determine the fair value of our investments in CLO Fund securities on a security-by-security basis.

Our investment in our Asset Manager Affiliates is carried at fair value, which is determined after taking into consideration a percentage of assets under management and a discounted cash flow model incorporating different levels of discount rates depending on the hierarchy of fees earned (including the likelihood of realization of senior, subordinate and incentive fees) and prospective modeled performance. Such valuation includes an analysis of comparable asset management companies. Our investment in our Asset Manager Affiliates is classified as a Level III investment (as described below). Any change in value from period to period is recognized as net change in unrealized appreciation or depreciation.

Fair values of other investments for which market prices are not observable are determined by reference to public market or private transactions or valuations for comparable companies or assets in the relevant asset class and or industry when such amounts are available. Generally these valuations are derived by multiplying a key performance metric of the investee company or asset (e.g., EBITDA) by the relevant valuation multiple observed for comparable companies or transactions, adjusted by management for differences between the investment and the referenced comparable. Such investments may also be valued at cost for a period of time after an acquisition as the best indicator of fair value. If the fair value of such investments cannot be valued by reference to observable valuation measures for comparable companies, then the primary analytical method used to estimate the fair value is a discounted cash flow

method and/or cap rate analysis. A sensitivity analysis is applied to the estimated future cash flows using various factors depending on the investment, including assumed growth rates (in cash flows), capitalization rates (for determining terminal values) and appropriate discount rates to determine a range of reasonable values or to compute projected return on investment.

We derive fair value for our illiquid loan investments that do not have indicative fair values based upon active trades primarily by using the Market Yield Approach, and also consider recent loan amendments or other activity specific to the subject asset as described above. Other significant assumptions, such as coupon and maturity, are asset-specific and are noted for each investment in the Schedules of Investments. Our Board of Directors may consider other methods of valuation to determine the fair value of investments as appropriate in conformity with GAAP.

The determination of fair value using this methodology takes into consideration a range of factors, including but not limited to the price at which the investment was acquired, the nature of the investment, local market conditions, trading values on public exchanges for comparable securities, current and projected operating performance and financing transactions subsequent to the acquisition of the investment. This valuation methodology involves a significant degree of management's judgment.

After our adoption of *Fair Value Measurements and Disclosures*, investments measured and reported at fair value are classified and disclosed in one of the following categories:

Level I – Unadjusted quoted prices are available in active markets for identical investments as of the reporting date. The type of investments included in Level I include listed equities and listed securities. As required by *Fair Value Measurements and Disclosures*, the Company does not adjust the quoted price for these investments, even in situations where the Company holds a large position and a sale could reasonably affect the quoted price.



Level II – Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date. Such inputs may be quoted prices for similar assets or liabilities, quoted markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full character of the financial instrument, or inputs that are derived principally from, or corroborated by, observable market information. Investments which are generally included in this category include illiquid corporate loans and bonds and less liquid, privately held or restricted equity securities for which some level of recent trading activity has been observed.

Level III – Pricing inputs are unobservable for the investment and includes situations where there is little, if any, market activity for the investment. The inputs may be based on the Company's own assumptions about how market participants would price the asset or liability or may use Level II inputs, as adjusted, to reflect specific investment attributes relative to a broader market assumption. These inputs into the determination of fair value may require significant management judgment or estimation. Even if observable market data for comparable performance or valuation measures (earnings multiples, discount rates, other financial/valuation ratios, etc.) are available, such investments are grouped as Level III if any significant data point that is not also market observable (private company earnings, cash flows, etc.) is used in the valuation methodology.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an investment's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and it considers factors specific to the investment. Substantially all of our investments are classified as Level III.

Our Board of Directors may consider other methods of valuation to determine the fair value of investments as appropriate in conformity with GAAP.

### ***Interest Income***

Interest income, adjusted for amortization of premium and accretion of discount, is recorded on the accrual basis to the extent that such amounts are expected to be collected. We generally place a loan on non-accrual status and cease recognizing interest income on such loan or security when a loan or security becomes 90 days or more past due or if we otherwise do not expect the debtor to be able to service its debt obligations. Non-accrual loans remain in such status until the borrower has demonstrated the ability and intent to pay contractual amounts due or such loans become current. As of September 30, 2012, five issuers representing less than 1% of our total investments at fair value were on non-accrual status. As of December 31, 2011, three issuers representing less than 1% of our total investments at fair value were on non-accrual status.

