**As filed with the Securities and Exchange Commission on October 3, 2012**

**Registration No. 333-183032**

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

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**FORM N-2**

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**(Check appropriate box or boxes)**
**o REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**
**x Pre-Effective Amendment No. 1**
**o Post-Effective Amendment No.**

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# KCAP FINANCIAL, INC.

(Exact Name of Registrant as Specified in Charter)

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**295 Madison Avenue, 6th Floor**
**New York, New York 10017**
**(212) 455-8300**

(Address and Telephone Number of Principal Executive Offices)

**Dayl W. Pearson**
**President and Chief Executive Officer**
**KCAP Financial, Inc.**
**295 Madison Avenue, 6th Floor**
**New York, New York 10017**

(Name and Address of Agent for Service)

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***Copy to:***

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**Approximate Date of Proposed Public Offering:**
As soon as practicable after the effective date of this Registration Statement.

If any securities being registered on this form will be offered on a delayed or continuous basis in reliance on Rule 415 under the Securities Act of 1933, other than securities offered in connection with a dividend reinvestment plan, check the following box. o

**CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933**

| Title of Securities Being Registered | Amount Being Registered | Proposed Maximum Offering Price Per Note | Proposed Maximum Aggregate Offering Price[1] [2] | Amount of Registration Fee[3] |
|---|---|---|---|---|
| Senior Notes | $ 34,500,000 | 100% | $ 34,500,000 | $ 3,954 |

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(1) Estimated solely for the purposes of determining the registration fee pursuant to Rule 457(a) under the Securities Act, as amended (the "Securities Act").

(2) Includes senior notes that may be issued pursuant to the underwriters' option to purchase additional notes.

(3) The Registrant previously paid $23,220 in connection with its Registration Statement on Form N-2 (File No. 333-175939) filed with the Securities and Exchange Commission on September 21, 2011, pursuant to which no securities were issued. Pursuant to Rule 457(p) of the Securities Act, $3,954 of the previously paid fee amount is offset against the currently due filing fee. As a result, no filing fee is due in connection with this filing.

**The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until this Registration Statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.**

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The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

**Subject to Completion**
**Preliminary Prospectus Dated October 3, 2012**

KCAP FINANCIAL INC.

**$30,000,000**
**% Senior Notes due 2019**

We are an internally managed, non-diversified closed-end investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940, as amended (the "1940 Act"). We originate, structure and invest in senior secured term loans, mezzanine debt and selected equity securities primarily in privately-held middle market companies. In addition to our middle market investment business, our wholly-owned portfolio companies, Katonah Debt Advisors, L.L.C., Trimaran Advisors, L.L.C., and related affiliates controlled by us (collectively, our "Asset Manager Affiliates"), manage collateralized loan obligation funds ("CLO Funds") that invest in broadly syndicated loans, high-yield bonds and other corporate credit instruments.

Our investment objective is to generate current income and capital appreciation from the investments made by our middle market business. We also expect to receive distributions of recurring fee income and to generate capital appreciation from our investment in the asset management business of our Asset Manager Affiliates.

We are offering $30,000,000 in aggregate principal amount of % senior notes due 2019, which we refer to as the "Notes." The Notes will mature on September 30, 2019. We will pay interest on the Notes on March 30, June 30, September 30 and December 30 of each year, beginning on December 30, 2012. We may redeem the Notes in whole or in part at any time, or from time to time on or after September 30, 2015, at the redemption price of par, plus accrued interest, as discussed under the caption "Description of the Notes — Optional Redemption." The Notes will be issued in minimum denominations of $25 and integral multiples of $25 in excess thereof.

The Notes will be our direct senior unsecured obligations and rank pari passu with all outstanding and future unsecured unsubordinated indebtedness issued by us.

We intend to list the Notes on the New York Stock Exchange and we expect trading to commence thereon within 30 days of the original issue date under the trading symbol "KAP." The Notes are expected to trade "flat." This means that purchasers will not pay, and sellers will not receive, any accrued and unpaid interest on the Notes that is not included in the trading price. Currently, there is no public market for the Notes and there can be no assurance that one will develop.

Please read this prospectus before investing and keep it for future reference. This prospectus contains important information about us that a prospective investor should know before investing in our Notes. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission. This information is available free of charge by contacting us at 295 Madison Avenue, 6th Floor, New York, New York 10017, by telephone at (212) 455-8300, or on our website at *http://www.kcapinc.com*. The information on our website is not incorporated by reference into this prospectus, and you should not consider that information to be part of this prospectus. The SEC also maintains a website at *www.sec.gov* that contains such information.

**Investing in the Notes is speculative and involves numerous risks, including the risks associated with the use of leverage. For more information regarding these risks, please see "Risk Factors" beginning on page 16 of this prospectus.**

**Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or determined if either this prospectus or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.**

| | Per Note | Total |
|---|---|---|
| Public offering price | 100% | $ |
| Underwriting discount (sales load) | % | $ |
| Proceeds to us before expenses[1] | % | $ |

(1) Before deducting expenses payable by us related to this offering, estimated at $300,000.

The underwriters may also purchase up to an additional $4,500,000 total aggregate principal amount of Notes offered hereby, within 30 days of the date of this prospectus. If the underwriters exercise this option in full, the total public offering price will be $ , the total underwriting discount (sales load) paid by us will be $ , and total proceeds, before expenses, will be $ .

**THE NOTES ARE NOT DEPOSITS OR OTHER OBLIGATIONS OF A BANK AND ARE NOT INSURED BY THE FEDERAL DEPOSIT INSURANCE CORPORATION OR ANY OTHER GOVERNMENT AGENCY.**

Delivery of the Notes in book-entry form only through The Depository Trust Company will be made on or about , 2012.

**Stifel Nicolaus Weisel** **Barclays**
**Janney Montgomery Scott** **JMP Securities**
**Ladenburg Thalmann & Co. Inc.** **Sandler O'Neill + Partners, L.P.** **Wunderlich Securities**

**The date of this prospectus is , 2012.**

You should rely only on the information contained in this prospectus. We have not authorized any dealer, salesperson or other person to provide you with different information or to make representations as to matters not stated in this prospectus. If anyone provides you with different or inconsistent information, you should not rely on it. This prospectus is not an offer to sell, or a solicitation of an offer to buy, any securities by any person in any jurisdiction where it is unlawful for that person to make such an offer or solicitation or to any person in any jurisdiction to whom it is unlawful to make such an offer or solicitation. The information in this prospectus is accurate only as of the date of this prospectus, and under no circumstances should the delivery of this prospectus or the sale of any securities imply that the information in this prospectus is accurate as of any later date or that the affairs of KCAP Financial, Inc., have not changed since the date hereof or thereof. We will update the information in these documents to reflect material changes only as required by law. Our business, financial condition, results of operations and prospectus may have changed since then.

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KCAP Financial, Inc., our logo and other trademarks of KCAP Financial, Inc., mentioned in this prospectus are the property of KCAP Financial, Inc. All other trademarks or trade names referred to in this prospectus are the property of their respective owners.

## PROSPECTUS SUMMARY

*This summary highlights some of the information in this prospectus and may not contain all of the information that is important to you. You should read carefully the more detailed information set forth under "Risk Factors" and the other information included in this prospectus. In this prospectus, unless the context otherwise requires, "Company," "KCAP Financial," "we," "us" and "our" refer to KCAP Financial, Inc., in each case together with our wholly-owned portfolio companies Katonah Debt Advisors, L.L.C. and Trimaran Advisors, L.L.C. "Katonah Debt Advisors" refers to Katonah Debt Advisors, L.L.C. and related affiliates controlled by us. "Trimaran Advisors" refers to Trimaran Advisors, L.L.C. and related affiliates controlled by us.*

### Overview

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, which we refer to as "EBITDA," of $10 million to $50 million and/or total debt of $25 million to $150 million. In addition to our middle market investment business, Katonah Debt Advisors and Trimaran Advisors (collectively, our "Asset Manager Affiliates"), our wholly-owned portfolio companies, each manage collateralized loan obligation funds ("CLO Funds") that invest in broadly syndicated loans, high-yield bonds and other corporate credit instruments. Each of Katonah Debt Advisors and Trimaran Advisors are registered investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act").

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. We also expect to receive distributions of recurring fee income and to generate capital appreciation from our investments in the asset management businesses of our 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. 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 the CLO Funds managed by our Asset Manager Affiliates or by other asset managers.

We seek to manage risk through a rigorous credit and investment underwriting process and an active portfolio monitoring program. 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 were formed in August 2006. In December 2006, we completed our initial public offering ("IPO"), which raised net proceeds of approximately $200 million after the exercise of the underwriters' over-allotment option. In connection with our IPO, we issued an additional 3,484,333 shares of our common stock in exchange for the ownership interests of Katonah Debt Advisors and in securities issued by the CLO Funds managed by Katonah Debt Advisors and two other asset managers. On April 28, 2008, we completed a rights offering which resulted in the issuance of 3.1 million common shares and net proceeds of approximately $27 million. On February 29, 2012, we purchased Trimaran Advisors, a CLO manager similar to Katonah Debt Advisors. Contemporaneously with the acquisition of Trimaran Advisors, we acquired from Trimaran Advisors equity interests in certain CLO Funds managed by Trimaran Advisors. As of June 30, 2012, Katonah Debt Advisors and Trimaran Advisors had approximately $3.3 billion of par value assets under management. Katonah Debt Advisors and Trimaran Advisors are each managed independently from us by separate management teams and investment committees.

Including employees of our Asset Manager Affiliates, we employ an experienced team of 13 investment professionals and 27 total staff members. Dayl W. Pearson, our President and Chief Executive Officer ("CEO") and one of our directors, has been in the financial services industry for over 33 years. During the past 20 years, Mr. Pearson has focused almost exclusively in the middle market and has originated, structured and underwritten over $7 billion of debt and equity securities. R. Jon Corless, our Chief Investment Officer ("CIO"), has managed investment portfolios in excess of $4 billion at several institutions and has been responsible for managing portfolios of leveraged loans, high-yield bonds, mezzanine securities and middle market loans. Edward U. Gilpin, our Chief Financial Officer ("CFO"), Secretary and Treasurer, has significant experience in overseeing the financial reporting for asset management businesses, including the fair value accounting of CLO securities owned by them.

We are an internally managed, non-diversified closed-end investment company that has elected to be regulated as a business development company ("BDC") under the Investment Company Act of 1940, as amended (the "1940 Act"). Because we are internally managed by our executive officers under the supervision of our Board of Directors and do not depend on a third party investment advisor, we do not pay investment advisory fees and all of our income is available to pay our operating costs and to make distributions to our stockholders. As a BDC, we are required to comply with regulatory requirements, including limitations on our use of debt. We are permitted to, and expect to continue to, finance our investments through borrowings. However, as a BDC, we are only generally allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowing. The 1940 Act also generally prohibits us from declaring any cash dividend or distribution on any class of our capital stock if our asset coverage is below 200% at the time of the declaration of the dividend or distribution.

In addition, under the investment company rules and regulations pursuant to Article 6 of Regulation S-X and the "Audit and Accounting Guide for Investment Companies" issued by the American Institute of Certified Public Accountants (the "AICPA Guide"), we are precluded from consolidating portfolio company investments, including those in which we have a controlling interest, unless the portfolio company is another investment company. An exception to this general principle in the AICPA Guide occurs if we own a controlled operating company that provides all or substantially all of its services directly to us, or to an investment company of ours. None of the investments made by us qualify for this exception. Therefore, our portfolio investments, including our investments in the Asset Manager Affiliates, are carried on the balance sheet at fair value with any adjustments to fair value recognized as "Net Change in Unrealized Appreciation (Depreciation)" in our statement of operations until the investment is exited, resulting in any gain or loss on exit being recognized as a "Net Realized Gain (Loss) from Investments."

We have also elected to be treated for U.S. federal income tax purposes as a regulated investment company ("RIC") under subchapter M of the Internal Revenue Code of 1986, as amended (the "Code") and intend to operate in a manner to maintain our RIC tax treatment. Accordingly, we generally will not pay corporate-level federal income taxes on any net ordinary income or realized capital gains that we timely distribute to our shareholders as dividends. To maintain our RIC tax treatment, we must meet specified source-of-income and asset diversification requirements and distribute annually at least 90% of our net ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, for each year.

**Recent Developments**

In July 2012, we changed our corporate name to KCAP Financial, Inc. from Kohlberg Capital Corporation.

In September 2012, our Board of Directors declared a quarterly cash dividend of $0.24 per share of common stock for the quarter ending September 30, 2012. The dividend is payable on October 29, 2012 to shareholders of record at the close of business as of October 10, 2012.

As of October 1, 2012, we had $28 million outstanding under a $30 million financing facility through an arrangement with Credit Suisse AG (the "Facility") that we entered into through our special-purpose bankruptcy remote wholly-owned subsidiary KCAP Funding.

**Investment Portfolio**

Our investment portfolio generates net investment income, which is generally used to pay principal and interest on our borrowings and to fund our dividends. Our investment portfolio consists of three primary components: debt securities, CLO fund securities and our investment in our wholly owned Asset Manager Affiliates. As of June 30, 2012, we also had investments in equity securities of approximately $7.7 million, which comprises approximately 2.6% of our investment portfolio. 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.

Through our middle market investment business, we invest in senior secured loans, mezzanine debt and, to a lesser extent, equity, of middle market companies in a variety of industries. We target middle market companies that have strong historical cash flows, experienced management teams and identifiable and defendable market positions in industries with positive dynamics. We generally target companies that generate positive cash flows because we look to cash flows as the primary source for servicing debt.

We may invest up to 30% of our investment portfolio in opportunistic investments in high-yield bonds, debt and equity securities of the CLO Funds, distressed debt or equity securities of public companies. In this regard, we typically make a minority investment in the subordinated securities or preferred stock of the CLO Funds raised and managed by our Asset Manager Affiliates and may selectively invest in securities issued by the CLO Funds managed by other asset management companies. 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. The underlying assets in the CLO Funds exclude mortgage pools or mortgage securities (residential mortgage bonds, commercial mortgage backed securities, or related asset-backed securities), debt to companies providing mortgage lending and emerging markets investments.

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. As of June 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 $73 million.

We expect to continue to benefit from our ownership of our Asset Manager Affiliates in four ways. First, by working with the investment professionals at our Asset Manager Affiliates, we have multiple sources of investment opportunities. Second, the experienced team of credit analysts at our Asset Manager Affiliates, have specializations covering more than 20 industry groups and they assist us in reviewing potential investments and monitoring our portfolio. Third, we may continue to make investments in the CLO Funds or other funds managed by our Asset Manager Affiliates, which we believe will provide us with a current cash investment return. Fourth, we expect to continue to receive distributions of recurring fee income and the potential to generate capital appreciation from our investment in our Asset Manager Affiliates as the platform grows.

As the managers 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 of the CLO Funds managed by Asset Manager Affiliates are paying both their senior and subordinated management fees on a current basis.

In future years, our Asset Manager Affiliates may receive accrued incentive fees from the 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 the 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. We also expect to receive distributions of recurring fee income and, if debt markets stabilize and recover, to generate capital appreciation from our investment in the asset management business of our Asset Manager Affiliates.

Below are summary attributes for each of our primary investment portfolio components as of and for the six months ended June 30, 2012:

***Debt Securities***

- represent approximately 47% of total investment portfolio;
- represent credit instruments issued by corporate borrowers;
- primarily senior secured and junior secured loans (49% and 30% of debt securities, respectively);
- spread across 24 different industries and 58 different entities;
- average balance per investment of approximately $2 million;
- all but four issuers (representing less than 1% of total investments at fair value) are current on their debt service obligations; and
- weighted average interest rate of 8.3% on income producing debt investments.

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

- represent approximately 21% of total assets at June 30, 2012;
- 89% of CLO Fund securities represent investments in subordinated securities or equity securities issued by the CLO Funds and 11% of CLO Fund securities are rated notes;
- all of the CLO Funds invest primarily in credit instruments issued by corporate borrowers;
- thirteen different CLO Fund securities; ten 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 $2,000, are not currently providing a dividend payment to us.

***Asset Manager Affiliates***

- represent approximately 24% of the 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 Asset Manager Affiliates are recognized as dividend income from affiliate asset managers in our statement of operations and are an additional source of income to pay our dividend;
- for the six months ended June 30, 2012, our Asset Manager Affiliates had EBITDA of approximately $1.3 million; and
- for the six months ended June 30, 2012, our Asset Manager Affiliates made a distribution of approximately $2.0 to the Company in the form of a dividend which is recognized as current earnings to the Company.

**COMPETITIVE ADVANTAGES**

We believe that we can successfully compete with other providers of capital in the markets in which we compete for the following reasons:

- ***Internally managed structure and significant management resources***. We are internally managed by our executive officers under the supervision of our Board of Directors and do not depend on a third party investment advisor. As a result, we do not pay investment advisory fees and all of our income is available to pay our operating costs, which include employing investment and portfolio management professionals, and to make distributions to our stockholders. We believe that our internally managed structure provides us with a beneficial operating expense structure when compared to other publicly traded and privately-held investment firms which are externally managed, and our internally managed structure allows us the opportunity to leverage our non-interest operating expenses as we grow our investment portfolio.
- ***Multiple sourcing capabilities for assets***. We have multiple sources of loans, mezzanine investments and equity investments through our industry relationships.
- ***Disciplined investment process***. We employ a rigorous credit review and due diligence process which our senior management has developed over more than 20 years of lending. For each analyzed company, we develop our own underwriting case and multiple stress case scenarios and an event-specific financial model reflecting company, industry and market variables.
- ***Investments in a wide variety of portfolio companies in a number of different industries with no exposure to mortgage-backed securities***. Our investment portfolio (excluding our investments in our Asset Manager Affiliates and CLO Fund securities) is spread across 25 different industries and 56 different entities with an average balance per investment of approximately $2 million.
- ***Significant equity ownership and alignment of incentives***. Our senior management team and the senior management team of our Asset Manager Affiliates together have a significant equity interest in the Company, ensuring that their incentives are strongly aligned with those of our stockholders.

**RISK FACTORS**

Investing in us involves significant risks. The following is a summary of certain risks that you should carefully consider before investing in us. For a further discussion of these risk factors, please see “Risk Factors” beginning on page 16.

**Risks Related to Our Business and Structure**

- We are dependent upon our senior management for our future success, and if we are unable to hire and retain qualified personnel or if we lose any member of our senior management team, our ability to achieve our investment objective could be significantly harmed.
- We operate in a highly competitive market for investment opportunities.
- If we are unable to source investments effectively, we may be unable to achieve our investment objective.
- 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 may have difficulty paying our required distributions if we recognize income before or without receiving cash equal to such income.
- We may incur losses as a result of "first loss" agreements into which we or our Asset Manager Affiliates may in the future enter into in connection with warehousing credit arrangements which we may put in place prior to raising a CLO Fund and pursuant to which we would typically agree to reimburse credit providers for a portion of losses (if any) on warehouse investments.
- Any unrealized losses we experience on our loan portfolio may be an indication of future realized losses, which could reduce our income available to make interest and principal payments on the Notes.
- We may experience fluctuations in our quarterly and annual operating results and credit spreads.
- We are exposed to risks associated with changes in interest rates and spreads.
- We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us.
- All of the investments originated with funds drawn under the Facility will be subject to security interests under Facility and if we default on our obligations thereunder, we may suffer adverse consequences, including the lender foreclosing on those investments. In addition, we have pledged and granted a security interest to the lender under the Facility in our right, title and interest in, to and under the senior management fees and subordinated management fees paid to us by certain CLO Funds managed by Trimaran Advisors.
- Our indebtedness could adversely affect our financial health and our ability to respond to changes in our business.
- Pending legislation may allow us to incur additional leverage.
- If market constraints prevent us from obtaining debt or additional equity capital, our liquidity could be adversely affected, our business prospects could be negatively impacted, we could lose key employees and our operating results could be negatively affected.
- Because we intend to continue to distribute substantially all of our income and net realized capital gains to our stockholders, we will need additional capital to finance our growth.
- We may from time to time expand our business through acquisitions, which could disrupt our business and harm our financial condition.
- Our Board of Directors may change our investment objective, operating policies and strategies without prior notice or stockholder approval.
- Our businesses may be adversely affected by litigation and regulatory proceedings, including those that are currently pending.
- A failure on our part to maintain our status as a BDC would significantly reduce our operating flexibility.
- Regulations governing our operation as a BDC affect our ability to, and the way in which we, raise additional capital.
- Changes in the laws or regulations governing our business and the business of our Asset Manager Affiliates, or changes in the interpretations thereof, and any failure by us or our Asset Manager Affiliates to comply with these laws or regulations, could negatively affect the profitability of our operations.
- If we do not invest a sufficient portion of our assets in "qualifying assets," or comply with certain exemptive relief granted by the SEC, we could fail to qualify as a BDC or be precluded from investing according to our current business strategy.