### ***Dividend Income from CLO Fund Securities***

We generate dividend income from our investments in the most junior class of securities of CLO Funds (typically preferred shares or subordinated securities) managed by the Asset Manager Affiliates and selective investments in securities issued by funds managed by other asset management companies using the effective interest method based on anticipated yield and estimated cash flows as updated quarterly for changes in prepayments, re-investment, credit losses and other items that may impact distributions. Our CLO Fund junior class securities are subordinated to senior note holders who typically receive a return on their investment at a fixed spread relative to the LIBOR index. The CLO Funds are leveraged funds and any excess cash flow or “excess spread” (interest earned by the underlying securities in the fund less payments made to senior note holders and less fund expenses and management fees) is paid to the holders of the CLO Fund’s subordinated securities or preferred shares. The level of excess spread from CLO Fund securities can be impacted from the timing and level of the resetting of the benchmark interest rate for the underlying assets (which reset at various times throughout the quarter) in the CLO Fund and the related CLO Fund note liabilities (which reset at each quarterly distribution date); in periods of short-term and volatile changes in the benchmark interest rate, the levels of excess spread and distributions to us can vary significantly. In addition, the failure of CLO Funds in which we invest to comply with certain financial covenants may lead to the temporary suspension or deferral of cash distributions to us. We make estimated interim accruals of such dividend income based on recent historical distributions and CLO Fund performance and adjust such accruals on a quarterly basis to reflect actual distributions.

For non-junior class CLO Fund securities, such as our investment in the class B-2L notes of Katonah 2007-1 CLO, interest is earned at a fixed spread relative to the LIBOR index.

### ***Dividends from Asset Manager Affiliates***

We record dividend income from our Asset Manager Affiliates on the declaration date, which represents the ex-dividend date.

### ***Payment in Kind Interest***

We may have loans in our portfolio that contain a payment-in-kind (“PIK”) provision. PIK interest, computed at the contractual rate specified in each loan agreement, is added to the principal balance of the loan and recorded as interest income. To maintain our RIC status, this non-cash source of income must be paid out to stockholders in the form of dividends, even though we have not yet collected the cash.

### ***Fee Income***

Fee income includes fees, if any, for due diligence, structuring, commitment and facility fees, and fees, if any, for transaction services and management services rendered by us to portfolio companies and other third parties. Commitment and facility fees are generally recognized as income over the life of the underlying loan, whereas due diligence, structuring, transaction service and management service fees are generally recognized as income when the services are rendered.

### ***Management Compensation***

We may, from time to time, issue stock options or restricted stock under our equity compensation plan to officers and employees for services rendered to us. We follow *Compensation – Stock Compensation*, a method by which the fair value of options or restricted stock is determined and expensed. We use a Binary Option Pricing Model (American, call option) as its valuation model to establish the expected value of all stock option grants.

We are internally managed and therefore do not incur management fees payable to third parties.

### ***United States Federal Income Taxes***

The Company has elected and intends to continue to qualify for the tax treatment applicable to RICs under Subchapter M of the Code and, among other things, intends to make the required distributions to its stockholders as specified therein. In order to qualify as a RIC, the Company is required to timely distribute to its stockholders at least 90% of investment company taxable income, as defined by the Code, for each year. Depending on the level of taxable income earned in a tax year, we may choose to carry forward taxable income in excess of current year distributions into the next tax year and pay a 4% excise tax on such income, to the extent required.

### ***Dividends***

Dividends and distributions to common stockholders are recorded on the ex-dividend date. The amount to be paid out as a dividend is determined by the Board of Directors each quarter and is generally based upon the earnings estimated by management for the period and year.

We have adopted a dividend reinvestment plan that provides for reinvestment of our distributions on behalf of our stockholders, unless a stockholder “opts out” of the plan to receive cash in lieu of having their cash dividends automatically reinvested in additional shares of our common stock.

### ***Recent Accounting Pronouncements***

*Improved Disclosures Regarding Fair Value Measurements.* In January 2010, the FASB issued Accounting Standards Update No. 2010-06, *Fair Value Measurements and Improving Disclosures About Fair Value Measurements (Topic 820)*, which provides for improving disclosures about fair value measurements, primarily significant transfers in and out of Levels I and II, and activity in Level III fair value measurements. The new disclosures and clarifications of existing disclosures are effective for the interim and annual reporting periods beginning after December 15, 2009, while the disclosures about the purchases, sales, issuances, and settlements in the roll forward activity in Level 3 fair value measurements are effective for fiscal years beginning after December 15, 2010 and for the interim periods within those fiscal years. Except for certain detailed Level III disclosures, which are effective for fiscal years beginning after December 15, 2010 and interim periods within those years, the new guidance became effective for the Company’s fiscal 2010 second quarter. The adoption of this disclosure-only guidance is included in Note 4 “—Investments” and did not have a material impact on the Company’s financial results.

In May 2011, the FASB issued FASB Accounting Standards Update (“ASU”) 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in GAAP and IFRS. The amendments in this ASU generally represent clarifications of Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This ASU results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with GAAP and IFRS. The amendments in this ASU are to be applied prospectively and are effective during interim and annual periods beginning after December 15, 2011. Management currently believes that the adoption of this ASU will not have a material impact on the Company’s operating results, financial position or cash flows.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

#### ***Interest Rate Risk***

Interest rate risk is defined as the sensitivity of our current and future earnings to interest rate volatility, variability of spread relationships, the difference in re-pricing intervals between our assets and liabilities and the effect that interest rates may have on our cash flows. Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest earning assets and our interest expense incurred in connection with our interest bearing debt and liabilities. Changes in interest rates can also affect, among other things, our ability to acquire and originate loans and securities and the value of our investment portfolio.

Our investment income is affected by fluctuations in various interest rates, including LIBOR and prime rates. As of September 30, 2012, approximately 69% of our loans at fair value in our portfolio were at floating rates with a spread to an interest rate index such as LIBOR or the prime rate. We generally expect that future portfolio investments will predominately be floating rate investments. As of September 30, 2012, we had \$60 million of borrowings outstanding at a fixed rate of 8.75%, and \$28 million at LIBOR + 300 basis points.

Because we borrow money to make investments, our net investment income is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest the funds borrowed. Accordingly, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of rising or lowering interest rates, the cost of the proportion of our debt associated with our Convertible Senior Notes would remain the same at 8.75% given that this debt is at a fixed rate. We would expect that an increase in the base rate index for our floating rate investment assets would increase our net investment income and that a decrease in the base rate index for such assets would decrease our net investment income (in either case, such increase/decrease may be limited by interest rate floors/minimums for certain investment assets).

We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that our balance sheet at September 30, 2012 was to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical increase of a 1% change in interest rates would correspondingly increase net interest income proportionately by approximately \$700,000 over a one-year period. Conversely, a hypothetical decrease of a 1% change in interest rates would correspondingly decrease net interest income proportionately by approximately \$500,000 over a one-year period.

Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect a net change in assets resulting from operations or net income. Accordingly, no assurances can be given that actual results would not materially differ from the potential outcome simulated by this estimate.

We did not hold any derivative financial instruments for hedging purposes as of September 30, 2012.

### ***Portfolio Valuation***

We carry our investments at fair value, as determined in good faith by our Board of Directors pursuant to a valuation methodology approved by our Board of Directors. Investments for which market quotations are generally readily available are generally valued at such market quotations. Investments for which there is not a readily available market value are valued at fair value as determined in good faith by our Board of Directors under a valuation policy and consistently applied valuation process. However, due to the inherent uncertainty of determining the fair value of investments that cannot be marked to market, the fair value of our investments may differ materially from the values that would have been used had a ready market existed for such investments. In addition, changes in the market environment and other events that may occur over the life of the investments may cause the value realized on these investments to be different than the valuations that are assigned. The types of factors that we may take into account in fair value pricing of our investments include, as relevant, the nature and realizable value of any collateral, third party valuations, the portfolio company's ability to make payments and its earnings and discounted cash flow, the markets in which the portfolio company does business, comparison to publicly-traded securities, recent sales of or offers to buy comparable companies, and other relevant factors.

In 2011 and 2010 we engaged an independent valuation firm, to provide a third-party review of our CLO fair value model relative to its functionality, model inputs and calculations as a reasonable method to determine CLO fair values, in the absence of Level I or Level II trading activity or observable market inputs. The independent valuation firm concluded that our CLO model appropriately factors in all the necessary inputs required to build a CLO equity cash flow for fair value purposes and that the inputs were being employed correctly.