- We will be subject to corporate-level income tax if we are unable to maintain our qualification as a RIC under Subchapter M of the Code.

**Risks Related to Our Investments**

- Our investments may be risky, and you could lose all or part of your investment.
- Our portfolio investments for which there is no readily available market, including our investment in our Asset Manager Affiliates and our investments in CLO Funds, are recorded at fair value as determined in good faith by our Board of Directors. As a result, there is uncertainty as to the value of these investments.
- We are a non-diversified investment company within the meaning of the 1940 Act, and therefore we may invest a significant portion of our assets in a relatively small number of issuers, which subjects us to a risk of significant loss if any of these issuers defaults on its obligations under any of its debt instruments or as a result of a downturn in the particular industry.
- Economic recessions or downturns could negatively impact our portfolio companies and harm our operating results.
- Defaults by our portfolio companies could harm our operating results.
- When we are a debt or minority equity investor in a portfolio company, which generally is the case, we may not be in a position to control the entity, and its management may make decisions that could decrease the value of our investment.
- Prepayments of our debt investments by our portfolio companies could negatively impact our operating results.
- Our portfolio companies may incur debt that ranks equal with, or senior to, our investments in such companies.
- 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.
- There may be circumstances where our debt investments could be subordinated to claims of other creditors or we could be subject to lender liability claims.
- Our investments in equity securities involve a substantial degree of risk.
- The lack of liquidity in our investments may adversely affect our business.
- We may not receive all or a portion of the income we expect to continue to receive from our Asset Manager Affiliates.
- We may not receive any return on our investment in the CLO Funds in which we have invested and we may be unable to raise additional CLO Funds.

**Risks Related to Our Notes**

- The Notes will be unsecured and therefore will be effectively subordinated to any secured indebtedness we have currently incurred or may incur in the future.
- The Notes will be structurally subordinated to the indebtedness and other liabilities of our subsidiaries and the portfolio companies with respect to which we hold equity investments, including the Asset Manager Affiliates.
- The indenture under which the Notes will be issued contains limited protection for holders of the Notes.
- There is no existing trading market for the Notes and, even if the NYSE approves the listing of the Notes, an active trading market for the Notes may not develop, which could limit the market price of the Notes or your ability to sell them.

- If we default on our obligations to pay our other indebtedness, we may not be able to make payments on the Notes.
- We may be unable to invest a significant portion of the net proceeds from this offering, which could harm our financial condition and operating results.

**Our Corporate Information**

Our principal executive offices are located at 295 Madison Avenue, 6th Floor, New York, New York 10017, and our telephone number is (212) 455-8300. We maintain a website on the Internet at *http://www.kcapinc.com*. Information contained in our website is not incorporated by reference into this prospectus, and you should not consider that information to be part of this prospectus.

As a public company, we file with or submit to the SEC annual, quarterly and current periodic reports, proxy statements and other information meeting the informational requirements of the Securities Exchange Act of 1934. This information is available free of charge by contacting us directly at the locations described above. You may also inspect and copy these reports, proxy statements and other information, as well as the registration statement of which this prospectus forms a part and the related exhibits and schedules, at the Public Reference Room of the SEC at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Copies of these reports, proxy and information statements and other information may be obtained, after paying a duplicating fee, by electronic request at the following e-mail address: publicinfo@sec.gov, or by writing the SEC's Public Reference Section, Washington, D.C. 20549-0102. In addition, the SEC maintains an Internet website that contains reports, proxy and information statements and other information filed electronically by us with the SEC at *http://www.sec.gov*.

## SPECIFIC TERMS OF THE NOTES AND THE OFFERING

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| Issuer | KCAP Financial, Inc. |
| Title of the securities | % Senior Notes due 2019 |
| Initial aggregate principal amount being offered | $30,000,000 |
| Option to purchase additional notes | The underwriters may also purchase from us from time to time up to an additional $4,500,000 aggregate principal amount of Notes within 30 days of the date of this prospectus. |
| Initial public offering price | 100% of the aggregate principal amount |
| Principal payable at maturity | 100% of the aggregate principal amount; the principal amount of each Note will be payable on its stated maturity date at the office of the Trustee, Paying Agent, Registrar and Transfer Agent for the Notes or at such other office in New York, New York as we may designate. |
| Type of Note | Fixed rate note |
| Listing | We intend to list the Notes on the New York Stock Exchange, within 30 days of the original issue date under the trading symbol “KAP.” |
| Interest Rate | % per year |
| Day count basis | 360-day year of twelve 30-day months |
| Original issue date | , 2012 |
| Stated maturity date | September 30, 2019 |
| Date interest starts accruing | , 2012 |
| Interest payment dates | Every March 30, June 30, September 30 and December 30, beginning December 30, 2012. If an interest payment date falls on a non-business day, the applicable interest payment will be made on the next business day and no additional interest will accrue as a result of such delayed payment. |
| Interest periods | The initial interest period will be the period from and including , 2012, to, but excluding, the initial interest payment date, and the subsequent interest periods will be the periods from and including an interest payment date to, but excluding, the next interest payment date or the stated maturity date, as the case may be. |
| Regular record dates for interest | March 15, June 15, September 15 and December 15 beginning December 15, 2012. |
| Specified currency | U.S. Dollars |
| Place of payment | New York City |
| Ranking of Notes | The Notes will be our direct unsecured obligations and will rank:<br>• *pari passu* with our existing and future senior |

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| | unsecured indebtedness, including our 8.75% convertible senior notes due 2016;<br>• senior to any of our future indebtedness that expressly provides it is subordinated to the Notes;<br>• effectively subordinated to all of our existing and future secured indebtedness (including indebtedness that is initially unsecured to which we subsequently grant security), to the extent of the value of the assets securing such indebtedness; and<br>• structurally subordinated to all existing and future indebtedness and other obligations of any of our subsidiaries and portfolio companies with respect to which we hold equity investments, including, without limitation, indebtedness of KCAP Funding (including the Facility), or the Asset Manager Affiliates. |
| Denominations | We will issue the Notes in denominations of $25 and integral multiples of $25 in excess thereof. |
| Business day | Each Monday, Tuesday, Wednesday, Thursday and Friday that is not a day on which banking institutions in New York City are authorized or required by law or executive order to close. |
| Optional redemption | The Notes may be redeemed in whole or in part at any time or from time to time at our option on or after September 30, 2015 upon not less than 30 days nor more than 60 days written notice by mail prior to the date fixed for redemption thereof, at a redemption price of 100% of the outstanding principal amount of the Notes to be redeemed plus accrued and unpaid interest payments otherwise payable thereon for the then-current quarterly interest period accrued to the date fixed for redemption.<br>You may be prevented from exchanging or transferring the Notes when they are subject to redemption. In case any Notes are to be redeemed in part only, the redemption notice will provide that, upon surrender of such Note, you will receive, without a charge, a new Note or Notes of authorized denominations representing the principal amount of your remaining unredeemed Notes.<br>Any exercise of our option to redeem the Notes will be done in compliance with the 1940 Act.<br>If we redeem only some of the Notes, the Trustee will determine the method for selection of the particular Notes to be redeemed, in accordance with the 1940 Act, and in accordance with the rules of any national securities exchange or quotation system on which the Notes are listed. Unless we default in payment of the redemption |

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| | price, on and after the date of redemption, interest will cease to accrue on the Notes called for redemption. |
| Sinking fund | The Notes will not be subject to any sinking fund. |
| Repayment at option of Holders | Holders will not have the option to have the Notes repaid prior to the stated maturity date. |
| Defeasance | The Notes are subject to defeasance by us. |
| Covenant defeasance | The Notes are subject to covenant defeasance by us. |
| Form of Notes | The Notes will be represented by global securities that will be deposited and registered in the name of The Depository Trust Company ("DTC") or its nominee. This means that, except in limited circumstances, you will not receive certificates for the Notes. Beneficial interests in the Notes will be represented through book-entry accounts of financial institutions acting on behalf of beneficial owners as direct and indirect participants in DTC. Investors may elect to hold interests in the Notes through either DTC, if they are a participant, or indirectly through organizations that are participants in DTC. |
| Trustee, Paying Agent, Registrar, and Transfer Agent | U.S. Bank National Association |
| Other covenants | In addition to any covenants described elsewhere in this prospectus, the following covenants shall apply to the Notes:<br>• We agree that for the period of time during which the Notes are outstanding, we will not violate (regardless of whether we are subject to) Section 18(a)(1)(A) as modified by Section 61(a)(1) of the 1940 Act or any successor provisions. These provisions generally prohibit us from making additional borrowings, including through the issuance of additional debt or the sale of additional debt securities, unless our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowings.<br>• We agree that for the period of time during which the Notes are outstanding, we will not violate (regardless of whether we are subject to) Section 18(a)(1)(B) as modified by Section 61(a)(1) of the 1940 Act or any successor provisions. These provisions generally prohibit us from declaring any cash dividend or distribution upon any class of our capital stock, or purchasing any such capital stock if our asset coverage, as defined in the 1940 Act, is below 200% at the time of the declaration of the dividend or distribution or the purchase and after deducting the amount of such dividend, distribution or purchase. |

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| | • We agree that, if, at any time, we are not subject to the reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934, or the Exchange Act, to file any periodic reports with the SEC, we agree to furnish to holders of the Notes and the Trustee, for the period of time during which the Notes are outstanding, our audited annual consolidated financial statements, within 90 days of our fiscal year end, and unaudited interim consolidated financial statements, within 45 days of our fiscal quarter end (other than our fourth fiscal quarter). All such financial statements will be prepared, in all material respects, in accordance with applicable United States generally accepted accounting principles. |
| Events of default | You will have rights if an Event of Default occurs with respect to the Notes and is not cured.<br><br>The term “Event of Default” in respect of the Notes means any of the following:<br><br>• We do not pay the principal of any Note on its due date.<br><br>• We do not pay interest on any Note when due, and such default is not cured within 30 days.<br><br>• We remain in breach of any other covenant with respect to the Notes for 60 days after we receive a written notice of default stating we are in breach. The notice must be sent by either the Trustee or holders of at least 25.0% of the principal amount of the Notes.<br><br>• The default by us with respect to any mortgage, agreement or other instrument under which there may be outstanding, or by which there may be secured or evidenced, any indebtedness for money borrowed in excess of $10 million in the aggregate (i) resulting in such indebtedness becoming or being declared due and payable or (ii) constituting a failure to pay the principal or interest of any such debt when due and payable at its stated maturity, upon required repurchase, upon declaration of acceleration or otherwise, unless such default is not cured within 30 days;<br><br>• A final judgment for the payment of $15 million or more (excluding any amounts covered by insurance) rendered against us, which judgment is not discharged or stayed within 60 days after (i) the date on which the right to appeal thereof has expired if no such appeal has commenced, or (ii) the date on which all rights to appeal have been extinguished; |

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| | • We file for bankruptcy or certain other events of bankruptcy, insolvency or reorganization occur and in the case of certain orders or decrees entered against us under any bankruptcy law, such order or decree remains undischarged or unstayed for a period of 90 days.<br>• On the last business day of each of twenty-four consecutive calendar months, the Notes have an asset coverage, as defined in the 1940 Act, of less than 100%. |
| Global Clearance and Settlement Procedures | Interests in the Notes will trade in DTC's Same Day Funds Settlement System, and any permitted secondary market trading activity in such Notes will, therefore, be required by DTC to be settled in immediately available funds. None of the Company, the Trustee or the Paying Agent will have any responsibility for the performance by DTC or its participants or indirect participants of their respective obligations under the rules and procedures governing their operations. |
| Use of Proceeds | We estimate that the net proceeds we receive from the sale of the Notes will be approximately $ million ($ million if the underwriters exercise their option to purchase additional Notes in full) after deducting underwriting discounts and commissions and estimated offering expenses. We expect to use the net proceeds from this offering for general corporate purposes, which include investing in portfolio companies and CLO funds in accordance with our investment objective and strategies described elsewhere in this prospectus. See "Use of Proceeds." |

## SELECTED FINANCIAL AND OTHER DATA

The following selected financial and other data for the years ended December 31, 2011, 2010, 2009, 2008 and 2007 is derived from our audited financial statements and financial highlights, and the following selected financial and other data for the six-month periods ended June 30, 2012 and 2011 is derived from our unaudited financial statements. The data should be read in conjunction with our financial statements and notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations," which are included in this prospectus. The historical data is not necessarily indicative of results to be expected for any future period.

| | Six months Ended June 30, 2012 | Six months Ended June 30, 2011 | Year Ended December 31, 2011 | Year Ended December 31, 2010 | Year Ended December 31, 2009 | Year Ended December 31, 2008 | Year Ended December 31, 2007[1] |
|---|---|---|---|---|---|---|---|
| **Income Statement Data:** | | | | | | | |
| Interest and related portfolio income: | | | | | | | |
| Interest and Dividends | $ 14,841,540 | $ 10,693,570 | $ 24,010,467 | $ 24,638,631 | $ 33,497,213 | $ 46,208,978 | $ 37,219,713 |
| Fees and other income | 161,605 | 29,508 | 86,057 | 215,233 | 399,338 | 1,653,232 | 759,301 |
| Dividends from affiliate asset managers | 2,025,000 | 650,000 | 1,910,000 | 4,500,000 | — | 1,350,000 | 500,000 |
| Other Income | — | 2,000,000 | 2,000,000 | — | — | — | — |
| Total interest and related portfolio income | 16,883,145 | 13,373,078 | 28,006,524 | 29,353,864 | 33,896,551 | 49,212,210 | 38,479,014 |
| Expenses: | | | | | | | |
| Interest and amortization of debt issuance costs | 3,088,638 | 1,727,230 | 4,588,482 | 7,088,202 | 9,276,563 | 10,925,624 | 7,229,597 |
| Compensation | 2,021,710 | 2,176,569 | 3,907,900 | 3,322,895 | 3,222,604 | 3,940,638 | 4,104,761 |
| Other | 2,129,696 | 1,828,566 | 3,490,939 | 7,045,648 | 3,066,729 | 3,640,031 | 4,385,707 |
| Total operating expenses | 7,240,044 | 5,732,365 | 11,987,321 | 17,456,745 | 15,565,896 | 18,506,293 | 15,720,065 |
| **Net Investment Income** | 9,643,101 | 7,640,713 | 16,019,203 | 11,897,119 | 18,330,655 | 30,705,917 | 22,758,949 |
| Realized and unrealized gains (losses) on investments: | | | | | | | |
| Net realized gains (losses) | 304,421 | (13,759,815) | (18,476,608) | (17,862,984) | (15,782,121) | (575,179) | 266,317 |
| Net change in unrealized gains (losses) | (7,144,571) | 16,597,564 | 10,106,949 | (8,322,812) | 31,854,736 | (93,414,146) | 3,116,719 |
| Total net gains (losses) | (7,448,992) | 2,837,749 | (8,369,659) | (26,185,796) | 16,072,615 | (93,989,325) | 3,383,036 |
| Net increase (decrease) in net assets resulting from operations | $ 2,194,109 | $ 10,478,462 | $ 7,649,544 | $(14,288,677) | $ 34,403,270 | $(63,283,408) | $ 26,141,985 |
| **Per Share:** | | | | | | | |
| Earnings per common share – basic | $ 0.09 | $ 0.46 | $ 0.33 | $ (0.64) | $ 1.56 | $ (3.09) | $ 1.45 |
| Earnings per common share – diluted | $ 0.09 | $ 0.46 | $ 0.33 | $ (0.64) | $ 1.56 | $ (3.09) | $ 1.45 |
| Net investment income per share – basic | $ 0.38 | $ 0.33 | $ 0.70 | $ 0.53 | $ 0.83 | $ 1.50 | $ 1.27 |
| Net investment income per share – diluted | $ 0.38 | $ 0.33 | $ 0.70 | $ 0.53 | $ 0.83 | $ 1.50 | $ 1.27 |

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| | Six months Ended June 30, 2012 | Six months Ended June 30, 2011 | Year Ended December 31, 2011 | Year Ended December 31, 2010 | Year Ended December 31, 2009 | Year Ended December 31, 2008 | Year Ended December 31, 2007[1] |
|---|---|---|---|---|---|---|---|
| Dividends declared per common share | $ 0.42 | $ 0.34 | $ 0.70 | $ 0.68 | $ 0.92 | $ 1.44 | $ 1.40 |
| **Balance Sheet Data:** | | | | | | | |
| Investment assets at fair value | $298,570,562 | $254,265,816 | $239,791,687 | $191,186,296 | $409,105,621 | $460,509,190 | $521,006,947 |
| Total assets | $306,245,762 | $260,778,603 | $248,133,661 | $279,822,686 | $439,416,057 | $469,156,229 | $533,141,959 |
| Total debt outstanding | $ 60,000,000 | $ 60,000,000 | $ 60,000,000 | $ 86,746,582 | $218,050,363 | $261,691,148 | $255,000,000 |
| Stockholders' equity | $204,160,309 | $194,591,919 | $180,525,942 | $186,925,667 | $213,895,724 | $196,566,018 | $259,068,164 |
| Net asset value per common share | $ 7.66 | $ 8.52 | $ 7.85 | $ 8.21 | $ 9.56 | $ 9.03 | $ 14.38 |
| Common shares outstanding | 26,664,132 | 22,841,172 | 22,992,211 | 22,767,130 | 22,363,281 | 21,776,519 | 18,017,699 |
| **Other Data:** | | | | | | | |
| Investments funded[2] | 45,165,857 | 49,157,362 | 85,541,809 | 11,245,300 | 23,482,349 | 109,442,643 | 373,852,286 |
| Principal collections related to investment repayments or sales[2] | $ 28,702,332 | $ 34,986,970 | $ 81,681,314 | $223,103,170 | $ 84,503,183 | $ 72,345,600 | $104,037,559 |
| Number of portfolio investments at period end[2] | 94 | 62 | 68 | 58 | 124 | 149 | 145 |
| Weighted average yield of income producing debt investments[3] | 8.3% | 8.1% | 8.4% | 8.6% | 6.5% | 7.0% | 9.5% |

(1) Certain prior year amounts have been reclassified to conform to current year presentation.

(2) Does not include investments in time deposits or money markets.

(3) Weighted average yield of income producing debt investments is calculated as the average yield to par outstanding balances for investments in loans and mezzanine debt. The yields on CLO Fund securities and investment in our wholly-owned portfolio managers, Katonah Debt Advisors and Trimaran Advisors, are excluded.

## RISK FACTORS

*Investing in our Notes involves a high degree of risk. Before you invest in our Notes, you should be aware of various significant risks, including those described below. You should carefully consider these risks, together with all of the other information included in this prospectus, before you decide whether to make an investment in our Notes. The risks set forth below are not the only risks we face. If any of the following risks occur, our business, financial condition and results of our operations could be materially adversely affected. In such case, you could lose all or part of your investment.*

### Risks Related to Our Business and Structure

***We are dependent upon our senior management for our future success, and if we are unable to hire and retain qualified personnel or if we lose any member of our senior management team, our ability to achieve our investment objective could be significantly harmed.***

We depend on the members of our senior management as well as other key personnel for the identification, final selection, structuring, closing and monitoring of our investments. These employees have critical industry experience and relationships that we rely on to implement our business plan. Our future success depends on the continued service of our senior management team. The departure of any of the members of our senior management or a significant number of our senior personnel could have a material adverse effect on our ability to achieve our investment objective. As a result, we may not be able to operate our business as we expect, and our ability to compete could be harmed, which could cause our operating results to suffer.

***We operate in a highly competitive market for investment opportunities.***

A large number of entities compete with us to make the types of investments that we plan to make in prospective portfolio companies. We compete with other BDCs, as well as a large number of investment funds, investment banks and other sources of financing, including traditional financial services companies, such as commercial banks and finance companies. Many of our competitors are substantially larger and have considerably greater financial, technical, marketing and other resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources that are not available to us. This may enable some of our competitors to make commercial loans with interest rates that are comparable to or lower than the rates we typically offer. We may lose prospective portfolio investments if we do not match our competitors' pricing, terms and structure. If we do match our competitors' pricing, terms or structure, we may experience decreased net interest income. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments, establish more relationships and build their market shares. Furthermore, many of our potential competitors have greater experience operating under, or are not subject to, the regulatory restrictions that the 1940 Act imposes on us as a BDC. As a result of this competition, there can be no assurance that we will be able to identify and take advantage of attractive investment opportunities or that we will be able to fully invest our available capital. If we are not able to compete effectively, our business and financial condition and results of operations will be adversely affected.