Beginning with the period ending June 30, 2011, the Company has engaged an independent valuation firm to provide third party valuation consulting services to the Company's Board of Directors. Each quarter, the independent valuation firm will perform third party valuations on the Company's investments on illiquid securities such that they are reviewed at least once during a trailing 12 month period. These third party valuation estimates were considered as one of the relevant data inputs in the Company's determination of fair value. The Board of Directors intends to continue to engage an independent valuation firm in the future to provide certain valuation services, including the review of certain portfolio assets, as part of the quarterly and annual year-end valuation process.

#### **Item 4**

#### **Controls and Procedures**

##### ***Evaluation of Disclosure Controls and Procedures***

The Company's management, under the supervision and with the participation of various members of management, including our CEO and our CFO, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) of the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation, our CEO and CFO have concluded that our current disclosure controls and procedures are effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

##### ***Changes in Internal Control Over Financial Reporting***

##### ***Changes in Internal Control Over Financial Reporting***

During the quarter ended September 30, 2012, the Company had no changes in its internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II. Other Information**

### **Item 1.**

### **Legal Proceedings**

On January 11, 2010, the staff of the SEC's Division of Enforcement informed the Company that it was conducting an informal inquiry. The focus of the inquiry concerns the valuation methodology and procedures used by the Company to value its investments. On April 30, 2010, the SEC Staff advised the Company that a formal order of private investigation had been issued and that the informal inquiry was now a formal investigation. A subpoena has been issued to the Company in connection with the formal investigation. The subpoena requests that the Company produce documents that primarily relate to the valuation methodology and procedures used by the Company to value its investments. Since January 2010, the Company has been providing documents in response to the informal inquiry and the subpoena, and the SEC Staff has taken testimony from Company representatives. The Company is cooperating fully with the SEC Staff's investigation.

In connection with the investigation described above, on April 19, 2012, the SEC Staff issued a "Wells Notice" to Michael I. Wirth, the Company's former Chief Financial Officer, indicating that the SEC Staff is considering recommending that the SEC institute proceedings against Mr. Wirth alleging that Mr. Wirth violated certain provisions of the federal securities laws. The Wells Notice does not constitute a determination that Mr. Wirth violated any law. Under the process established by the SEC, Mr. Wirth will have the opportunity to make a Wells Submission before the SEC Staff makes a formal recommendation to the SEC regarding what action, if any, should be brought by the SEC. Mr. Wirth has informed the Company that he has made such a submission.

Neither the Company nor any other person employed by the Company has received a Wells Notice. The Company and the other officers involved in this matter, including Dayl W. Pearson, the Company's President and Chief Executive Officer, are engaged in settlement negotiations in an effort to resolve the matter and believe that discussions to date with the SEC Staff will lead to a settlement. Any settlement remains subject to approval by the SEC.

The Company cannot at this time predict with certainty the outcome of the above matter, including whether the SEC will approve any settlement or whether the SEC will ultimately determine to issue a Wells Notice to the Company or any other person involved in this matter. The Company does not anticipate that the Wells Notice referenced above or the terms of any settlement involving the Company and the other officers involved in the matter will have a material adverse impact on its business, financial condition or results of operations.

Except as set forth above, neither the Company, nor any of its subsidiaries, is currently a party to any material legal proceedings, other than routine litigation and administrative proceedings arising in the ordinary course of business. Such proceedings are not expected to have a material adverse effect on the business, financial condition, or results of the Company's operations.



**Item 1A.**

***Risk Factors***

Other than as described below, there have been no material changes from the risk factors previously disclosed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2011, and in Part II, “Item 1A. Risk Factors” in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, which should be read together with the other risk factors and information disclosed elsewhere in this Quarterly Report on Form 10-Q and our other reports filed with the SEC.

***Our business model depends to a significant extent upon strong referral relationships, and our inability to maintain or develop these relationships, as well as the failure of these relationships to generate investment opportunities, could adversely affect our business.***

We expect that members of our senior management team will maintain their relationships with intermediaries, financial institutions, investment bankers, commercial bankers, financial advisors, attorneys, accountants, consultants and other individuals within our network, and we will rely to a significant extent upon these relationships to provide us with potential investment opportunities. If our senior management team fails to maintain its existing relationships or develop new relationships with sources of investment opportunities, we will not be able to grow our investment portfolio. In addition, individuals with whom members of our senior management team have relationships are not obligated to provide us with investment opportunities, and, therefore, there is no assurance that such relationships will generate investment opportunities for us.