***If we are unable to source investments effectively, we may be unable to achieve our investment objective.***

Our ability to achieve our investment objective depends on our senior management team's ability to identify, evaluate and invest in suitable companies that meet our investment criteria. Accomplishing this result on a cost-effective basis is largely a function of our marketing capabilities, our management of the investment process, our ability to provide efficient services and our access to financing sources on acceptable terms. In addition to monitoring the performance of our existing investments, members of our management team and our investment professionals may also be called upon to provide managerial assistance to our portfolio companies. These demands on their time may distract them or slow the rate of investment. To grow, we need to continue to hire, train, supervise and manage new employees and to implement computer and other systems capable of effectively accommodating our growth. However, we cannot provide assurance that any such employees will contribute to the success of our business or that we will implement such systems effectively. Failure to manage our future growth effectively could have a material adverse effect on our business, financial condition and results of operations.

***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.

***We may have difficulty paying our required distributions if we recognize income before or without receiving cash equal to such income.***

In accordance with the Code, we include in income certain amounts that we have not yet received in cash, such as contracted non-cash PIK interest, which represents contractual interest added to the loan balance and due at the end of the loan term. The increases in loan balances as a result of contracted non-cash PIK arrangements are included in income for the period in which such non-cash PIK interest was received, which is often in advance of receiving cash payment, and are separately identified on our statements of cash flows. We also may be required to include in income certain other amounts that we will not receive in cash. Any warrants that we receive in connection with our debt investments generally are valued as part of the negotiation process with the particular portfolio company. As a result, a portion of the aggregate purchase price for the debt investments and warrants is allocated to the warrants that we receive. This generally results in the associated debt investment having "original issue discount" for tax purposes, which we must recognize as ordinary income as it accrues. This increases the amounts we are required to distribute to qualify as a RIC eligible for pass-through tax treatment. Because such original issue discount income might exceed the amount of cash received in a given year with respect to such investment, we might need to obtain cash from other sources to satisfy such distribution requirements. Other features of the debt instruments that we hold may also cause such instruments to generate original issue discount.

Since in certain cases we may recognize income before or without receiving cash representing such income, we may have difficulty meeting the requirement to annually distribute at least 90% of our net ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any. If we are unable to meet these distribution requirements, we will not maintain our qualification for tax treatment as a RIC. Accordingly, we may have to sell some of our assets, raise additional debt or equity securities or reduce new investment originations to meet these distribution requirements. See "Material United States Federal Income Tax Considerations."

***We may incur losses as a result of "first loss" agreements into which we or our Asset Manager Affiliates may in the future enter into in connection with warehousing credit arrangements which we may put in place prior to raising a CLO Fund and pursuant to which we would typically agree to reimburse credit providers for a portion of losses (if any) on warehouse investments.***

We and our Asset Manager Affiliates have in the past entered, and may in the future enter, into "first loss" agreements in connection with warehouse credit lines to be established by our Asset Manager Affiliates to fund the initial accumulation of loan investments for future CLO Funds that our Asset Manager Affiliates will manage. Such agreements (referred to as "first loss agreements" or "first loss obligations") frequently relate to (i) losses as a result of individual loan investments being ineligible for purchase by the CLO Fund (typically due to a payment default on such loan) when such fund formation is completed or (ii) if the CLO Fund has not been completed before the expiration of the warehouse credit line, the loss (if any, and net of any accumulated interest income) on the resale of such loans funded by the warehouse credit line. As a result, we may incur losses if loans and debt obligations that had been purchased in the warehouse facility become ineligible for inclusion in the CLO Fund or if a planned CLO Fund does not close.

***Any unrealized losses we experience on our loan portfolio may be an indication of future realized losses, which could reduce our income available to make interest and principal payments on the Notes.***

As a BDC, we are required to carry our investments at market value or, if no market value is ascertainable, at the fair value as determined in good faith by our Board of Directors pursuant to a valuation methodology approved by our Board of Directors. Decreases in the market values or fair values of our investments will be recorded as unrealized losses. An unrealized loss in our loan portfolio could be an indication of a portfolio company's inability to meet its repayment obligations with respect to the affected loans. This could result in realized losses in the future and ultimately in reductions of our income available to make interest and principal payments on the Notes.

***We may experience fluctuations in our quarterly and annual operating results and credit spreads.***

We could experience fluctuations in our quarterly and annual operating results due to a number of factors, some of which are beyond our control, including our ability to make investments in companies that meet our investment criteria, the interest rate payable on the debt securities we acquire, the default rate on such securities, our level of expenses, variations in and timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets and general economic conditions. As a result of these factors, results for any period should not be relied upon as being indicative of performance in future periods.

***We are exposed to risks associated with changes in interest rates and spreads.***

Changes in interest rates may have a substantial negative impact on our investments, the value of our securities and our rate of return on invested capital. A reduction in the interest spreads on new investments could also have an adverse impact on our net interest income. An increase in interest rates could decrease the value of any investments we hold which earn fixed interest rates, including mezzanine securities and high-yield bonds, and also could increase our interest expense, thereby decreasing our net income. An increase in interest rates due to an increase in credit spreads, regardless of general interest rate fluctuations, could also negatively impact the value of any investments we hold in our portfolio.

***We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us.***

Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in the Notes. We have issued senior securities, and in the future may borrow from, or issue additional senior securities (such as preferred or convertible securities or debt securities) to, banks and other lenders and investors. 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. Lenders and holders of such senior securities have fixed dollar claims on our consolidated assets that may be superior to the claims of the holders of the Notes. Leverage is generally considered a speculative investment technique. Any increase in our consolidated income in excess of consolidated interest payable on our outstanding indebtedness would cause our net income to increase more than it would have had we not incurred leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not incurred leverage. Such a decline could negatively affect our ability to make interest and principal payments of the Notes. There can be no assurance that our leveraging strategy will be successful.

As of June 30, 2012, we had $60 million in aggregate principal amount of our 8.75% convertible senior notes due 2016 outstanding, which we refer to as the Convertible Senior Notes. As of June 30, 2012, there was an outstanding balance of $21.5 million under the Facility. As of October 1, 2012, we had $28 million outstanding under the Facility. We may incur additional indebtedness in the future, although there can be no assurance that we will be successful in doing so. Our ability to service our debt depends largely on our financial performance and is subject to prevailing economic conditions and competitive pressures. The amount of leverage that we employ at any particular time will depend on our management's and our Board of Directors' assessment of market and other factors at the time of any proposed borrowing.

Our convertible senior notes and the Facility impose, and additional debt we may incur in the future will likely impose, financial and operating covenants that restrict our business activities, including limitations that

could hinder our ability to finance additional loans and investments or to make the distributions required to maintain our status as a RIC. A failure to add new debt facilities or issue additional debt securities or other evidences of indebtedness in lieu of or in addition to existing indebtedness could have a material adverse effect on our business, financial condition or results of operations.

***All of the investments originated with funds drawn under the Facility will be subject to security interests under Facility and if we default on our obligations thereunder, we may suffer adverse consequences, including the lender foreclosing on those investments. In addition, we have pledged and granted a security interest to the lender under the Facility in our right, title and interest in, to and under the senior management fees and subordinated management fees paid to us by certain CLO Funds managed by Trimaran Advisors.***

All of the investments originated with funds drawn under the Facility will be subject to security interests under the Facility. If we default on our obligations under the Facility, the lender may have the right to foreclose upon and sell, or otherwise transfer, the collateral subject to its security interests. In such event, we may be forced to sell our investments to raise funds to repay our outstanding borrowings in order to avoid foreclosure and these forced sales may be at times and at prices we would not consider advantageous. In connection with any such foreclosure and our subsequent liquidation, the lender would receive proceeds therefrom before the holders of the Notes and, as a result, the holders of the Notes may not receive any proceeds upon the liquidation of these investments. If the lender exercises its right to sell the assets pledged under Facility, such sales may be completed at distressed sale prices, thereby diminishing or potentially eliminating the amount of cash available to us after repayment of the amounts outstanding under the Facility.

In addition, we have pledged and granted a security interest to the lender under the Facility in our right, title and interest in, to and under the senior management fees and subordinated management fees paid to us by certain CLO Funds managed by Trimaran Advisors. If we default on our obligations under the Facility, the lender (and not us) would be entitled to receive such fees from Trimaran Advisors, which could impair our financial condition and operating results.

***Our indebtedness could adversely affect our financial health and our ability to respond to changes in our business.***

With certain limited exceptions, we are only allowed to borrow amounts or issue senior securities such that our asset coverage, as defined in the 1940 Act, is at least 200% immediately after such borrowing or issuance. As of June 30, 2012, our asset coverage ratio was 351%. The amount of leverage that we employ in the future will depend on our management's and our Board of Directors' assessment of market and other factors at the time of any proposed borrowing. There is no assurance that a leveraging strategy will be successful. As a result of the level of our leverage:

- our exposure to risk of loss is greater if we incur debt or issue senior securities to finance investments because a decrease in the value of our investments has a greater negative impact on our returns and, therefore, the value of our business if we did not use leverage;
- the decrease in our asset coverage ratio resulting from increased leverage and the covenants contained in documents governing our indebtedness (which may impose asset coverage or investment portfolio composition requirements that are more stringent than those imposed by the 1940 Act) limit our flexibility in planning for, or reacting to, changes in our business and industry, as a result of which we could be required to liquidate investments at an inopportune time;
- we are required to dedicate a portion of our cash flow to interest payments, limiting the availability of cash for dividends and other purposes; and
- our ability to obtain additional financing in the future may be impaired.

We cannot be sure that our leverage will not have a material adverse effect on us. In addition, we cannot be sure that additional financing will be available when required or, if available, will be on terms satisfactory to us. Further, even if we are able to obtain additional financing, we may be required to use some or all of the proceeds thereof to repay our outstanding indebtedness.

***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). We have agreed in the covenant in the indenture governing the Notes not to violate this section of the 1940 Act, whether or not we continue to be subject to such provision, but giving effect, in either case, to any exemptive relief granted to us by the SEC. Recent legislation introduced in the U.S. House of Representatives, if passed, would modify this section 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 the Notes may increase.

***If market constraints prevent us from obtaining debt or additional equity capital, our liquidity could be adversely affected, our business prospects could be negatively impacted, we could lose key employees and our operating results could be negatively affected.***

Recent economic and capital market conditions in the U.S. have resulted in a severe reduction in the availability of debt and equity capital for the market as a whole, and financial services firms in particular. These conditions have constrained us and other companies in the financial services sector, limiting or completely preventing access to markets for debt and equity capital needed to maintain operations, continue investment originations and to grow. Reflecting concern about the stability of the financial markets, many lenders and institutional investors have reduced or ceased providing funding to borrowers. This market turmoil and tightening of credit has led to increased market volatility and widespread reduction of business activity generally. If we are unable to obtain new debt or additional equity capital, our liquidity may be impacted. If these conditions continue for a prolonged period of time, or worsen in the future, we could lose key employees and our business prospects could be negatively impacted. Even if we are able to incur new debt, we may not be able to do so on favorable terms. In addition, the debt or equity capital that will be available, if at all, may be at a high cost and/or on unfavorable terms and conditions. Equity capital is, and may continue to be, difficult to raise because, subject to some limited exceptions, we are not generally able to issue and sell our common stock at a price below the net asset value per share of our common stock without stockholder approval. These events and our inability to raise capital have resulted in a reduction in new originations, curtailed our ability to grow and have had a negative impact on our liquidity and operating results. The continued inability to raise additional capital could further constrain our liquidity, negatively impact our business prospects, cause the departure of key employees and negatively impact our operating results.

We obtained shareholder approval to sell our common stock at a price below net asset value at our 2012 annual meeting of shareholders and such approval is effective for a period expiring on the earlier of June 22, 2013, the one-year anniversary of the date of the shareholder approval, or the date of our 2013 annual meeting of shareholders.

***Because we intend to continue to distribute substantially all of our income and net realized capital gains to our stockholders, we will need additional capital to finance our growth.***

In order to qualify as a RIC, to avoid payment of excise taxes and to minimize or avoid payment of income taxes, we intend to continue to distribute to our stockholders substantially all of our net ordinary income and realized net capital gains except for certain net long-term capital gains (which we may retain, pay applicable income taxes with respect thereto, and elect to treat as deemed distributions to our stockholders). As a BDC, in order to incur new debt, we are generally required to meet a coverage ratio of total assets to total senior securities, which includes all of our borrowings and any preferred stock we may issue in the future, of at least 200%, as measured immediately after issuance of such security. This requirement limits the amount that we may borrow. Because we will continue to need capital to grow our loan and investment portfolio, this limitation may prevent us from incurring debt and require us to issue additional equity at a time when it may be disadvantageous to do so. We cannot assure you that debt and equity financing will be available to us on favorable terms, or at all, and debt financings may be restricted by the terms of such borrowings. If additional funds are not available to us, we could be forced to continue to curtail or cease new lending and investment activities.

***We may from time to time expand our business through acquisitions, which could disrupt our business and harm our financial condition.***

We may pursue potential acquisitions of, and investments in, businesses complementary to our business and from time to time engage in discussions regarding such possible acquisitions. For example, in February 2012, we completed the acquisition of Trimaran Advisors. Such acquisition and any other acquisitions we may undertake involve a number of risks, including:

- failure of the acquired businesses to achieve the results we expect;
- substantial cash expenditures;
- diversion of capital and management attention from operational matters;
- our inability to retain key personnel of the acquired businesses;
- incurrence of debt and contingent liabilities and risks associated with unanticipated events or liabilities; and
- the potential disruption and strain on our existing business and resources that could result from our planned growth and continuing integration of our acquisitions.

If we fail to properly evaluate acquisitions or investments, we may not achieve the anticipated benefits of such acquisitions, we may incur costs in excess of what we anticipate, and management resources and attention may be diverted from other necessary or valuable activities. Any acquisition, including the Trimaran Advisors acquisition, may not result in short-term or long-term benefits to us. If we are unable to integrate or successfully manage any business that we acquire, we may not realize anticipated cost savings, improved efficiencies or revenue growth, which may result in reduced profitability or operating losses.

***Our Board of Directors may change our investment objective, operating policies and strategies without prior notice or stockholder approval.***

Our Board of Directors has the authority to modify or waive certain of our operating policies and strategies without prior notice (except as required by the 1940 Act) and without stockholder approval. However, absent stockholder approval, we may not change the nature of our business so as to cease to be, or withdraw our election as, a BDC. We cannot predict the effect any changes to our current operating policies and strategies would have on our business and operating results. Nevertheless, the effects may adversely affect our business and impact our ability to make interest and principal payments of the Notes.

***Our businesses may be adversely affected by litigation and regulatory proceedings, including those that are currently pending.***

From time to time, we may be subject to legal actions as well as various regulatory, governmental and law enforcement inquiries, investigations and subpoenas. In any such claims or actions, demands for substantial monetary damages may be asserted against us and may result in financial liability or an adverse effect on our reputation among investors. We may be unable to accurately estimate our exposure to litigation risk when we record balance sheet reserves for probable loss contingencies. As a result, any reserves we establish to cover any settlements or judgments may not be sufficient to cover our actual financial exposure, which may have a material impact on our results of operations or financial condition. In regulatory enforcement matters, claims for disgorgement, the imposition of penalties and the imposition of other remedial sanctions are possible.

***A failure on our part to maintain our status as a business development company would significantly reduce our operating flexibility.***

If we do not continue to qualify as a business development company, we might be regulated as a registered closed-end investment company under the 1940 Act; our failure to qualify as a BDC would make us subject to additional regulatory requirements, which may significantly decrease our operating flexibility by limiting our ability to employ leverage and issue common stock.

***Regulations governing our operation as a BDC affect our ability to, and the way in which we, raise additional capital.***

Our business requires a substantial amount of additional capital. We may acquire additional capital from the issuance of senior securities or other indebtedness, the issuance of additional shares of our common stock or from securitization transactions. However, we may not be able to raise additional capital in the future on favorable terms or at all. We may issue debt securities or preferred securities, which we refer to collectively as "senior securities," and we may borrow money from banks or other financial institutions, up to the maximum amount permitted by the 1940 Act. The 1940 Act permits us to issue senior securities or incur indebtedness only in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% immediately after such issuance or incurrence. With respect to certain types of senior securities, we must make provisions to prohibit any dividend distribution to our stockholders or the repurchase of certain of our securities, unless we meet the applicable asset coverage ratios at the time of the dividend distribution or repurchase. If the value of our assets declines, we may be unable to satisfy the asset coverage test. If that happens, we may be required to liquidate a portion of our investments and repay a portion of our indebtedness at a time when such sales may be disadvantageous.

- *Senior Securities*. As a result of issuing senior securities, we would also be exposed to typical risks associated with leverage, including an increased risk of loss.
- *Additional Common Stock*. Our Board of Directors may decide to issue common stock to finance our operations rather than issuing debt or other senior securities. As a BDC, we are generally not able to issue our common stock at a price below the net asset value per share of our common stock without first obtaining required approvals from our stockholders and our independent directors. In any such case, the price at which our securities are to be issued and sold may not be less than a price, that in the determination of our Board of Directors, closely approximates the market value of such securities (less any commission or discount). We obtained shareholder approval to sell our common stock at a price below net asset value at our 2012 annual meeting of shareholders and such approval is effective for a period expiring on the earlier of June 22, 2013, the one-year anniversary of the date of the shareholder approval, or the date of our 2013 annual meeting of shareholders. We may also make rights offerings to our stockholders at prices per share less than the net asset value per share of our common stock, subject to the 1940 Act.
- *Securitization*. In addition to issuing securities to raise capital as described above, we may securitize a portion of the loans we may obtain to generate cash for funding new investments. If we are unable to successfully securitize our loan portfolio our ability to grow our business and fully execute our business strategy and our earnings (if any) may be adversely affected. Moreover, even successful securitization of our loan portfolio might expose us to losses, as the residual loans in which we do not sell interests tend to be those that are riskier and more apt to generate losses.

***Changes in the laws or regulations governing our business and the business of our Asset Manager Affiliates, or changes in the interpretations thereof, and any failure by us or our Asset Manager Affiliates to comply with these laws or regulations, could negatively affect the profitability of our operations.***

Changes in the laws or regulations or the interpretations of the laws and regulations that govern BDCs, registered investment advisers (such as our Asset Manager Affiliates), RICs or non-depository commercial lenders could significantly affect our operations and our cost of doing business. We are subject to federal, state and local laws and regulations and are subject to judicial and administrative decisions that affect our operations, including our loan originations, maximum interest rates, fees and other charges, disclosures to portfolio companies, the terms of secured transactions, collection and foreclosure procedures and other trade practices. In addition, as registered investment advisers, the Asset Manager Affiliates are subject to new and existing regulations, regulatory risks, costs and expenses associated with operating as registered investment advisers that may limit their ability to operate, structure or expand their businesses in the future. If these laws, regulations or decisions change, or if we expand our business into jurisdictions that have adopted more stringent requirements than those in which we currently conduct business, we may have to incur significant expenses in order to comply or we might have to restrict our operations. In addition, if we do not comply with applicable laws, regulations and decisions, we may lose licenses needed for the conduct of our business

and be subject to civil fines and criminal penalties, any of which could have a material adverse effect upon our business, results of operations or financial condition.

***If we do not invest a sufficient portion of our assets in "qualifying assets," or comply with certain exemptive relief granted by the SEC, we could fail to qualify as a BDC or be precluded from investing according to our current business strategy.***

As a BDC, we may not acquire any assets other than "qualifying assets" for purposes of the 1940 Act unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are "qualifying assets." See "Regulation".

We believe that most of the senior loans and mezzanine investments that we acquire constitute "qualifying assets." However, investments in the securities of CLO Funds generally do not constitute "qualifying assets," and we may invest in other assets that are not "qualifying assets." If we do not invest a sufficient portion of our assets in "qualifying assets," we may be precluded from investing in what we believe are attractive investments or could lose our status as a BDC, which would have a material adverse effect on our business, financial condition and results of operations. These restrictions could also prevent us from making investments in the equity securities of CLO Funds, which could limit our Asset Manager Affiliates' ability to organize new CLO Funds. Similarly, these rules could prevent us from making follow-on investments in existing portfolio companies (which could result in the dilution of our position).

In addition, we have received certain exemptive relief from the SEC relating to our status as a BDC and our ability to own securities issued by or any other interest in the business of a person who is a registered investment company. The conditions of such exemptive relief may limit our ability or the ability of our Asset Manager Affiliates, each a registered investment adviser, to operate, structure or expand their businesses in the future.

***We will be subject to corporate-level income tax if we are unable to qualify as a RIC under Subchapter M of the Code.***

To maintain RIC tax treatment under the Code, we must meet the following annual distribution, income source and asset diversification requirements:

- The annual distribution requirement for a RIC will be satisfied if we distribute to our stockholders on an annual basis at least 90% of our net ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any. Because we use debt financing, we are subject to certain asset coverage ratio requirements under the 1940 Act and are (and may in the future become) subject to certain financial covenants under loan and credit agreements that could, under certain circumstances, restrict us from making distributions necessary to satisfy the distribution requirement. If we are unable to obtain cash from other sources, we could fail to qualify for RIC tax treatment and thus become subject to corporate-level income tax.
- The source income requirement will be satisfied if we obtain at least 90% of our income for each year from distributions, interest, gains from the sale of stock or securities or similar sources.
- The asset diversification requirement will be satisfied if we meet certain asset diversification requirements at the end of each quarter of our taxable year. To satisfy this requirement, at least 50% of the value of our assets must consist of cash, cash equivalents, U.S. Government securities, securities of other RICs, and other acceptable securities; and no more than 25% of the value of our assets can be invested in the securities, other than U.S. government securities or securities of other RICs, of one issuer, of two or more issuers that are controlled, as determined under applicable Code rules, by us and that are engaged in the same or similar or related trades or businesses or of certain "qualified publicly traded partnerships."

Failure to meet these requirements may result in our having to dispose of certain investments quickly in order to prevent the loss of RIC status. Because most of our investments will be in private companies, and therefore will be illiquid, any such dispositions could be made at disadvantageous prices and could result in substantial losses. Moreover, if we fail to maintain RIC tax treatment for any reason and are subject to corporate income tax, the resulting corporate taxes could substantially reduce our net assets and the amount of income available to make interest and principal payments on the Notes.

## Risks Related to Our Investments

***Our investments may be risky, and you could lose all or part of your investment.***

We invest primarily in senior secured term loans, mezzanine debt and selected equity investments issued by middle market companies.

*Secured Loans*. When we extend secured term loans, we generally take a security interest (either as a first lien position or as a second lien position) in the available assets of these portfolio companies, including the equity interests of their subsidiaries, which we expect to assist in mitigating the risk that we will not be repaid. However, there is a risk that the collateral securing our loans may decrease in value over time, may be difficult to sell in a timely manner, may be difficult to appraise and may fluctuate in value based upon the success of the business and market conditions, including as a result of the inability of the portfolio company to raise additional capital, and, in some circumstances, our lien could be subordinated to claims of other creditors. In addition, deterioration in a portfolio company's financial condition and prospects, including its inability to raise additional capital, may be accompanied by deterioration in the value of the collateral for the loan. Consequently, the fact that a loan is secured does not guarantee that we will receive principal and interest payments according to the loan's terms, or at all, or that we will be able to collect on the loan should we be forced to exercise our remedies.

*Mezzanine Debt*. Our mezzanine debt investments generally are subordinated to senior loans and generally are unsecured. This may result in an above average amount of risk and volatility or loss of principal.

These investments may entail additional risks that could adversely affect our investment returns. To the extent interest payments associated with such debt are deferred, such debt is subject to greater fluctuations in value based on changes in interest rates and such debt could subject us to phantom income. Since we generally do not receive any cash prior to maturity of the debt, the investment is of greater risk.

*Equity Investments*. We have made and expect to make selected equity investments. In addition, when we invest in senior secured loans or mezzanine debt, we may acquire warrants in the equity of the portfolio company. Our goal is ultimately to dispose of such equity interests and realize gains upon our disposition of such interests. However, the equity interests we receive may not appreciate in value and, in fact, may decline in value. Accordingly, we may not be able to realize gains from our equity interests, and any gains that we do realize on the disposition of any equity interests may not be sufficient to offset any other losses we experience.

*Risks Associated with Middle Market Companies*. Investments in middle market companies also involve a number of significant risks, including:

- limited financial resources and inability to meet their obligations, which may be accompanied by a deterioration in the value of any collateral and a reduction in the likelihood of our realizing the value of any guarantees we may have obtained in connection with our investment;
- shorter operating histories, narrower product lines and smaller market shares than larger businesses, which tend to render them more vulnerable to competitors' actions and market conditions, as well as general economic downturns;
- dependence on management talents and efforts of a small group of persons; therefore, the death, disability, resignation or termination of one or more of these persons could have a material adverse impact on our portfolio company and, in turn, on us;
- less predictable operating results, being parties to litigation from time to time, engaging in rapidly changing businesses with products subject to a substantial risk of obsolescence and requiring substantial additional capital expenditures to support their operations, finance expansion or maintain their competitive position;
- difficulty accessing the capital markets to meet future capital needs; and
- generally less publicly available information about their businesses, operations and financial condition.

***Our portfolio investments for which there is no readily available market, including our investment in our Asset Manager Affiliates and our investments in CLO Funds, are recorded at fair value as determined in good faith by our Board of Directors. As a result, there is uncertainty as to the value of these investments.***

Our investments consist primarily of securities issued by privately-held companies, the fair value of which is not readily determinable. In addition, we are not permitted to maintain a general reserve for anticipated loan losses. Instead, we are required by the 1940 Act to specifically value each investment and record an unrealized gain or loss for any asset that we believe has increased or decreased in value. We value these securities at fair value as determined in good faith by our Board of Directors pursuant to a valuation methodology approved by our Board of Directors. These valuations are initially prepared by our management and reviewed by our Valuation Committee, which uses its best judgment in arriving at the fair value of these securities. However, the Board of Directors retains ultimate authority to determine the appropriate valuation for each investment. From time to time, our Board of Directors has used the services of an independent valuation firm to aid it in determining fair value, including in the case of our investments in CLO Funds and in our Asset Manager Affiliates. 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. In addition to such third-party input, the types of factors that may be considered in valuing our investments include the nature and realizable value of any collateral, the portfolio company's ability to make payments and its earnings, the markets in which the portfolio company does business, comparison to publicly-traded companies, discounted cash flow and other relevant factors. 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. Because such valuations, and particularly valuations of private investments and private companies, are inherently uncertain and may be based on estimates, our determinations of fair value may differ materially from the values that would be assessed if a ready market for these securities existed. Our net asset value could be adversely affected if our determinations regarding the fair value of our illiquid investments were materially higher than the values that we ultimately realize upon the disposal of such securities.

***We are a non-diversified investment company within the meaning of the 1940 Act, and therefore we may invest a significant portion of our assets in a relatively small number of issuers, which subjects us to a risk of significant loss if any of these issuers defaults on its obligations under any of its debt instruments or as a result of a downturn in the particular industry.***

We are classified as a non-diversified investment company within the meaning of the 1940 Act, and therefore we may invest a significant portion of our assets in a relatively small number of issuers in a limited number of industries. As of June 30, 2012, our largest investment, our 100% equity interest in our Asset Manager Affiliates, equaled approximately 24% of the fair value of our total assets. Beyond the asset diversification requirements associated with our qualification as a RIC, we do not have fixed guidelines for diversification, and while we are not targeting any specific industries, relatively few industries may become significantly represented among our investments. To the extent that we assume large positions in the securities of a small number of issuers, our net asset value may fluctuate to a greater extent than that of a diversified investment company as a result of changes in the financial condition or the market's assessment of the issuer, changes in fair value over time or a downturn in any particular industry. We may also be more susceptible to any single economic or regulatory occurrence than a diversified investment company.

***Economic recessions or downturns could negatively impact our portfolio companies and harm our operating results.***

Many of our portfolio companies may be susceptible to economic slowdowns or recessions and may be unable to repay our loans during these periods. Therefore, our non-performing assets are likely to increase and the value of our portfolio is likely to decrease during these periods. Adverse economic conditions may also decrease the value of collateral securing some of our loans and the value of our equity investments. Economic slowdowns or recessions could lead to financial losses in our portfolio and a decrease in revenues, net income and assets. Unfavorable economic conditions also could increase our funding costs, limit our access to the capital markets or result in a decision by lenders not to extend credit to us. These events could prevent us from increasing investments and harm our operating results.

***Defaults by our portfolio companies could harm our operating results.***

A portfolio company's failure to satisfy financial or operating covenants imposed by us or other debt holders could lead to defaults and, potentially, acceleration of the time when the loans are due and foreclosure on its secured assets. Such events could trigger cross-defaults under other agreements and jeopardize a portfolio company's ability to meet its obligations under the debt that we hold and the value of any equity securities we own. We may incur expenses to the extent necessary to seek recovery upon default or to negotiate new terms with a defaulting portfolio company.

***When we are a debt or minority equity investor in a portfolio company, which generally is the case, we may not be in a position to control the entity, and its management may make decisions that could decrease the value of our investment.***

Most of our investments are either debt or minority equity investments in our portfolio companies. Therefore, we are subject to the risk that a portfolio company may make business decisions with which we disagree, and the stockholders and management of such company may take risks or otherwise act in ways that do not serve our interests. As a result, a portfolio company may make decisions that could decrease the value of our portfolio holdings. In addition, we generally are not in a position to control any portfolio company by investing in its debt securities.

***Prepayments of our debt investments by our portfolio companies could negatively impact our operating results.***

We are subject to the risk that the investments we make in our portfolio companies may be repaid prior to maturity. When this occurs, we generally reinvest these proceeds in temporary investments, pending their future investment in new portfolio companies. These temporary investments typically have substantially lower yields than the debt being prepaid and we could experience significant delays in reinvesting these amounts. Any future investment in a new portfolio company may also be at lower yields than the debt that was repaid. Consequently, our results of operations could be materially adversely affected if one or more of our portfolio companies elects to prepay amounts owed to us. Additionally, prepayments could negatively impact our return on equity, which could result in a decline in the market price of our common stock and the market price, if any, of the Notes.

***Our portfolio companies may incur debt that ranks equal with, or senior to, our investments in such companies.***

We invest primarily in debt securities issued by our portfolio companies. In some cases portfolio companies are permitted to have other debt that ranks equal with, or senior to, the debt securities in which we invest. By their terms, such debt instruments may provide that the holders thereof are entitled to receive payment of interest or principal on or before the dates on which we are entitled to receive payments in respect of the debt securities in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization or bankruptcy of a portfolio company, holders of debt instruments ranking senior to our investment in that portfolio company would typically be entitled to receive payment in full before we receive any distribution in respect of our investment. After repaying such senior creditors, such portfolio company may not have any remaining assets to use for repaying its obligation to us. In the case of debt ranking equal

with debt securities in which we invest, we would have to share on an equal basis any distributions with other creditors holding such debt in the event of an insolvency, liquidation, dissolution, reorganization or bankruptcy of a portfolio company.

***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.

***There may be circumstances where our debt investments could be subordinated to claims of other creditors or we could be subject to lender liability claims.***

Even though we may have structured certain of our investments as senior loans, if one of our portfolio companies were to go bankrupt, depending on the facts and circumstances, including the size of our investment and the extent to which we actually provided managerial assistance to that portfolio company, a bankruptcy court might recharacterize our debt investment and subordinate all or a portion of our claim to that of other creditors. In addition, lenders can be subject to lender liability claims for actions taken by them where they become too involved in the borrower's business or exercise control over the borrower. It is possible that we could become subject to a lender's liability claim, including as a result of actions taken in rendering significant managerial assistance.

***Our investments in equity securities involve a substantial degree of risk.***

We may purchase common stock and other equity securities, including warrants. Although equity securities have historically generated higher average total returns than fixed-income securities over the long term, equity securities have also experienced significantly more volatility in those returns. The equity securities we acquire may fail to appreciate and may decline in value or become worthless, and our ability to recover our investment depends on our portfolio company's success. Investments in equity securities involve a number of significant risks, including the risk of further dilution as a result of additional issuances, inability to access additional capital and failure to pay current distributions. Investments in preferred securities involve special risks, such as the risk of deferred distributions, credit risk, illiquidity and limited voting rights.

***The lack of liquidity in our investments may adversely affect our business.***

We invest in securities issued by private companies. These securities may be subject to legal and other restrictions on resale or otherwise be less liquid than publicly-traded securities. The illiquidity of these investments may make it difficult for us to sell these investments when desired. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we had previously recorded these investments. Our investments are usually subject to contractual or legal restrictions on resale or are otherwise illiquid because there is usually no established trading market for such investments. The illiquidity of most of our investments may make it difficult for us to dispose of them at a favorable price, and, as a result, we may suffer losses.

***We may not receive all or a portion of the income we expect to continue to receive from our Asset Manager Affiliates.***

We expect to receive distributions of recurring fee income, after the payment of its expenses, from the asset management activities of our Asset Manager Affiliates. However, the existing asset management agreements pursuant to which our Asset Manager Affiliates receive such fee income from the CLO Funds for which they serve as managers may be terminated for "cause" by the holders of a majority of the most senior class of securities issued by such CLO Funds and the holders of a majority of the subordinated securities issued by such CLO Funds. "Cause" is defined in the asset management agreements to include a material breach by our Asset Manager Affiliates of the indenture governing the applicable CLO Fund, breaches by our Asset Manager Affiliates of certain specified provisions of the indenture, material breaches of representations or warranties made by our Asset Manager Affiliates, bankruptcy or insolvency of our Asset Manager Affiliates, fraud or criminal activity on the part of our Asset Manager Affiliates or an event of default under the indenture governing the CLO Funds. We expect that future asset management agreements will contain comparable provisions. Further, a significant portion of the asset management fees payable to our Asset Manager Affiliates under the asset management agreements are subordinated to the prior payments of interest on the senior securities issued by the CLO Funds. If the asset management agreements are terminated or the CLO Funds do not generate enough income or otherwise have insufficient residual cash flow due to diversion of cash as a result of the failure by the CLO Funds to satisfy certain restrictive covenants contained in their indenture agreements to pay the subordinated management fees, we will not receive the fee income that we expect to continue to receive from our Asset Manager Affiliates, which will reduce income available to make distributions to our stockholders. At June 30, 2012, our Asset Manager Affiliates were receiving all (senior and subordinate) management fees payable by the CLO Funds managed by them.

***We may not receive any return on our investment in the CLO Funds in which we have invested and we may be unable to raise additional CLO Funds.***

As of June 30, 2012, we had $63.9 million at fair value invested in the subordinated securities or preferred shares issued by the CLO Funds managed by our Asset Manager Affiliates and certain other third party asset managers. Subject to market conditions and legal requirements applicable to us under the 1940 Act, we expect to continue to acquire subordinated securities in the future in CLO Funds managed by our Asset Manager Affiliates and/or third party managers. These subordinated securities are the most junior class of securities issued by the CLO Funds and are subordinated in priority of payment to every other class of securities issued by these CLO Funds. Therefore, they only receive cash distributions if the CLO Funds have made all cash interest payments to all other debt securities issued by the CLO Fund. The subordinated securities are also unsecured and rank behind all of the secured creditors, known or unknown, of the CLO Fund, including the holders of the senior securities issued by the CLO Fund. Consequently, to the extent that the value of a CLO Fund's loan investments has been reduced as a result of conditions in the credit markets, or as a result of default loans or individual fund assets, the value of the subordinated securities at their redemption could be reduced. Additionally, we may not be able to continue to complete new CLO Funds due to prevailing CLO market conditions or other factors.

## Risks Related to Our Notes

***The Notes will be unsecured and therefore will be effectively subordinated to any secured indebtedness we have currently incurred or may incur in the future.***

The Notes will not be secured by any of our assets or any of the assets of our subsidiaries or the Asset Manager Affiliates. As a result, the Notes will effectively be subordinated to any secured indebtedness we or they have currently incurred and may incur in the future (or any indebtedness that is initially unsecured to which we subsequently grant security) to the extent of the value of the assets securing such indebtedness, including indebtedness under the Facility. In any liquidation, dissolution, bankruptcy or other similar proceeding, the holders of any of our existing or future secured indebtedness and the secured indebtedness of our subsidiaries and the Asset Manager Affiliates may assert rights against the assets pledged to secure that indebtedness in order to receive full payment of their indebtedness before the assets may be used to pay other creditors, including the holders of the Notes. As of October 1, 2012, there was $28 million outstanding under the Facility.

***The Notes will be structurally subordinated to the indebtedness and other liabilities of our subsidiaries and portfolio companies with respect to which we hold equity investments, including the Asset Manager Affiliates.***

The Notes will be obligations exclusively of KCAP Financial, Inc., and not of any of our subsidiaries or the Asset Manager Affiliates. None of our subsidiaries or the Asset Manager Affiliates will be a guarantor of the Notes and the Notes will not be required to be guaranteed by any subsidiary or asset management firm we may acquire or create in the future. Any assets of our subsidiaries and the Asset Manager Affiliates will not be directly available to satisfy the claims of our creditors, including holders of the Notes. Except to the extent we are a creditor with recognized claims against our subsidiaries, all claims of creditors of our subsidiaries will have priority over our equity interests in such entities (and therefore the claims of our creditors, including holders of the Notes) with respect to the assets of such entities. Even if we are recognized as a creditor of one or more of these entities, our claims would still be effectively subordinated to any security interests in the assets of any such entity and to any indebtedness or other liabilities of any such entity senior to our claims. Consequently, the Notes will be structurally subordinated to all indebtedness and other liabilities of any of our subsidiaries and portfolio companies with respect to which we hold equity investments, including the Asset Manager Affiliates and any subsidiaries of the Asset Manager Affiliates that we may in the future acquire or establish. These entities may incur substantial indebtedness in the future, all of which would be structurally senior to the Notes.

***The indenture under which the Notes will be issued contains limited protection for holders of the Notes.***

The indenture under which the Notes will be issued offers limited protection to holders of the Notes. The terms of the indenture and the Notes do not restrict our or any of our subsidiaries or the Asset Manager Affiliates' ability to engage in, or otherwise be a party to, a variety of corporate transactions, circumstances or events that could have a material adverse impact on your investment in the Notes. In particular, the terms of the indenture and the Notes will not place any restrictions on our or our subsidiaries or the Asset Manager Affiliates' ability to:

- issue securities or otherwise incur additional indebtedness or other obligations, including (1) any indebtedness or other obligations that would be equal in right of payment to the Notes, (2) any indebtedness or other obligations that would be secured and therefore rank effectively senior in right of payment to the Notes to the extent of the values of the assets securing such debt, (3) indebtedness of ours that is guaranteed by one or more of our subsidiaries or the Asset Manager Affiliates and which therefore is structurally senior to the Notes and (4) securities, indebtedness or obligations issued or incurred by our subsidiaries or the Asset Manager Affiliates that would be senior to our equity interests in those entities and therefore rank structurally senior to the Notes with respect to the assets of our subsidiaries and the Asset Manager Affiliates, in each case other than an incurrence of indebtedness or other obligation that would cause a violation of Section 18(a)(1)(A) as modified by Section 61(a)(1) of the 1940 Act or any successor provisions. These provisions generally prohibit us from making additional borrowings, including through the issuance of additional debt or the sale of additional debt securities, unless our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowings;
- pay dividends on, or purchase or redeem or make any payments in respect of, capital stock or other securities ranking junior in right of payment to the Notes, including subordinated indebtedness, in each case other than dividends, purchases, redemptions or payments that would cause a violation of Section 18(a)(1)(B) as modified by Section 61(a)(1) of the 1940 Act or any successor provisions. These provisions generally prohibit us from declaring any cash dividend or distribution upon any class of our capital stock, or purchasing any such capital stock if our asset coverage, as defined in the 1940 Act, is below 200% at the time of the declaration of the dividend or distribution or the purchase and after deducting the amount of such dividend, distribution or purchase;
- sell assets (other than certain limited restrictions on our ability to consolidate, merge or sell all or substantially all of our assets);
- enter into transactions with affiliates;

- create liens (including liens on the shares of our subsidiaries) or enter into sale and leaseback transactions;
- make investments; or
- create restrictions on the payment of dividends or other amounts to us from our subsidiaries;

In addition, the indenture will not require us to offer to purchase the Notes in connection with a change of control or any other event.

Furthermore, the terms of the indenture and the Notes do not protect holders of the Notes in the event that we experience changes (including significant adverse changes) in our financial condition, results of operations or credit ratings, if any, as they do not require that we adhere to any financial tests or ratios or specified levels of net worth, revenues, income, cash flow, or liquidity other than as described under "Description of the Notes — Events of Default" beginning on page 123 below. Any changes to the 200% asset coverage ratio in the 1940 Act could affect the Notes. See "Risk Factors — Risks Related to Our Business and Structure — Pending legislation may allow us to incur additional leverage."

Our ability to recapitalize, incur additional debt and take a number of other actions that are not limited by the terms of the Notes may have important consequences for you as a holder of the Notes, including making it more difficult for us to satisfy our obligations with respect to the Notes or negatively affecting the trading value of the Notes.

Other debt we issue or incur in the future could contain more protections for its holders than the indenture and the Notes, including additional covenants and events of default. The issuance or incurrence of any such debt with incremental protections could affect the market for and trading levels and prices of the Notes.

***There is no existing trading market for the Notes and, even if the NYSE approves the listing of the Notes, an active trading market for the Notes may not develop, which could limit your ability to sell the Notes or the market price of the Notes.***

The Notes will be a new issue of debt securities for which there initially will not be a trading market. We intend to list the Notes on the NYSE within 30 days of the original issue date under the symbol "KAP." However, there is no assurance that the Notes will be approved for listing on the NYSE.