*Pending legislation may allow us to incur additional leverage.*

As a business development company, under the 1940 Act generally we are not permitted to incur indebtedness unless immediately after such borrowing we have an asset coverage for total borrowings of at least 200% (i.e., the amount of debt may not exceed 50% of the value of our assets). Recent legislation introduced in the U.S. House of Representatives, if passed, would modify this provision of the 1940 Act and increase the amount of debt that business development companies may incur by modifying the percentage from 200% to 150%. As a result, we may be able to incur additional indebtedness in the future and therefore your risk of an investment in us may increase.

*Second priority liens on collateral securing loans that we make to our portfolio companies may be subject to control by senior creditors with first priority liens. If there is a default, the value of the collateral may not be sufficient to repay in full both the first priority creditors and us.*

Certain loans that we make are secured by a second priority security interest in the same collateral pledged by a portfolio company to secure senior debt owed by the portfolio company to commercial banks or other traditional lenders. Often the senior lender has procured covenants from the portfolio company prohibiting the incurrence of additional secured debt without the senior lender's consent. Prior to and as a condition of permitting the portfolio company to borrow money from us secured by the same collateral pledged to the senior lender, the senior lender will require assurances that it will control the disposition of any collateral in the event of bankruptcy or other default. In many such cases, the senior lender will require us to enter into an “intercreditor agreement” prior to permitting the portfolio company to borrow from us. Typically the intercreditor agreements we are requested to execute expressly subordinate our debt instruments to those held by the senior lender and further provide that the senior lender shall control: (1) the commencement of foreclosure or other proceedings to liquidate and collect on the collateral; (2) the nature, timing and conduct of foreclosure or other collection proceedings; (3) the amendment of any collateral document; (4) the release of the security interests in respect of any collateral; and (5) the waiver of defaults under any security agreement. Because of the control we may cede to senior lenders under intercreditor agreements we may enter, we may be unable to realize the proceeds of any collateral securing some of our loans.

## Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds*

While we did not engage in any sales of unregistered securities during the three months ended September 30, 2012, we issued a total of 16,949 shares of common stock under our dividend reinvestment plan (“DRIP”). This issuance was not subject to the registration requirements of the Securities Act of 1933. The aggregate value of the shares of our common stock issued under our DRIP was approximately \$133,000.

### Item 3. *Defaults Upon Senior Securities*

None.

**Item 4.**

***Mine Safety Disclosures***

Not Applicable.

**Item 5.**

***Other Information***

None.

**Item 6.**

***Exhibits***

Reference is made to the Exhibit List filed as a part of this report beginning on page E-1. Each of such exhibits is incorporated by reference herein.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

KCAP Financial, Inc.

Date:

November 9, 2012 By /s/ Dayl W. Pearson

Dayl W. Pearson  
*President and Chief Executive Officer*  
*(Principal Executive Officer)*

Date:

November 9, 2012 By /s/ Edward U. Gilpin

Edward U. Gilpin  
*Chief Financial Officer*  
*(Principal Financial and Accounting Officer)*

\* \* \* \* \*

## **Table of Contents**

### **Exhibit Index**

<b>Exhibit Number</b>	<b>Description of Document</b>
10.1	Employment Agreement between the Company and Dayl W. Pearson* (Incorporated by referenced to Exhibit k.2 to a registration statement on Form N-2 filed with the SEC on August 2, 2012).
10.2	Employment Agreement between the Company and Edward U. Gilpin* (Incorporated by reference to Exhibit 10.1 of the Current Report on Form 8-K filed with the SEC on June 5, 2012).
10.3	Employment Agreement between the Company and R. Jon Corless* (Incorporated by referenced to Exhibit k.4 to a registration statement on Form N-2 filed with the SEC on August 2, 2012).
10.4	Employment Agreement between Katonah Debt Advisors and E.A. Kratzman* (Incorporated by referenced to Exhibit k.5 to a registration statement on Form N-2 filed with the SEC on August 2, 2012).
10.5	Employment Agreement between Katonah Debt Advisors and Daniel P. Gilligan* (Incorporated by referenced to Exhibit k.6 to a registration statement on Form N-2 filed with the SEC on August 2, 2012).
31.1**	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2**	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of Chief Executive Officer Pursuant to 18 U. S. C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of Chief Financial Officer Pursuant to 18 U. S. C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Indicates a management contract or compensatory plan, contract or agreement.

\*\* Submitted herewith.