Moreover, even if the listing of the Notes is approved, we cannot provide any assurances that an active trading market will develop for the Notes or that you will be able to sell your Notes. If the Notes are traded after their initial issuance, they may trade at a discount from their initial offering price depending on prevailing interest rates, the market for similar securities, our credit ratings, if any, general economic conditions, our financial condition, performance and prospects and other factors. The underwriters have advised us that they intend to make a market in the Notes, but they are not obligated to do so. The underwriters may discontinue any market-making in the Notes at any time at their sole discretion.

Accordingly, we cannot assure you that the Notes will be approved for listing on the NYSE, that a liquid trading market will develop for the Notes, that you will be able to sell your Notes at a particular time or that the price you receive when you sell will be favorable. To the extent an active trading market does not develop, the liquidity and trading price for the Notes may be harmed. Accordingly, you may be required to bear the financial risk of an investment in the Notes for an indefinite period of time.

***If we default on our obligations to pay our other indebtedness, we may not be able to make payments on the Notes.***

Any default under the agreements governing our indebtedness, including a default under the 8.75% convertible senior notes due 2016 and the Facility or other indebtedness to which we may be a party that is not waived by the required lenders, and the remedies sought by the holders of such indebtedness could make us unable to pay principal, premium, if any, and interest on the Notes and substantially decrease the market value of the Notes. If we are unable to generate sufficient cash flow and are otherwise unable to obtain funds necessary to meet required payments of principal, premium, if any, and interest on our indebtedness, or if we otherwise fail to comply with the various covenants, including financial and operating covenants, in the

instruments governing our indebtedness, we could be in default under the terms of the agreements governing such indebtedness. In the event of such default, the holders of such indebtedness could elect to declare all the funds borrowed thereunder to be due and payable, together with accrued and unpaid interest, the lender under the Facility or other debt we may incur in the future could elect to terminate its commitment, cease making further loans and institute foreclosure proceedings against our assets, and we could be forced into bankruptcy or liquidation. If our operating performance declines, we may in the future need to seek to obtain waivers from the lender under the Facility or other debt that we may incur in the future to avoid being in default. If we breach our covenants under the Facility or other debt and seek a waiver, we may not be able to obtain a waiver from the required lenders. If this occurs, we would be in default under the Facility or other debt, the lender could exercise its rights as described above, and we could be forced into bankruptcy or liquidation. If we are unable to repay debt, lenders having secured obligations could proceed against the collateral securing the debt. Because the 8.75% convertible senior notes due 2016 have, and any future debt we issue will likely have, customary cross-default provisions, if the indebtedness under the Notes or any other debt we may issue is accelerated, we may be unable to repay or finance the amounts due.

***We may be unable to invest a significant portion of the net proceeds from this offering, which could harm our financial condition and operating results.***

Delays in investing the net proceeds raised in this offering may cause our performance to be worse than that of other fully invested BDCs or other lenders or investors pursuing comparable investment strategies. We cannot assure you that we will be able to identify any investments that meet our investment objective or that any investment that we make will produce a positive return. We may be unable to invest the net proceeds of this offering on acceptable terms within the time period that we anticipate or at all, which could harm our financial condition and operating results.

We anticipate that, depending on market conditions and the amount of the capital, it may take us a substantial period of time to invest substantially all of the net proceeds from this offering in investments meeting our investment objective. During this period, we will invest the capital primarily in high quality, short-term debt securities consistent with our BDC election and our election to be taxed as a RIC, which may produce returns that are significantly lower than the returns which we expect to achieve when our portfolio is fully invested in investments meeting our investment objective.

## FORWARD-LOOKING STATEMENTS

This prospectus includes forward-looking statements. The matters discussed in this prospectus, as well as in future oral and written statements by management of the Company 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,” “contemplates,” “believes,” “estimates,” “predicts,” “potential” or “continue” or the negative of these terms or other similar words. Important assumptions include our ability to acquire or originate new investments, achieve certain margins and levels of profitability, 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 prospectus should not be regarded as a representation by us that our plans or objectives will be achieved. The forward-looking statements contained in this prospectus 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 BDC and a RIC, including the impact of changes in laws or regulations governing our operations, the operations of the Asset Manager Affiliates 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, including our Asset Manager Affiliates;
- 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; and
- market conditions and our ability to access additional capital.

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 prospectus, please see the discussion under “Risk Factors.” You should not place undue reliance on these forward-looking statements. The forward-looking statements made in this prospectus 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 of this prospectus.

## USE OF PROCEEDS

We estimate that the net proceeds we will receive from the sale of the $30 million aggregate principal amount of Notes in this offering will be approximately $ million (or approximately $ million if the underwriters fully exercise their overallotment option), in each case at the public offering price of 100% of par, after deducting the underwriting discounts and commissions of $ (or approximately $ if the underwriters fully exercise their overallotment option) payable by us and estimated offering expenses of approximately $300,000 payable by us.

We intend to use the net proceeds from the sale of the Notes for general corporate purposes, which includes investing in portfolio companies and CLO funds in accordance with our investment objective and strategies described elsewhere in this prospectus. We anticipate that substantially all of the net proceeds of the offering of the Notes pursuant to this prospectus will be used for the above purposes within six to nine months of any such offering, depending on the availability of appropriate investment opportunities consistent with our investment objective and strategies and market conditions.

Pending the uses described above, we intend to invest the net proceeds of the offering in cash, cash equivalents, U.S. government securities or high-quality debt securities maturing in one year or less from the time of investment. These securities may earn yields substantially lower than the income that we anticipate receiving once we are fully invested in accordance with our investment objective. See “Regulation — Temporary Investments” for additional information about temporary investments we may make while waiting to make longer-term investments in pursuit of our investment objective.

## CAPITALIZATION

The following table sets forth our capitalization as of June 30, 2012, actual and as adjusted for the sale of $30.0 million aggregate principal amount of the Notes offered hereby. This table should be read in conjunction with our "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and notes thereto included in this prospectus.

| | As of June 30, 2012 | |
|---|---|---|
| | Actual | As Adjusted |
| | (Unaudited) | (Unaudited) |
| Cash | $ 1,617,867 | $ |
| Borrowings[(1)] | 81,500,000 | |
| Stockholders' equity: | | |
| Common stock, par value $0.01 per share; 100,000,000 common shares authorized, 26,664,132 shares outstanding | 263,079 | |
| Capital in excess of par value | 310,713,834 | |
| Accumulated undistributed net investment income | 5,726,464 | |
| Accumulated realized losses on investments | (52,497,979) | |
| Net unrealized depreciation of investments | (60,045,089) | |
| Total stockholders' equity | $204,160,309 | $ |
| Total capitalization | $285,660,309 | $ |

(1) As of October 1, 2012, we had $28 million outstanding under the Facility and $60 million of convertible senior notes outstanding.

## RATIOS OF EARNINGS TO FIXED CHARGES

For purposes of computing the ratios of earnings to fixed charges, earnings represent net increase in net assets resulting from operations plus (or minus) income tax provision (benefit) including excise tax expense plus fixed charges. Fixed charges include interest and credit facility fees and amortization of deferred financing fees.

For the six months ended June 30, 2012 and the years ended December 31, 2011, 2010, 2009, 2008, and 2007, the ratios of earnings to fixed charges of the Company, computed as set forth below, were as follows:

| | Six Months Ended June 30, 2012 | Year Ended December 31, 2011 | Year Ended December 31, 2010 | Year Ended December 31, 2009 | Year Ended December 31, 2008 | Year Ended December 31, 2007 |
|---|---|---|---|---|---|---|
| Earnings to Fixed Charges[1] | 1.71 | 2.67 | (1.06) | 4.80 | (4.88) | 4.67 |

(1) Earnings include net realized and unrealized gains or losses. Net realized and unrealized gains or losses can vary substantially from period to period.

- Excluding net unrealized gains or losses, the earnings to fixed charges ratio would be 4.22 for the six months ended June 30, 2012, (0.42) for the year ended December 31, 2011, (0.14) for the year ended December 31, 2010, 1.28 for the year ended December 31, 2009, 3.80 for the year ended December 31, 2008, 4.23 for the year ended December 31, 2007.
- Excluding net realized and unrealized gains or losses, the earnings to fixed charges ratio would be 4.12 for the six months ended June 30, 2012, 4.45 for the year ended December 31, 2011, 2.72 for the year ended December 31, 2010, 3.02 for the year ended December 31, 2009, 3.85 for the year ended December 31, 2008, 4.19 for the year ended December 31, 2007.

## PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on The NASDAQ Global Select Market under the symbol "KCAP." We completed the initial public offering of our common stock in December 2006 at an initial public offering price of $15.00 per share. Prior to such initial public offering, there was no public market for our common stock. On September 28, 2012, the last reported closing price of our stock was $9.26 per share. As of September 28, 2012, we had 18 stockholders of record.

The following table sets forth the range of high and low closing prices of our common stock as reported on The NASDAQ Global Select Market since our initial public offering. The stock quotations are inter-dealer quotations and do not include markups, markdowns or commissions and as such do not necessarily represent actual transactions.

| | NAV[1] | Price Range | | Discount of High Sales Price to NAV | Discount of Low Sales Price to NAV |
|---|---|---|---|---|---|
| | | High | Low | | |
| **2010** | | | | | |
| First quarter (January 1, 2010 through March 31, 2010) | $ 9.62 | $ 5.71 | $ 3.79 | (40.6)% | (60.6)% |
| Second quarter (April 1, 2010 through June 30, 2010) | $ 9.20 | $ 5.88 | $ 4.43 | (36.1)% | (51.9)% |
| Third quarter (July 1, 2010 through September 30, 2010) | $ 8.84 | $ 6.69 | $ 4.55 | (24.3)% | (48.5)% |
| Fourth quarter (October 1, 2010 through December 31, 2010) | $ 8.21 | $ 7.10 | $ 6.34 | (13.5)% | (22.8)% |
| **2011** | | | | | |
| First quarter (January 1, 2011 through March 31, 2011) | $ 8.64 | $ 8.58 | $ 6.70 | (0.7)% | (22.5)% |
| Second quarter (April 1, 2011 through June 30, 2011) | $ 8.52 | $ 8.16 | $ 7.12 | (4.2)% | (16.4)% |
| Third quarter (July 1, 2011 through September 30, 2011) | $ 8.29 | $ 8.26 | $ 5.33 | (0.36)% | (35.7)% |
| Fourth quarter (October 1, 2011 through December 31, 2011) | $ 7.85 | $ 6.85 | $ 5.65 | (12.7)% | (28.0)% |
| **2012** | | | | | |
| First quarter (January 1, 2012 through March 31, 2012) | $ 7.78 | $ 7.34 | $ 6.35 | (5.7)% | (18.4)% |
| Second quarter (April 1, 2012 through June 30, 2012) | $ 7.66 | $ 7.26 | $ 5.58 | (5.2)% | (27.2)% |
| Third quarter (July 1, 2012 through September 28, 2012) | (2) | $ 9.36 | $ 7.10 | (2) | (2) |

(1) Net asset value, or "NAV," per share is generally determined as of the last day in the relevant quarter and therefore may not reflect the net asset value per share on the date of the high and low closing sales prices. The net asset value shown is based on the number of shares outstanding at the end of the applicable period.

(2) Net asset value has not yet been calculated for this period. We generally determine the net asset value per share of our common stock on a quarterly basis.

Shares of BDCs may trade at a market price that is less than the value of the net assets attributable to those shares. The possibility that our shares of common stock will trade at a discount from net asset value or at premiums that are unsustainable over the long term are separate and distinct from the risk that our net asset value will decrease.

Our dividends, if any, are determined by our Board of Directors. We have elected to be treated for federal income tax purposes as a RIC under Subchapter M of the Code. As long as we qualify as a RIC, we will not be taxed on our net ordinary income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to stockholders on a timely basis.

To maintain RIC tax treatment, we must, among other things, distribute at least 90% of our net ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, for each year. We generally will endeavor in each taxable year to make sufficient distributions to our stockholders to avoid the 4% excise tax on our income. However, 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 the 4% excise tax on such income. Any such carryover taxable income must be distributed through a dividend declared prior to filing the final tax return related to the year which generated such taxable income. We may, in the future, make actual distributions to our stockholders of our net capital gains.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*The following discussion should be read in conjunction with our financial statements and related notes and other financial information appearing elsewhere in this prospectus. In addition to historical information, the following discussion and other parts of this prospectus contain forward-looking information that involves risks and uncertainties. Our actual results could differ materially from those anticipated by such forward-looking information due to the factors discussed under "Risk Factors" and "Forward-Looking Statements" appearing elsewhere in this prospectus.*

### GENERAL

We are an internally managed, non-diversified closed-end investment company that is regulated as a BDC under the 1940 Act. 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 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. We also expect to receive distributions of recurring fee income and to generate capital appreciation from our investments in the asset management businesses of Katonah Debt Advisors and Trimaran Advisors.

Katonah Debt Advisors, a registered investment adviser, 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, we purchased Trimaran Advisors, a registered investment adviser and CLO manager similar to Katonah Debt Advisors with assets under management of approximately $1.5 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 June 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. Kathonah Debt Advisors and Trimaran Advisors are each managed independently from us by separate management teams and investment committees.

Under the investment company rules and regulations pursuant to Article 6 of Regulation S-X and the "Audit and Accounting Guide for Investment Companies" issued by the AICPA Guide, we are precluded from consolidating portfolio company investments, including those in which we have a controlling interest, unless the portfolio company is another investment company. An exception to this general principle in the AICPA Guide occurs if we own a controlled operating company that provides all or substantially all of its services directly to us, or to an investment company of ours. None of the investments made by us qualify for this exception. Therefore, our portfolio investments, including our investments in the Asset Manager Affiliates, are carried on the balance sheet at fair value with any adjustments to fair value recognized as "Net Change in Unrealized Appreciation (Depreciation)" in our statement of operations until the investment is exited, resulting in any gain or loss on exit being recognized as a "Net Realized Gain (Loss) from Investments."

We have elected to be treated for U.S. Federal income tax purposes as a RIC and intend to operate in a manner to maintain our RIC status. As a RIC, we intend to distribute to our stockholders substantially all of our net ordinary income and the excess of realized net short-term capital gains over realized net long-term capital losses, if any, for each year. To qualify as a RIC, we must, among other things, meet certain source-of-income and asset diversification requirements. Pursuant to these elections, we generally will not have to pay corporate-level taxes on any income that we timely distribute to our 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 June 30, 2012 was $7.66. On June 29, 2012, the last reported sale price of a share of our common stock on The NASDAQ Global Select Market was $7.26.

## KEY QUANTITATIVE AND QUALITATIVE FINANCIAL MEASURES AND INDICATORS

### Net Asset Value

Our net asset value per share was $7.66 and $7.85 as of June 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.

| | June 30, 2012 (unaudited) | | December 31, 2011 | |
|---|---|---|---|---|
| | Fair Value[1] | Per Share[1] | Fair Value[1] | Per Share[1] |
| Investments at fair value: | | | | |
| Investments in time deposits | $ 17,098 | $ — | $ 229,152 | $ 0.01 |
| Investments in money market accounts | 10,790,686 | 0.40 | 31,622,134 | 1.38 |
| Investments in debt securities | 143,264,021 | 5.37 | 114,673,506 | 4.99 |
| Investments in CLO Fund securities | 63,883,515 | 2.40 | 48,438,317 | 2.11 |
| Investments in equity securities | 7,719,242 | 0.29 | 6,040,895 | 0.26 |
| Investments in Asset Manager Affiliates | 72,896,000 | 2.73 | 40,814,000 | 1.78 |
| Cash | 1,617,867 | 0.06 | 2,555,259 | 0.11 |
| Restricted Cash | 815,478 | 0.03 | — | — |
| Other assets | 5,241,855 | 0.21 | 3,760,398 | 0.16 |
| Total Assets | $ 306,245,762 | $ 11.49 | $ 248,133,661 | $ 10.79 |
| Borrowings | $ 21,500,000 | $ 0.81 | $ — | $ — |
| Other liabilities | 20,585,453 | 0.77 | 7,607,719 | 0.33 |
| Convertible Senior Notes | 60,000,000 | 2.25 | 60,000,000 | 2.61 |
| Total Liabilities | $ 102,085,453 | $ 3.83 | $ 67,607,719 | $ 2.94 |
| NET ASSET VALUE | $ 204,160,309 | $ 7.66 | $ 180,525,942 | $ 7.85 |

(1) 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 June 30, 2012, we had approximately $82 million of outstanding borrowings and our asset coverage ratio of total assets to total borrowings was 351%, 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 indenture governing the Convertible Senior Notes prohibits us and our consolidated subsidiaries from incurring additional senior secured indebtedness in excess of 50% of our total stockholders' equity.

The Convertible Senior Notes are convertible into shares of Company's common stock based on an initial conversion rate of 118.5255 shares of common stock per $1,000 principal amount of Convertible Senior Notes, which is equivalent to an initial conversion price of approximately $8.44 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 under 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 June 30, 2012, there was an outstanding balance under the Facility of $21.5 and we are in compliance with all its debt covenants. As of June 30, 2012, we had restricted cash balances of approximately $0.8 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 Six Months ended June 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 $8 million, which comprises approximately 3% of our investment portfolio. Below are summary attributes for each of our primary investment portfolio components (see "— Investment Portfolio — Investment Securities" for a more detailed description) as of and for the six months ended June 30, 2012:

***Debt Securities***

- represent approximately 47% of total assets;
- represent credit instruments issued by corporate borrowers;
- primarily senior secured and junior secured loans (49% and 30% of debt securities, respectively);
- spread across 24 different industries and 58 different entities;

- average balance per investment of approximately $2 million;
- all but four issuers (representing less than 1% of total investments at fair value) are current on their debt service obligations; and
- weighted average interest rate of 8.3% on income producing debt investments.

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

- represent approximately 21% of total assets at June 30, 2012;
- 89% of CLO Fund securities represent investments in subordinated securities or equity securities issued by CLO Funds and 11% 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 $2,000, 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 managers in our statement of operations and are an additional source of income to pay our dividend;
- for the six months ended June 30, 2012, our Asset Manager Affiliates had EBITDA of approximately $1.3 million; and
- for the six months ended June 30, 2012, our Asset Manager Affiliates made a distribution of $2,025,000 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 and six months ended June 30, 2012, the Company's investments had a net increase in unrealized depreciation of approximately $4 million and $8 million, respectively. During the three and six months ended June 30, 2011, the Company's investments had a net increase in unrealized appreciation of approximately $10 million and $17 million, respectively.

The net increase in unrealized depreciation of approximately $4 million for the three months ended June 30, 2012 is primarily due to (i) an approximate $2.9 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 $200,000 in the unrealized appreciation of CLO Fund securities; and (iii) an approximate increase of $1.7 million in the unrealized depreciation of our Asset Manager Affiliates.

The net increase in unrealized depreciation of approximately $8 million for the six months ended June 30, 2012 is primarily due to (i) an approximate $3.3 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 $2.6 million in the unrealized appreciation of CLO Fund securities; and (iii) an approximate increase of $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 June 30, 2012 and 2011 was an increase of approximately $2 million and $874,000, respectively, or $0.06 and $0.04 per share, respectively. The net change in net assets resulting from operations for the six months ended June 30, 2012 and 2011 was an increase of approximately $2 million and $10 million, respectively, or $0.09 and $0.46 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 June 30, 2012, net investment income and net realized gains were approximately $6 million, or $0.23 per share. For the three months ended June 30, 2011, net investment income and net realized gains were approximately $9 million or $0.41 per share. For the six months ended June 30, 2012, net investment income and net realized losses were approximately $10 million, or $0.39 per share. For the six months ended June 30, 2011, net investment income and net realized gains were approximately $6 million or $0.27 per share.

**Dividends**

For the three months ended June 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 second quarter declaration, which was booked in the third quarter. For the six months ended June 30, 2012, we declared a $0.42 dividend per share. As a result, there was a dividend distribution of approximately $11.0 million for the first and second quarter declarations, which were booked in the second and third quarters, respectively. 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: | | | | |
| 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 | $ 0.42 | | | |
| 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 six months ended June 30, 2012, our Asset Manager Affiliates had approximately $1.3 million of EBITDA and made a distribution of $2,025,000 to us. For the six months ended June 30, 2011, our Katonah Debt Advisors earned approximately $840,000 of EBITDA 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 June 30, 2012 and December 31, 2011:

| | June 30, 2012 (unaudited) | | | December 31, 2011 | | |
|---|---|---|---|---|---|---|
| Security Type | Cost | Fair Value | %[1] | Cost | Fair Value | %[1] |
| Time Deposits | $ 17,098 | $ 17,098 | —% | $ 229,152 | $ 229,152 | —% |
| Money Market Account | 10,790,686 | 10,790,686 | 5 | 31,622,134 | 31,622,134 | 18 |
| Senior Secured Loan | 79,181,776 | 70,444,927 | 34 | 54,045,184 | 45,259,328 | 25 |
| Junior Secured Loan | 59,984,315 | 43,399,869 | 21 | 58,936,728 | 47,300,172 | 26 |
| Mezzanine Investment | 10,950,636 | 11,588,115 | 6 | 10,931,428 | 11,588,115 | 6 |
| Senior Subordinated Bond | 17,383,292 | 17,435,390 | 9 | 9,997,898 | 10,125,891 | 6 |
| CLO Fund Securities | 79,407,564 | 63,883,515 | 31 | 65,820,840 | 48,438,317 | 27 |
| Equity Securities | 16,559,610 | 7,719,242 | 4 | 16,559,610 | 6,040,895 | 3 |
| Preferred | 400,000 | 395,720 | — | 400,000 | 400,000 | — |
| Asset Manager Affiliates | 83,419,910 | 72,896,000 | 36 | 44,338,301 | 40,814,000 | 23 |
| Total | $358,094,887 | $298,570,562 | 146% | $292,881,275 | $241,818,004 | 134% |

(1) 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 June 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 8.3% and 8.7%, respectively.

The investment portfolio (excluding the Company's investments in its Asset Manager Affiliates and CLO Funds) at June 30, 2012 was spread across 24 different industries and 58 different entities with an average balance per entity of approximately $2 million. As of June 30, 2012, all but four 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 June 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 June 30, 2012, our ten largest portfolio companies represented approximately 55% of the total fair value of our investments. Our largest investment is comprised of our wholly-owned Asset Manager Affiliates and represented 24% of the total fair value of our investments. Excluding our Asset Manager Affiliates and CLO Fund securities, our ten largest portfolio companies represent approximately 21% 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 June 30, 2012, we had approximately $64 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 June 30, 2012 and December 31, 2011 are as follows:

| | | | June 30, 2012 (unaudited) | | December 31, 2011 | |
|---|---|---|---|---|---|---|
| CLO Fund Securities | Investment | %[1] | Cost | Fair Value | Cost | Fair Value |
| Grant Grove CLO, Ltd. | Subordinated Securities | 22.2% | $ 4,899,382 | $ 2,982,620 | $ 4,750,401 | $ 3,042,400 |
| Katonah III, Ltd.[3] | Preferred Shares | 23.1 | 4,476,930 | 1,000 | 4,453,860 | 1,000 |
| Katonah V, Ltd.[3] | Preferred Shares | 26.7 | 3,320,000 | 1,000 | 3,320,000 | 1,000 |
| Katonah VII CLO Ltd.[2] | Subordinated Securities | 16.4 | 4,578,293 | 2,291,282 | 4,579,546 | 2,358,700 |
| Katonah VIII CLO Ltd.[2] | Subordinated Securities | 10.3 | 3,452,605 | 2,104,917 | 3,412,466 | 1,888,700 |
| Katonah IX CLO Ltd.[2] | Preferred Shares | 6.9 | 2,073,387 | 1,524,070 | 2,024,594 | 1,336,800 |
| Katonah X CLO Ltd.[2] | Subordinated Securities | 33.3 | 11,891,547 | 9,117,423 | 11,723,768 | 8,645,600 |
| Katonah 2007-1 CLO Ltd.[2] | Preferred Shares | 100.0 | 31,053,938 | 26,703,361 | 30,343,592 | 24,488,400 |
| Katonah 2007-1 CLO Ltd.[2] | Class B-2L Notes | 100.0 | 1,230,482 | 7,320,000 | 1,212,612 | 6,675,717 |
| Trimaran CLO IV, Ltd.[2] | Preferred Shares | 18.9 | 3,607,100 | 3,222,196 | — | — |
| Trimaran CLO V, Ltd.[2] | Subordinate Notes | 20.8 | 2,753,500 | 2,799,198 | — | — |
| Trimaran CLO VI, Ltd.[2] | Income Notes | 16.2 | 2,911,700 | 2,744,720 | — | — |
| Trimaran CLO VII, Ltd.[2] | Income Notes | 10.5 | 3,158,700 | 3,071,728 | — | — |
| Total | | | $79,407,564 | $63,883,515 | $65,820,839 | $48,438,317 |

(1) Represents percentage of class held.

(2) An affiliate CLO Fund managed by an Asset Manager Affiliate.

(3) As of June 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 June 30, 2012:

| CLO Fund Securities[1] | Number of Securities | Number of Issuers | Number of Industries | Average Security Position Size | Average Issuer Position Size |
|---|---|---|---|---|---|
| Grant Grove CLO, Ltd.[2] | 294 | 236 | 32 | $ 941,457 | $ 1,172,832 |
| Katonah III, Ltd.[2] | 92 | 53 | 23 | 1,290,543 | 2,240,187 |
| Katonah V, Ltd.[2] | 107 | 62 | 27 | 484,950 | 836,930 |
| Katonah VII CLO Ltd. | 170 | 142 | 31 | 1,696,364 | 2,030,858 |
| Katonah VIII CLO Ltd. | 208 | 169 | 31 | 1,825,588 | 2,246,878 |
| Katonah IX CLO Ltd. | 223 | 193 | 29 | 1,840,738 | 2,126,863 |
| Katonah X CLO Ltd. | 246 | 205 | 28 | 1,955,466 | 2,346,559 |
| Katonah 2007-1 CLO Ltd. | 199 | 169 | 28 | 1,546,800 | 1,821,380 |
| Trimaran CLO IV, Ltd. | 128 | 101 | 21 | 2,357,482 | 2,987,701 |
| Trimaran CLO V, Ltd. | 147 | 117 | 23 | 1,942,537 | 2,440,624 |
| Trimaran CLO VI, Ltd. | 170 | 131 | 23 | 1,776,066 | 2,304,819 |
| Trimaran CLO VII, Ltd. | 182 | 145 | 26 | 2,612,066 | 3,278,593 |

(1) All data from most recent Trustee reports as of June 30, 2012.

(2) Managed by non-affiliates as of June 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 June 30, 2012 were approximately $7.3 million, $1.2 million, and $6.1 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 June 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 $73 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 six months ended June 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 | 61,919,776 | 12,000,000 | — | 39,081,609 | 113,001,385 |
| Pay-downs / pay-offs / sales | (28,761,432) | — | — | — | (28,761,432) |
| Net accretion of interest | 126,018 | 879,081 | — | — | 1,005,099 |
| Net realized losses | 304,421 | — | — | — | 304,421 |
| Increase (decrease) in fair value | (4,998,268) | 2,566,117 | 1,678,347 | (6,999,609) | (7,753,413) |
| Fair Value at June 30, 2012 | $143,264,021 | $ 63,883,515 | $ 7,719,242 | $ 72,896,000 | $ 287,762,778 |

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.

### Comparison of three and six months ended June 30, 2012 and 2011

Set forth below is a discussion of our results of operations for the three and six months ended June 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 June 30, 2012 and 2011 was approximately $9 million and $6 million, respectively. Of these amounts, approximately $3 million and $2 million was attributable to interest income on our loan and bond investments, respectively. For the three months ended June 30, 2012 and 2011, approximately $5 million and $3 million of investment income is attributable to dividends earned on CLO equity investments, respectively.

Investment income for the six months ended June 30, 2012 and 2011 was approximately $17 million and $13 million, respectively. Of these amounts, approximately $5 million and $4 million was attributable to interest income on our loan and bond investments, respectively. For the six months ended June 30, 2012 and 2011, approximately $10 million and $7 million of investment income is attributable to dividends earned on CLO equity investments, respectively.

The increase in our interest income for the three and six months ended June 30, 2012 as compared to the three and six months ended June 30, 2011 was primarily attributable to a higher average level of outstanding debt securities, partially offset by a decrease in the weighted average interest rate on our debt securities from 8.9% to 8.3% during the year-over-year periods.

The increase in investment income from CLO Fund securities for the three and six months ended June 30, 2012 as compared to the three and six months ended June 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 six months ended June 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 six months ended June 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 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 June 30, 2012, our investment in the Asset Manager Affiliates was valued at approximately $73 million. For the three months ended June 30, 2012 and 2011, our Asset Manager Affiliates had EBITDA of approximately $1.2 million and $420,000, respectively. For the six months ended June 30, 2012 and 2011, our Asset Manager Affiliates had EBITDA of approximately $1.3 million and $840,000, respectively. For the three months ended June 30, 2012 and 2011, our Asset Manager Affiliates made distributions of net income of $1,200,000 and $650,000, respectively. For the six months ended June 30, 2012 and 2011, our Asset Manager Affiliates made distributions of net income of $2,025,000 and 650,000, 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 six months ended June 30, 2012 as compared to the three and six months ended June 30, 2011 was largely attributable to our acquisition of Trimaran Advisors in February 2012.

**Expenses**

Total expenses for the three months ended June 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 $75 million and $60 million, respectively. Approximately

$1 million and $1 million, respectively, of expenses were attributable to employment compensation, including salaries, bonuses and stock option expense for the three months ended June 30, 2012 and 2011. For the three months ended June 30, 2012, other expenses included approximately $757,000 for professional fees, insurance, administrative and other. For the three months ended June 30, 2011, other expenses included approximately $628,000 for professional fees, insurance, administrative and other. For the three months ended June 30, 2012 and 2011, administrative and other costs (including occupancy expense, insurance, technology and other office expenses) totaled approximately $369,000 and $218,000, respectively.

Total expenses for the six months ended June 30, 2012 and 2011 were approximately $7 million and $6 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 $3 million and $2 million, respectively, on average debt outstanding of $68 million and $48 million, respectively. Approximately $2 million and $2 million, respectively, of expenses were attributable to employment compensation, including salaries, bonuses and stock option expense for the six months ended June 30, 2012 and 2011. For the six months ended June 30, 2012, other expenses included approximately $2 million for professional fees, insurance, administrative and other. For the six months ended June 30, 2011, other expenses included approximately $2 million for professional fees, insurance, administrative and other. For the six months ended June 30, 2012 and 2011, administrative and other costs (including occupancy expense, insurance, technology and other office expenses) totaled approximately $695,000 and $530,000, 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 six months ended June 30, 2012 are higher by approximately $100,000 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 Appreciation (Depreciation) on Investments**

During the three months ended June 30, 2012, our total investments had a increase in net unrealized appreciation of approximately $4.4 million. During the three months ended June 30, 2011, our total investments had an increase in net unrealized appreciation of approximately $10.1 million. For the three months ended June 30, 2012, our Asset Manager Affiliates had a increase in net unrealized depreciation of approximately $1.7 million. For the three months ended June 30, 2011, our Asset Manager Affiliates had an increase in net unrealized appreciation of approximately $15,000. For the three months ended June 30, 2012, 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 $2.7 million. For the three months ended June 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 $10.1 million.

During the six months ended June 30, 2012, our total investments had a increase in net unrealized depreciation of approximately $7.8 million. During the six months ended June 30, 2011, our total investments had an increase in net unrealized appreciation of approximately $16.6 million. For the six months ended June 30, 2012, our Asset Manager Affiliates had a increase in net unrealized depreciation of approximately $7 million. For the six months ended June 30, 2011, our Asset Manager Affiliates had an increase in net unrealized appreciation of approximately $860,000. For the six months ended June 30, 2012, 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 $750,000. For the six months ended June 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 $15.7 million.

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

For the three and six months ended June 30, 2012 the net change in net assets resulting from operations was an approximate increase of $2 million and $2 million, or $0.06 and $0.09 per share, respectively. The net change in net assets resulting from operations for the three and six months ended June 30, 2011 was an approximate increase of $874,000 and $10 million, or $0.04 and $0.46 per share, respectively.

**Comparison of year ended December 31, 2011, 2010, and 2009**

Set forth below is a discussion of our results of operations for the years ended December 31, 2011, 2010, and 2009.

***Investment Income***

Investment income for the years ended December 31, 2011, 2010, and 2009 was approximately $28 million, $29 million, and $34 million, respectively. Of this amount, approximately $9 million, $14 million and $24 million, respectively, was attributable to interest income on our loan and bond investments. A portion of such interest income is attributable to net interest earned on assets accumulated for future CLO issuance on which Katonah Debt Advisors entered into a first loss agreement in connection with loan warehouse arrangements for Katonah Debt Advisors CLO Funds. For the years ended December 31, 2011 and December 31, 2010 no income related to first loss arrangements was earned. For the year ended December 31, 2009, approximately $107,000 of such net interest related to the first loss arrangements previously accrued was written off. For the years ended December 31, 2011, 2010, and 2009, approximately $15 million, $10 million and $9 million, respectively, of investment income was attributable to investments in CLO fund securities.

During the three months ended March 31, 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 three months ended March 31, 2011.

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 bond 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.

***Dividends from Affiliate Asset Manager***

As of December 31, 2011, our investment in Katonah Debt Advisors was approximately $41 million. For the year ended December 31, 2011 and 2010, Katonah Debt Advisors had EBITDA of approximately $2.3 million and $1.4 million, respectively. During the year ended December 31, 2011 distributions from Katonah Debt Advisors totaled approximately $1.9 million. For the year ended December 31, 2010 distributions from Katonah Debt Advisors totaled approximately $4.5 million, a portion of which represented undistributed earnings from prior years.

Distributions of Katonah Debt Advisors' net income are recorded as dividends from affiliate asset manager. The Company intends to distribute the accumulated undistributed net income of Katonah Debt Advisors in the future. For purposes of calculating distributable tax income for required quarterly dividends as a RIC, Katonah Debt Advisors' net income is further reduced by approximately $2 million per annum for tax goodwill amortization resulting from its acquisition by us prior to our initial public offering. 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).

***Expenses***

Interest and compensation expense are generally expected to be our largest expenses each period. Interest expense is dependent on the average outstanding principal balance of our borrowings and the applicable 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 paid annually.

Total expenses for the years ended December 31, 2011, 2010, and 2009 were approximately $12 million, $17 million, and $16 million, respectively. Interest expense and amortization on debt issuance costs for the period, which includes facility and program fees on the unused loan balance, was approximately $5 million, $7 million, and $9 million, respectively, on average debt outstanding of $54 million, $155 million, and $236 million, respectively.

For the years ended December 31, 2011, 2010, and 2009 approximately $4 million, $3 million, and $3 million respectively, of expenses were attributable to employment compensation, including salaries, bonuses and stock option expense. For the year ended December 31, 2011, professional fees and insurance expenses totaled approximately $3 million. For the year ended December 31, 2010 and December 31, 2009, professional fees and insurance expenses totaled approximately $6 million, and $2 million, respectively. For the year ended December 31, 2011, administrative and other costs totaled approximately $987,000. For the year ended December 31, 2010 and December 31, 2009, administrative and other costs totaled approximately $1 million and $991,000, respectively. These costs include occupancy expense, technology and other office expenses.

Professional fee expenses for the year ended December 31, 2011 are significantly lower by approximately $3 million relative to the same prior year period. This decrease in professional fees is primarily related to legal proceedings and our complaint against our lenders and additional legal, accounting and valuation costs related to the restatement (and defense on the related class-action and SEC investigation net of reimbursable legal fees covered by directors' and officers' insurance) of our year-end 2008 and first- and second- quarter 2009 financial statements.

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

During the year ended December 31, 2011, our total investments had net unrealized appreciation of approximately $10 million. During the years ended December 31, 2010 and December 31, 2009, our total investments had net unrealized depreciation of approximately $8 million, and net unrealized appreciation of $32 million, respectively.

The $10 million of unrealized gains during the year ended December 31, 2011 are due to unrealized gains of $11 million on debt securities, equity securities and CLO Fund securities in our investment portfolio, and a $485,000 decrease in the value of Katonah Debt Advisors.

The $8 million of unrealized loss during the year ended December 31, 2010 were primarily due to unrealized gains of approximately $9 million and $4 million on debt securities and CLO Fund securities, respectively, in our investment portfolio, offset in part by approximately a $1 million unrealized loss on equity securities, and an approximate decrease of $20 million in the value of Katonah Debt Advisors. The $31 million of unrealized gains during the year ended December 31, 2009 were primarily due to unrealized gains of $25 million and $13 million on debt securities and CLO Fund securities, respectively, in our investment portfolio, as well as an approximate unrealized loss on equity of $7 million and an approximate $2 million unrealized loss on Katonah Debt Advisors.

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

The net increase in net assets resulting from operations for the year ended December 31, 2011 was an approximately $8 million, or $0.33 per share. The net decrease in net assets resulting from operations for the

year ended December 31, 2010 was $14 million, or $0.64 per share, and the net increase in net assets resulting from operations for the year ended December 31, 2009 was approximately $34 million, or $1.56 per share.

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

| | Investments at Fair Value | |
|---|---|---|
| **Security Type** | **June 30, 2012** | **December 31, 2011** |
| | (unaudited) | |
| Cash | $ 1,617,867 | $ 2,555,259 |
| Time Deposits | 17,098 | 229,152 |
| Money Market Accounts | 10,790,686 | 31,622,134 |
| Senior Secured Loan | 70,444,927 | 45,259,328 |
| Junior Secured Loan | 43,399,869 | 47,300,172 |
| Mezzanine Investment | 11,588,115 | 11,588,115 |
| Senior Subordinated Bond | 17,435,390 | 10,125,891 |
| CLO Fund Securities | 63,883,515 | 48,438,317 |
| Equity Securities | 7,719,242 | 6,040,895 |
| Preferred | 395,720 | 400,000 |
| Affiliate Asset Managers | 72,896,000 | 40,814,000 |
| Total | $ 300,188,429 | $ 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 June 30, 2012, we had approximately $82 million of outstanding borrowings and our asset coverage ratio of total assets to total borrowings was 351%, 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 the 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 under 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 June 30, 2012, there was an outstanding balance of $21.5 million under the Facility and we are in compliance with all its debt covenants. As of June 30, 2012, we had restricted cash balances of approximately $0.8 million which we maintained in accordance with the terms of the Facility.

As of June 30, 2012, we had total outstanding indebtedness of approximately $82 million. As of June 30, 2012, we had cash, time deposits, and money market accounts of approximately $12 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 June 30, 2012 and December 31, 2011, we had committed to make a total of approximately $0 and $2 million, respectively, of investments.

## CONTRACTUAL OBLIGATIONS

The following table summarizes our contractual cash obligations and other commercial commitments as of December 31, 2011:

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| **Contractual Obligations** | **Total** | **Less than one year** | **1 — 3 years** | **3 — 5 years** | **More than 5 years** |
| Operating lease obligations | $ 4,671,981 | $ 335,445 | $ 1,073,220 | $ 369,432 | $ 2,893,884 |
| Long-term debt obligations | 60,000,000 | — | — | — | 60,000,000 |
| Unused lending commitments[1] | 2,000,000 | 2,000,000 | — | — | — |
| Total | $ 66,671,981 | $ 2,335,445 | $ 1,073,220 | $ 369,432 | $ 62,893,884 |

(1) Represents the unfunded lending commitment in connection with revolving lines of credit or delayed funding draws on loans made to portfolio companies.

## 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 June 30, 2012, four 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 maintain its qualification as a RIC, the Company is required to timely distribute to its stockholders at least 90% of our net ordinary income and the excess of realized net short-term capital gains over realized net long-term capital losses, if any, 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.

## 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 June 30, 2012, approximately 72% 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 June 30, 2012, we had $60 million of borrowings outstanding at a fixed rate of 8.75%, and $21.5 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, our current cost of debt would remain the same at 8.75% given that our 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 June 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 June 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.

## DEBT OBLIGATIONS AND INDEBTEDNESS

Information about our debt obligations and indebtedness is shown in the following table as of December 31 for the years indicated in the table, unless otherwise noted. Grant Thornton LLP's report on the table as of December 31, 2011, is attached as an exhibit to the registration statement of which this prospectus is a part.

| Class and Year | Total Amount Outstanding Exclusive of Treasury Securities[1] | Asset Coverage per Unit[2] | Involuntary Liquidating Preference per Unit[3] | Average Market Value per Unit[4] |
|---|---|---|---|---|
| | (dollars in thousands) | | | |
| Senior securities payable | | | | |
| 2006 | N/A | N/A | N/A | N/A |
| 2007 | $ 255,000 | 2,016 | — | N/A |
| 2008 | 261,691 | 1,751 | — | N/A |
| 2009 | 218,050 | 1,981 | — | N/A |
| 2010 | 86,747 | 3,155 | — | N/A |
| 2011 | 60,000 | 4,009 | — | N/A |
| 2012 (as of June 30, 2012, unaudited) | 81,500 | 3,505 | — | N/A |

(1) Total amount of each class of senior securities outstanding at the end of the period presented.

(2) Asset coverage per unit is the ratio of the carrying value of our total consolidated assets, less all liabilities and indebtedness not represented by senior securities, to the aggregate amount of senior securities representing indebtedness. Asset coverage per unit is expressed in terms of dollar amounts per $1,000 of indebtedness.

(3) The amount to which such class of senior security would be entitled upon the involuntary liquidation of the issuer in preference to any security junior to it. The "—" indicates information which the Securities and Exchange Commission expressly does not require to be disclosed for certain types of senior securities.

(4) Not applicable because senior securities are not registered for public trading.

**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. As a result of the repayment, the Company had no outstanding balance under this secured credit facility as of March 31, 2011.

On February 24, 2012, the Company entered into the Facility. The scheduled maturity date for the Facility is December 20, 2014. Interest on the Facility is LIBOR + 300 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 October 1, 2012, there was an outstanding balance of $28 million under the Facility and the Company is in compliance with all its debt covenants. As of June 30, 2012, the Company had restricted cash balances of approximately $815,000 which it maintained 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, which approximates the effective yield method, of which approximately $397,000 remains to be amortized.

**Convertible Senior Notes**

On March 16, 2011, the Company issued $55 million in aggregate principal amount of the 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 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 118.5255 shares of common stock per $1,000 principal amount of Convertible Senior Notes, which is equivalent to an initial conversion price of approximately $8.44 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 $1.7 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 $61.2 million at June 30, 2012. The fair value was determined based on the average of indicative bid and offer pricing for the Convertible Senior Notes.

## BUSINESS

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, which we refer to as "EBITDA," of $10 million to $50 million and/or total debt of $25 million to $150 million. In addition to our middle market investment business, Katonah Debt Advisors and Trimaran Advisors (collectively, our "Asset Manager Affiliates"), our wholly-owned portfolio companies, each manage collateralized loan obligation funds ("CLO Funds") that invest in broadly syndicated loans, high-yield bonds and other corporate credit instruments. Each of Katonah Debt Advisors and Trimaran Advisors are registered investment advisers under the Advisers Act.

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. We also expect to receive distributions of recurring fee income and to generate capital appreciation from our investments in the asset management businesses of our 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. 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 the CLO Funds managed by our Asset Manager Affiliates or by other asset managers.

We seek to manage risk through a rigorous credit and investment underwriting process and an active portfolio monitoring program. 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 were formed in August 2006. In December 2006, we completed our IPO, which raised net proceeds of approximately $200 million after the exercise of the underwriters' over-allotment option. In connection with our IPO, we issued an additional 3,484,333 shares of our common stock in exchange for the ownership interests of Katonah Debt Advisors and in securities issued by the CLO Funds managed by Katonah Debt Advisors and two other asset managers. On April 28, 2008, we completed a rights offering which resulted in the issuance of 3.1 million common shares and net proceeds of approximately $27 million. On February 29, 2012, we purchased Trimaran Advisors, a CLO manager similar to Katonah Debt Advisors. Contemporaneously with the acquisition of Trimaran Advisors, we acquired from Trimaran Advisors equity interests in certain CLO Funds managed by Trimaran Advisors. As of June 30, 2012, Katonah Debt Advisors and Trimaran Advisors are the Company's only wholly-owned portfolio companies and have approximately $3.3 billion of par value assets under management. Kathonah Debt Advisors and Trimaran Advisors are each managed independently from us by separate management teams and investment committees.

Including employees of our Asset Manager Affiliates, we employ an experienced team of 13 investment professionals and 20 total staff members. Dayl W. Pearson, our President and Chief Executive Officer ("CEO") and one of our directors, has been in the financial services industry for over 33 years. During the past 20 years, Mr. Pearson has focused almost exclusively in the middle market and has originated, structured and underwritten over $7 billion of debt and equity securities. R. Jon Corless, our Chief Investment Officer ("CIO"), has managed investment portfolios in excess of $4 billion at several institutions and has been responsible for managing portfolios of leveraged loans, high-yield bonds, mezzanine securities and middle market loans. Edward U. Gilpin, our Chief Financial Officer ("CFO"), Secretary and Treasurer, has significant experience in overseeing the financial reporting for asset management businesses, including the fair value accounting of CLO securities owned by them.

We are an internally managed, non-diversified closed-end investment company that has elected to be regulated as a BDC under the 1940 Act. Because we are internally managed by our executive officers under the supervision of our Board of Directors and do not depend on a third party investment advisor, we do not pay investment advisory fees and all of our income is available to pay our operating costs and to make distributions to our stockholders. As a BDC, we are required to comply with regulatory requirements, including limitations on our use of debt. We are permitted to, and expect to continue to, finance our investments through borrowings. However, as a BDC, we are only generally allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowing. The 1940 Act also generally prohibits us from declaring any cash dividend or distribution on any class of our capital stock if our asset coverage is below 200% at the time of the declaration of the dividend or distribution.

In addition, under the investment company rules and regulations pursuant to Article 6 of Regulation S-X and the "Audit and Accounting Guide for Investment Companies" issued by the AICPA Guide, we are precluded from consolidating portfolio company investments, including those in which we have a controlling interest, unless the portfolio company is another investment company. An exception to this general principle in the AICPA Guide occurs if we own a controlled operating company that provides all or substantially all of its services directly to us, or to an investment company of ours. None of the investments made by us qualify for this exception. Therefore, our portfolio investments, including our investments in the Asset Manager Affiliates, are carried on the balance sheet at fair value with any adjustments to fair value recognized as "Net Change in Unrealized Appreciation (Depreciation)" in our statement of operations until the investment is exited, resulting in any gain or loss on exit being recognized as a "Net Realized Gain (Loss) from Investments."

We have also elected to be treated for U.S. federal income tax purposes as a RIC under the Code and intend to operate in a manner to maintain our RIC tax treatment. Accordingly, we generally will not pay corporate-level federal income taxes on any net ordinary income or capital gains that we timely distribute to our shareholders as dividends. To maintain our RIC tax treatment, we must meet specified source-of-income and asset diversification requirements and distribute annually at least 90% of our net ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, for each year.

**Investment Portfolios**

Our investment portfolio generates net investment income, which is generally used to pay principal and interest on our borrowings and to fund our dividends. Our investment portfolio consists of three primary components: debt securities, CLO fund securities and our investment in our wholly owned Asset Manager Affiliates. As of June 30, 2012, we also had investments in equity securities of approximately $7.7 million, which comprises approximately 2.6% of our investment portfolio. 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.

Through our middle market investment business, we invest in senior secured loans, mezzanine debt and, to a lesser extent, equity, of middle market companies in a variety of industries. We target middle market companies that have strong historical cash flows, experienced management teams and identifiable and defendable market positions in industries with positive dynamics. We generally target companies that generate positive cash flows because we look to cash flows as the primary source for servicing debt.

We may invest up to 30% of our investment portfolio in opportunistic investments in high-yield bonds, debt and equity securities of the CLO Funds, distressed debt or equity securities of public companies. In this regard, we typically make a minority investment in the subordinated securities or preferred stock of the CLO Funds raised and managed by our Asset Manager Affiliates and may selectively invest in securities issued by the CLO Funds managed by other asset management companies. 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. The underlying assets in the

CLO Funds exclude mortgage pools or mortgage securities (residential mortgage bonds, commercial mortgage backed securities, or related asset-backed securities), debt to companies providing mortgage lending and emerging markets investments.

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. As of June 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 $73 million.

We expect to continue to benefit from our ownership of our Asset Manager Affiliates in four ways. First, by working with the investment professionals at our Asset Manager Affiliates, we have multiple sources of investment opportunities. Second, the experienced team of credit analysts at our Asset Manager Affiliates have specializations covering more than 20 industry groups and they assist us in reviewing potential investments and monitoring our portfolio. Third, we may continue to make investments in the CLO Funds or other funds managed by our Asset Manager Affiliates, which we believe will provide us with a current cash investment return. Fourth, we expect to continue to receive distributions of recurring fee income and the potential to generate capital appreciation from our investment in our Asset Manager Affiliates as the platform grows.

As the managers 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 of the CLO Funds managed by Asset Manager Affiliates are paying both their senior and subordinated management fees on a current basis.

In future years, our Asset Manager Affiliates may receive accrued incentive fees from the 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 the 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. We also expect to receive distributions of recurring fee income and, if debt markets stabilize and recover, to generate capital appreciation from our investment in the asset management business of our Asset Manager Affiliates.

**Competitive Advantages**

We believe that we can successfully compete with other providers of capital in the markets in which we compete for the following reasons:

- ***Internally managed structure and significant management resources***. We are internally managed by our executive officers under the supervision of our Board of Directors and do not depend on a third party investment advisor. As a result, we do not pay investment advisory fees and all of our income is available to pay our operating costs, which include employing investment and portfolio management professionals, and to make distributions to our stockholders. We believe that our internally managed structure provides us with a beneficial operating expense structure when compared to other publicly traded and privately-held investment firms which are externally managed, and our internally managed structure allows us the opportunity to leverage our non-interest operating expenses as we grow our investment portfolio.

- ***Multiple sourcing capabilities for assets***. We have multiple sources of loans, mezzanine investments and equity investments through our industry relationships.
- ***Disciplined investment process***. We employ a rigorous credit review and due diligence process which our senior management has developed over more than 20 years of lending. For each analyzed company, we develop our own underwriting case and multiple stress case scenarios and an event-specific financial model reflecting company, industry and market variables.
- ***Investments in a wide variety of portfolio companies in a number of different industries with no exposure to mortgage-backed securities***. Our investment portfolio (excluding our investments in our Asset Manager Affiliates and CLO Fund securities) is spread across 25 different industries and 56 different entities with an average balance per investment of approximately $2 million.
- ***Significant equity ownership and alignment of incentives***. Our senior management team and the senior management team of our Asset Manager Affiliates together have a significant equity interest in the Company, ensuring that their incentives are strongly aligned with those of our stockholders.

**Our Corporate Information**

Our principal executive offices are located at 295 Madison Avenue, 6th Floor, New York, New York 10017, and our telephone number is (212) 455-8300. We maintain a website on the Internet at *http://www.kcapinc.com*. Information contained in our website is not incorporated by reference into this prospectus, and you should not consider that information to be part of this prospectus.

**Investment Structure and Process**

***Structure***

We originate, structure and invest in senior secured term loans, mezzanine debt and selected equity securities primarily in privately-held middle market companies. In addition to our middle market investment business, our wholly-owned portfolio companies manage the CLO Funds, in which we also may make an investment, that invest in broadly syndicated loans, high-yield bonds and other corporate credit instruments.

Our investments generally average between $1 million to $10 million, although particular investments may be larger or smaller. The size of individual investments will vary according to their priority in a company's capital structure, with larger investments in more secure positions in an effort to maximize capital preservation. We expect that the size of our investments and maturity dates will vary as follows:

- senior secured term loans from $5 to $10 million maturing in five to seven years;
- second lien term loans from $5 to $20 million maturing in six to eight years;
- senior unsecured loans $5 to $10 million maturing in six to eight years;
- mezzanine loans from $5 to $20 million maturing in seven to ten years; and
- equity investments from $1 to $5 million.

When we extend senior secured term loans, we will generally take a security interest in the available assets of the portfolio company, including the equity interests of their subsidiaries, which we expect to help mitigate the risk that we will not be repaid. Nonetheless, there is a possibility that our lien could be subordinated to claims of other creditors. Structurally, mezzanine debt ranks subordinate in priority of payment to senior term loans and is often unsecured. Relative to equity, mezzanine debt ranks senior to common and preferred equity in a borrower's capital structure. Typically, mezzanine debt has elements of both debt and equity instruments, offering the fixed returns in the form of interest payments associated with a loan, while providing an opportunity to participate in the capital appreciation of a borrower, if any, through an equity interest that is typically in the form of equity purchased at the time the mezzanine loan is repaid or warrants to purchase equity at a future date at a fixed cost. Mezzanine debt generally earns a higher return than senior secured debt due to its higher risk profile and usually less restrictive covenants. The warrants associated with mezzanine debt are typically detachable, which allows lenders to receive repayment of their principal on an agreed amortization schedule while retaining their equity interest in the borrower. Mezzanine

debt also may include a "put" feature, which permits the holder to sell its equity interest back to the borrower at a price determined through an agreed formula.

***Process***

We employ the same due diligence intensive investment strategy that our senior management team has used over the past 30 years. Due to our ability to source transactions through multiple channels, we expect to continue to maintain a substantial pipeline of opportunities to allow comparative risk return analysis and selectivity. By focusing on the drivers of revenue and cash flow, we develop our own underwriting cases, and multiple stress and event specific case scenarios for each company analyzed.

We focus on lending and investing opportunities in:

- companies with EBITDA of $10 to $50 million;
- companies with financing needs of $25 to $150 million;
- companies purchased by top tier equity sponsors;
- non-sponsored companies with successful management and systems;
- high-yield bonds and broadly syndicated loans to larger companies on a selective basis; and
- equity co-investment in companies where we see substantial opportunity for capital appreciation.

We expect to continue to source investment opportunities from:

- private equity sponsors;
- regional investment banks for non-sponsored companies;
- other middle market lenders with whom we can "club" loans; and
- our Asset Manager Affiliates with regard to high-yield bonds and syndicated loans.

In our experience, good credit judgment is based on a thorough understanding of both the qualitative and quantitative factors which determine a company's performance. Our analysis begins with an understanding of the fundamentals of the industry in which a company operates, including the current economic environment and the outlook for the industry. We also focus on the company's relative position within the industry and its historical ability to weather economic cycles. Other key qualitative factors include the experience and depth of the management team and the financial sponsor, if any.

Only after we have a comprehensive understanding of the qualitative factors do we focus on quantitative metrics. We believe that with the context provided by the qualitative analysis, we can gain a better understanding of a company's financial performance. We analyze a potential portfolio company's sales growth and margins in the context of its competition as well as its ability to manage its working capital requirements and its ability to generate consistent cash flow. Based upon this historical analysis, we develop a set of projections which represents a reasonable underwriting case of most likely outcomes for the company over the period of our investment. We also look at a variety of potential downside cases to determine a company's ability to service its debt in a stressed credit environment.

Elements of the *qualitative analysis* we use in evaluating investment opportunities include the following:

- industry fundamentals;
- competitive position and market share;
- past ability to work through historical down-cycles;
- quality of financial and technology infrastructure;
- sourcing risks and opportunities;
- labor and union strategy;
- technology risk;

- diversity of customer base and product lines;
- quality and experience of management;
- quality of financial sponsor (if applicable); and
- acquisition and integration history.

Elements of the *quantitative analysis* we use in evaluating investment opportunities include the following:

- income statement analysis of growth and margin trends;
- balance sheet analysis of working capital efficiency;
- cash flow analysis of capital expenditures and free cash flow;
- financial ratio and market share standing among comparable companies;
- financial projections: underwriting versus stress case;
- event specific credit modeling;
- future capital expenditure needs and asset sale plans;
- downside protection to limit losses in an event of default;
- risk adjusted returns and relative value analysis; and
- enterprise and asset valuations.

The origination, structuring and credit approval processes are fully integrated. Our credit team is directly involved in all due diligence and analysis prior to the formal credit approval process.

**Monitoring**

Our management team has significant experience monitoring portfolios of middle market investments and this is enhanced by the credit monitoring procedures of our Asset Manager Affiliates. Along with origination and credit analysis, portfolio management is one of the key elements of our business. Most of our investments will not be liquid and, therefore, we must prepare to act quickly if potential issues arise so that we can work closely with management and the private equity sponsor, if applicable, of the portfolio company to take any necessary remedial action quickly. In addition, most of our senior management team, including the credit team at Asset Manager Affiliates, have substantial workout and restructuring experience.

In order to assist us in detecting issues with portfolio companies as early as possible, we perform a monthly financial analysis of each portfolio company. This analysis typically includes:

- reviewing financial statements with comparisons to prior year financial statements, as well as the current budget including key financial ratios such as debt/EBITDA, margins and fixed charge coverage;
- independently computing and verifying compliance with financial covenants;
- reviewing and analyzing monthly borrowing base, if any;
- a monthly discussion of MD&A with management and the private equity sponsor, if applicable;
- determining if current performance could cause future financial covenant default;
- discussing prospects with the private equity sponsor, if applicable;
- determining if a portfolio company should be added to our “watch list” (companies to be reviewed in more depth);
- if a company is not meeting expectations, reviewing original underwriting assumptions and determining if either enterprise value or asset value has deteriorated enough to warrant further action; and
- a monthly update to be reviewed by both our Chief Executive Officer and Chief Investment Officer.

**Competition**

Our primary competitors provide financing to prospective portfolio companies and include commercial banks, specialty finance companies, hedge funds, structured investment funds and investment banks. Many of these entities have greater financial and managerial resources than we have, and the 1940 Act imposes certain regulatory restrictions on us as a BDC to which many of our competitors are not subject. For additional information concerning the competitive risks we face, see "Risk Factors — Risks Related to Our Business and Structure — We operate in a highly competitive market for investment opportunities."

We believe that we provide a unique combination of an experienced middle market origination and credit team and an existing credit platform at both Katonah Debt Advisors and Trimaran Advisors that includes experienced lenders with broad industry expertise. We believe that this combination of resources provides us with a thorough credit process and multiple sources of investment opportunities to enhance our asset selection process.

**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 2008 and 2009 valuations of certain of the Company's investments and the valuation methodology and procedures used by the Company to value its investments prior to 2010. 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 2008 and 2009 valuations of certain of the Company's investments and the valuation methodology and procedures used by the Company to value its investments prior to 2010. 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. Neither the Company nor any person employed by the Company has received a Wells Notice.

The Company and the other officers involved in this matter, Dayl W. Pearson, the Company's Chief Executive Officer, and R. Jon Corless, the Company's Chief Investment Officer, and Mr. Wirth 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 a lawsuit will be filed, 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 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.

**Employees**

As of June 30, 2012, we had 27 employees.

## OUR INVESTMENTS AND PORTFOLIO COMPANIES

Our investment portfolio consists of three primary components: debt securities, CLO fund securities and our investment in our wholly owned Asset Manager Affiliates. Our investment portfolio (excluding the Company's investments in its Asset Manager Affiliates and the CLO Funds) at June 30, 2012 was spread across 24 different industries and 58 different entities with an average balance per entity of approximately $2 million. As of June 30, 2012, all but four of our portfolio companies (representing less than 1% of total investments at fair value) were current on their debt service obligations. At June 30, 2012, our ten largest portfolio companies represented approximately 55% of the total fair value of our investments. Our largest investment is comprised of our wholly-owned Asset Manager Affiliates and represented 24% of the total fair value of our investments. Excluding our Asset Manager Affiliates and CLO Fund securities, our ten largest portfolio companies represent approximately 21% of the total fair value of our investments.

The following table shows the Company's portfolio by security type at June 30, 2012:

| | June 30, 2012 (unaudited) | | |
|---|---|---|---|
| **Security Type** | **Cost** | **Fair Value** | **%[1]** |
| Time Deposits | $ 17,098 | $ 17,098 | —% |
| Money Market Account | 10,790,686 | 10,790,686 | 5 |
| Senior Secured Loan | 79,181,776 | 70,444,927 | 34 |
| Junior Secured Loan | 59,984,315 | 43,399,869 | 21 |
| Mezzanine Investment | 10,950,636 | 11,588,115 | 6 |
| Senior Subordinated Bond | 17,383,292 | 17,435,390 | 9 |
| CLO Fund Securities | 79,407,564 | 63,883,515 | 31 |
| Equity Securities | 16,559,610 | 7,719,242 | 4 |
| Preferred | 400,000 | 395,720 | — |
| Asset Manager Affiliates | 83,419,910 | 72,896,000 | 36 |
| Total | $ 358,094,887 | $ 298,570,562 | 146% |

(1) Calculated as a percentage of net asset value.

The industry concentrations, based on the fair value of our investment portfolio as of June 30, 2012, were as follows:

| | June 30, 2012 (unaudited) | | |
|---|---|---|---|
| **Industry Classification** | **Cost** | **Fair Value** | **%(1)** |
| Aerospace and Defense | $ 19,716,746 | $ 19,274,720 | 9% |
| Asset Management Companies(2) | 83,419,910 | 72,896,000 | 36 |
| Automobile | 4,970,281 | 4,934,202 | 3 |
| Beverage, Food and Tobacco | 18,970,913 | 19,008,315 | 9 |
| Broadcasting and Entertainment | 3,970,685 | 3,976,312 | 2 |
| Buildings and Real Estate(3) | 18,591,674 | 519,378 | — |
| Cargo Transport | — | — | — |
| Chemicals, Plastics and Rubber | 4,799,852 | 4,781,126 | 2 |
| CLO Fund Securities | 79,407,564 | 63,883,515 | 31 |
| Containers, Packaging and Glass | 1,952,878 | 1,923,599 | 1 |
| Diversified/Conglomerate Manufacturing | 6,913,503 | 7,108,500 | 3 |
| Diversified/Conglomerate Service | 5,525,008 | 3,148,720 | 2 |
| Electronics | 9,138,837 | 9,222,784 | 5 |
| Finance | 1,788,204 | 1,840,130 | 1 |
| Healthcare, Education and Childcare | 20,965,362 | 13,542,303 | 7 |
| Home and Office Furnishings, Housewares, and Durable Consumer Products | 19,070,930 | 19,677,879 | 10 |
| Insurance | 4,934,081 | 4,131,500 | 2 |
| Leisure, Amusement, Motion Pictures, Entertainment | 2,387,800 | 2,071,525 | 1 |
| Machinery (Non-Agriculture, Non-Construction, Non-Electronic) | 11,405,906 | 12,712,450 | 6 |
| Mining, Steel, Iron and Non-Precious Metals | 791,965 | 274,352 | — |
| Personal and Non Durable Consumer Products (Mfg. Only) | 5,000,000 | 3,431,250 | 2 |
| Personal, Food and Miscellaneous Services | 4,731,557 | 4,700,243 | 2 |
| Personal Transportation | 2,025,078 | 1,990,511 | 1 |
| Printing and Publishing | 3,017,894 | 3,139,404 | 2 |
| Retail Stores | 6,684,451 | 6,664,961 | 3 |
| Telecommunications | 2,969,402 | 2,678,707 | 1 |
| Time Deposit and Money Market Accounts | 10,807,784 | 10,807,784 | 5 |
| Utilities | 4,136,622 | 230,392 | — |
| Total | $358,094,887 | $298,570,562 | 146% |

(1) Calculated as a percentage of net asset value.

(2) Represents the Asset Manager Affiliates.

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

The following tables set forth certain information as of June 30, 2012, regarding each of our investments in portfolio companies. Unless otherwise noted in these tables, the only relationship between us and each portfolio company is our investment in such portfolio company.

**Debt Securities Portfolio**

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Advanced Lighting Technologies, Inc. *Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Subordinated Bond — 10.5% Cash, Due 6/19 | $ 3,000,000 | $ 2,925,037 | $ 2,925,000 |
| Alaska Communications Systems Holdings, Inc.[13] *Telecommunications* | Senior Secured Loan — Term Loan 5.5% Cash, Due 10/16 | 2,955,000 | 2,969,402 | 2,678,707 |
| Allison Transmission, Inc.[12] *Automobile* | Senior Secured Loan — Term B-2 Loan 3.8% Cash, Due 8/17 | 1,990,000 | 1,978,081 | 1,965,433 |
| Aramark Corporation[12] *Diversified/Conglomerate Service* | Senior Secured Loan — LC-3 Facility 3.5% Cash, Due 7/16 | 61,707 | 61,561 | 61,360 |
| Aramark Corporation[12] *Diversified/Conglomerate Service* | Senior Secured Loan — U.S. Term C Loan 3.7% Cash, Due 7/16 | 938,293 | 936,072 | 933,015 |
| Atlantic Broadband Finance, LLC[12] *Broadcasting and Entertainment* | Senior Secured Loan — Term Loan (First Lien) 5.3% Cash, Due 4/19 | 2,000,000 | 1,990,310 | 2,008,320 |
| Avis Budget Car Rental, LLC[12],[13] *Personal Transportation* | Senior Secured Loan — Tranche C Term Loan 4.3% Cash, Due 3/19 | 1,995,000 | 2,025,078 | 1,990,511 |
| Bankruptcy Management Solutions, Inc. *Diversified/Conglomerate Service* | Junior Secured Loan — Loan (Second Lien) 1.2% Cash, 7.0% PIK, Due 8/15 | 1,355,173 | 1,217,438 | 49,125 |
| Bankruptcy Management Solutions, Inc. *Diversified/Conglomerate Service* | Senior Secured Loan — Term Loan B 6.5% Cash, 1.0% PIK, Due 8/14 | 1,438,962 | 1,422,517 | 494,046 |
| Berry Plastics Holding Corporation[12] *Containers, Packaging and Glass* | Senior Secured Loan — Term C Loan 2.2% Cash, Due 4/15 | 1,989,501 | 1,952,878 | 1,923,599 |
| Bicent Power LLC[8] *Utilities* | Junior Secured Loan — Advance (Second Lien) 9.3% Cash, Due 12/14 | 3,967,474 | 3,967,474 | 61,496 |
| Blue Coat Systems, Inc. *Electronics* | Junior Secured Loan — Loan (Second Lien) 11.5% Cash, Due 8/18 | 2,250,000 | 2,283,750 | 2,283,750 |
| Burger King Corporation[12],[13] *Personal, Food and Miscellaneous Services* | Senior Secured Loan — Tranche B Term Loan 4.5% Cash, Due 10/16 | 1,947,389 | 1,943,962 | 1,942,764 |
| Burger King Corporation *Personal, Food and Miscellaneous Services* | Senior Secured Loan — Tranche B Term Loan 4.5% Cash, Due 10/16 | 849,548 | 849,548 | 847,531 |
| Caribe Media Inc. (fka Caribe Information Investments Incorporated) *Printing and Publishing* | Senior Secured Loan — Loan 10.0% Cash, Due 11/14 | 652,924 | 652,924 | 652,924 |
| Catalina Marketing Corporation[12] *Diversified/Conglomerate Service* | Senior Secured Loan — 2017 Term Loan 5.7% Cash, Due 9/17 | 1,704,212 | 1,668,829 | 1,610,174 |
| Chrysler Group LLC[12] *Automobile* | Senior Secured Loan — Tranche B Term Loan 6.0% Cash, Due 5/17 | 1,989,950 | 1,989,950 | 2,007,362 |

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| CoActive Technologies LLC (fka CoActive Technologies, Inc.) *Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Junior Secured Loan — Term Loan (Second Lien) 7.2% Cash, Due 1/15 | $ 2,000,000 | $ 1,985,906 | $ 1,505,200 |
| Del Monte Foods Company[12] *Beverage, Food and Tobacco* | Senior Secured Loan — Initial Term Loan 4.5% Cash, Due 3/18 | 1,927,154 | 1,905,270 | 1,903,073 |
| Del Monte Foods Company *Beverage, Food and Tobacco* | Senior Secured Loan — Initial Term Loan 4.5% Cash, Due 3/18 | 949,123 | 951,077 | 937,263 |
| eInstruction Corporation *Healthcare, Education and Childcare* | Junior Secured Loan — Term Loan (Second Lien) 11.5% Cash, Due 7/14 | 10,000,000 | 10,000,000 | 3,985,000 |
| ELO Touch Solutions, Inc.[12] *Electronics* | Senior Secured Loan — Term Loan (First Lien) 8.0% Cash, Due 6/18 | 2,000,000 | 1,920,000 | 1,945,000 |
| First Data Corporation[12] *Finance* | Senior Secured Loan — 2018 Dollar Term Loan 4.2% Cash, Due 3/18 | 2,000,000 | 1,788,204 | 1,840,130 |
| Fram Group Holdings Inc./Prestone Holdings Inc.[12] *Automobile* | Senior Secured Loan — Term Loan (First Lien) 6.5% Cash, Due 7/17 | 994,987 | 1,002,250 | 961,407 |
| Freescale Semiconductor, Inc.[13] *Electronics* | Senior Subordinated Bond — 10.125% – 12/2016 10.1% Cash, Due 12/16 | 1,036,000 | 1,038,255 | 1,090,390 |
| Getty Images, Inc.[12] *Printing and Publishing* | Senior Secured Loan — Initial Term Loan 5.3% Cash, Due 11/16 | 1,980,449 | 2,005,205 | 1,987,866 |
| Ginn LA Conduit Lender, Inc.[8] *Buildings and Real Estate[4]* | Senior Secured Loan — First Lien Tranche A Credit-Linked Deposit 7.8% Cash, Due 6/11 | 1,257,143 | 1,224,101 | 40,857 |
| Ginn LA Conduit Lender, Inc.[8] *Buildings and Real Estate[4]* | Senior Secured Loan — First Lien Tranche B Term Loan 7.8% Cash, Due 6/11 | 2,694,857 | 2,624,028 | 87,583 |
| Ginn LA Conduit Lender, Inc.[8] *Buildings and Real Estate[4]* | Junior Secured Loan — Loan (Second Lien) 11.8% Cash, Due 6/12 | 3,000,000 | 2,715,997 | 30,015 |
| Gymboree Corporation., The[12] *Retail Stores* | Senior Secured Loan — Term Loan 5.0% Cash, Due 2/18 | 1,467,299 | 1,393,383 | 1,392,298 |
| HMSC Corporation (aka Swett and Crawford) *Insurance* | Junior Secured Loan — Loan (Second Lien) 5.7% Cash, Due 10/14 | 5,000,000 | 4,934,081 | 4,131,500 |
| Hunter Defense Technologies, Inc. *Aerospace and Defense* | Junior Secured Loan — Term Loan (Second Lien) 7.0% Cash, Due 2/15 | 5,000,000 | 4,930,051 | 4,901,500 |
| Hunter Fan Company *Home and Office Furnishings, Housewares, and Durable Consumer Products* | Junior Secured Loan — Loan (Second Lien) 7.0% Cash, Due 10/14 | 3,000,000 | 3,000,000 | 2,741,400 |
| International Architectural Products, Inc.[8] *Mining, Steel, Iron and Non-Precious Metals* | Senior Secured Loan — Term Loan 8.8% Cash, Due 5/15 | 525,678 | 499,114 | 273,352 |
| Jones Stephens Corp. *Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Term Loan 7.0% Cash, Due 9/15 | 4,350,315 | 4,350,315 | 4,350,315 |
| KIK Custom Products Inc. *Personal and Non Durable Consumer Products (Mfg. Only)* | Junior Secured Loan — Loan (Second Lien) 5.2% Cash, Due 12/14 | 5,000,000 | 5,000,000 | 3,431,250 |

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Kaseman Holdings and Sallyport Holdings<br>*Aerospace and Defense* | Mezzanine Investment — Mezzanine Notes<br>14.5% Cash, Due 6/17 | $ 11,250,597 | $10,950,636 | $ 11,588,115 |
| LBREP/L-Suncal Master I LLC[8]<br>*Buildings and Real Estate[4]* | Senior Secured Loan — Term Loan (First Lien)<br>7.5% Cash, Due 1/10 | 3,401,921 | 3,401,921 | 359,923 |
| Legacy Cabinets, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Term Loan<br>1.0% Cash, 6.3% PIK, Due 5/14 | 508,384 | 463,380 | 508,384 |
| Lord & Taylor Holdings LLC (LT Propco LLC)[12]<br>*Retail Stores* | Senior Secured Loan — Term Loan<br>5.8% Cash, Due 1/19 | 1,300,208 | 1,306,498 | 1,302,783 |
| Merisant Company<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Loan<br>7.5% Cash, Due 1/14 | 4,570,471 | 4,557,714 | 4,570,471 |
| Metropolitan Health Networks, Inc.[13]<br>*Healthcare, Education and Childcare* | Junior Secured Loan — Term Loan (Second Lien)<br>13.5% Cash, Due 10/17 | 5,000,000 | 4,912,243 | 5,000,000 |
| Michael Foods Group, Inc. (f/k/a M-Foods Holdings, Inc.)[12]<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Term B Facility<br>4.3% Cash, Due 2/18 | 1,920,993 | 1,924,416 | 1,924,989 |
| Neiman Marcus Group Inc., The[12]<br>*Retail Stores* | Senior Secured Loan — Term Loan<br>4.8% Cash, Due 5/18 | 2,000,000 | 1,984,570 | 1,981,380 |
| Pegasus Solutions, Inc.<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Junior Secured Loan — Senior Subordinated Second Lien PIK Notes,<br>13.0% PIK, Due 4/14 | 1,587,800 | 1,587,800 | 1,587,800 |
| Perseus Holding Corp.<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Preferred Stock — Preferred Stock,<br>14.0% PIK, Due 4/14 | 400,000 | 400,000 | 395,720 |
| PetCo Animal Supplies, Inc.[12]<br>*Retail Stores* | Senior Secured Loan — New Loan<br>4.5% Cash, Due 11/17 | 2,000,000 | 2,000,000 | 1,988,500 |
| Pinnacle Foods Finance LLC[12]<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Extended Initial Term Loan<br>3.7% Cash, Due 10/16 | 1,134,339 | 1,132,921 | 1,125,128 |
| Potters Holdings, II, L.P.<br>*Diversified/Conglomerate Manufacturing* | Junior Secured Loan — Term B Loan (Second Lien)<br>10.3% Cash, Due 11/17 | 7,000,000 | 6,913,503 | 7,108,500 |
| TPF Generation Holdings, LLC[12]<br>*Utilities* | Senior Secured Loan — Synthetic LC Deposit (First Lien)<br>2.7% Cash, Due 12/13 | 169,532 | 169,148 | 168,896 |
| Trinseo Materials Operating S.C.A. (fka Styron S.A.R.L)[3],[13]<br>*Chemicals, Plastics and Rubber* | Senior Secured Loan — Term Loan<br>6.0% Cash, Due 8/17 | 1,979,899 | 1,830,002 | 1,859,878 |
| TriZetto Group, Inc. (TZ Merger Sub, Inc.)[12]<br>*Electronics* | Senior Secured Loan — Term Loan<br>4.8% Cash, Due 5/18 | 1,343,216 | 1,337,638 | 1,316,016 |
| TriZetto Group, Inc. (TZ Merger Sub, Inc.)<br>*Electronics* | Senior Secured Loan — Term Loan<br>4.8% Cash, Due 5/18 | 626,593 | 602,873 | 613,904 |
| TUI University, LLC<br>Healthcare, Education and Childcare | Senior Secured Loan — Term Loan (First Lien)<br>3.7% Cash, Due 10/14 | 3,040,242 | 2,989,272 | 2,582,382 |
| TWCC Holding Corp.[12]<br>*Broadcasting and Entertainment* | Senior Secured Loan — Term Loan<br>4.3% Cash, Due 2/17 | 1,966,350 | 1,980,375 | 1,967,992 |

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Twin-Star International, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Subordinated Bond — Senior Subordinated Note 13.0% Cash, Due 4/14 | $ 5,500,000 | $ 5,500,000 | $ 5,500,000 |
| Univar Inc.<br>*Chemicals, Plastics and Rubber* | Senior Secured Loan — Term B Loan 5.0% Cash, Due 6/17 | 2,969,849 | 2,969,849 | 2,921,248 |
| US Foods, Inc. (aka U.S. Foodservice, Inc.)[12]<br>*Personal, Food and Miscellaneous Services* | Senior Secured Loan — Extended Term Loan 5.8% Cash, Due 3/17 | 1,989,529 | 1,938,046 | 1,909,948 |
| Vertafore, Inc.[12]<br>*Electronics* | Senior Secured Loan — Term Loan (First Lien) 5.3% Cash, Due 7/16 | 1,243,691 | 1,238,640 | 1,239,804 |
| Vertafore, Inc.<br>*Electronics* | Senior Secured Loan — Term Loan (First Lien) 5.3% Cash, Due 7/16 | 736,221 | 717,683 | 733,920 |
| Warner Chilcott Company, LLC[13]<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-2 Loan 4.3% Cash, Due 3/18 | 452,560 | 453,538 | 451,182 |
| Warner Chilcott Corporation[13]<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-1 Loan 4.3% Cash, Due 3/18 | 905,120 | 907,077 | 902,364 |
| WC Luxco S.A.R.L. (Warner Chilcott)[3],[13]<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-3 Loan 4.3% Cash, Due 3/18 | 622,270 | 623,615 | 620,375 |
| Wesco Aircraft Hardware Corp.[13]<br>*Aerospace and Defense* | Senior Secured Loan — Tranche B Term Loan 4.3% Cash, Due 4/17 | 2,590,244 | 2,585,098 | 2,596,512 |
| Wholesome Sweeteners, Inc.<br>*Beverage, Food and Tobacco* | Junior Secured Loan — Subordinated Note (Second Lien) 12.0% Cash, 2.0% PIK, Due 10/17 | 6,583,333 | 6,536,072 | 6,583,333 |
| WireCo WorldGroup Inc.<br>*Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Senior Subordinated Bond — 11.75% – 05/2017 11.8% Cash, Due 5/17 | 8,000,000 | 7,920,000 | 7,920,000 |
| WM. Bolthouse Farms, Inc.[12]<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Term Loan (First Lien) 5.5% Cash, Due 2/16 | 1,953,675 | 1,963,443 | 1,964,058 |
| **Total Investment in Debt Securities (70% of net asset value at fair value)** | | $ 170,015,175 | $167,900,019 | $143,264,021 |

## Equity Portfolio

| Portfolio Company/Principal Business | Investment | Percentage Interest/Shares | Cost | Value[2] |
|---|---|---|---|---|
| Aerostructures Holdings L.P.[6]<br>*Aerospace and Defense* | Partnership Interests | 1.2% | $ 1,000,000 | $ 1,000 |
| Aerostructures Holdings L.P.[6]<br>*Aerospace and Defense* | Series A Preferred Interests | 1.2% | 250,961 | 187,593 |
| Bankruptcy Management Solutions, Inc.[6]<br>*Diversified/Conglomerate Service* | Common Stock | 1.2% | 218,592 | 1,000 |
| Bankruptcy Management Solutions, Inc.[6]<br>*Diversified/Conglomerate Service* | Warrants | 0.1% | — | — |
| Coastal Concrete Holding II, LLC[6]<br>*Buildings and Real Estate[4]* | Class A Units | 10.8% | 8,625,626 | 1,000 |
| eInstruction Acquisition, LLC[6]<br>*Healthcare, Education and Childcare* | Membership Units | 1.1% | 1,079,617 | 1,000 |

| Portfolio Company/Principal Business | Investment | Percentage Interest/Shares | Cost | Value[2] |
|---|---|---|---|---|
| FP WRCA Coinvestment Fund VII, Ltd.[3], [6], [13]<br>*Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Class A Shares | 1,500 | $ 1,500,000 | $ 3,287,250 |
| International Architectural Products, Inc.[6]<br>*Mining, Steel, Iron and Non-Precious Metals* | Common | 2.5% | 292,851 | 1,000 |
| Legacy Cabinets, Inc.[6]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Equity | 4.0% | 115,580 | 1,000 |
| Perseus Holding Corp.[6]<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Common | 0.2% | 400,000 | 88,005 |
| Plumbing Holdings Corporation[6]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Common | 7.8% | — | 549,542 |
| Plumbing Holdings Corporation<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Preferred Stock | 15.5% | 2,716,618 | 3,102,238 |
| Caribe Media Inc. (fka Caribe Information Investments Incorporated)[6]<br>*Printing and Publishing* | Common | 1.3% | 359,765 | 498,614 |
| **Total Investment in Equity Securities (4% of net asset value at fair value)** | | | $16,559,610 | $ 7,719,242 |

## CLO Fund Securities

### CLO Equity Investments

| Portfolio Company | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Grant Grove CLO, Ltd.[3], [10], [13] | Subordinated Securities | 22.2% | $ 4,899,382 | $ 2,982,620 |
| Katonah III, Ltd.[3], [10], [11], [13] | Preferred Shares | 23.1% | 4,476,930 | 1,000 |
| Katonah V, Ltd.[3], [10], [11], [13] | Preferred Shares | 26.7% | 3,320,000 | 1,000 |
| Katonah VII CLO Ltd.[3], [7], [10], [13] | Subordinated Securities | 16.4% | 4,578,293 | 2,291,282 |
| Katonah VIII CLO Ltd[3], [7], [10], [13] | Subordinated Securities | 10.3% | 3,452,605 | 2,104,917 |
| Katonah IX CLO Ltd[3], [7], [10], [13] | Preferred Shares | 6.9% | 2,073,387 | 1,524,070 |
| Katonah X CLO Ltd [3], [7], [10], [13] | Subordinated Securities | 33.3% | 11,891,547 | 9,117,423 |
| Katonah 2007-I CLO Ltd.[3], [7], [10], [13] | Preferred Shares | 100.0% | 31,053,938 | 26,703,361 |
| Trimaran CLO IV, Ltd.[3], [7], [10], [13] | Preferred Shares | 18.9% | 3,607,100 | 3,222,196 |
| Trimaran CLO V, Ltd.[3], [7], [10], [13] | Subordinate Notes | 20.8% | 2,753,500 | 2,799,198 |
| Trimaran CLO VI, Ltd.[3], [7], [10], [13] | Income Notes | 16.2% | 2,911,700 | 2,744,720 |
| Trimaran CLO VII, Ltd.[3], [7], [10], [13] | Income Notes | 10.5% | 3,158,700 | 3,071,728 |
| **Total Investment in CLO Equity Securities** | | | $78,177,082 | $ 56,563,515 |

**CLO Rated-Note Investment**

| Portfolio Company | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Katonah 2007-I CLO Ltd.[3], [7], [10], [13] | Class B-2L Notes Par Value of $10,500,000 5.2%, Due 4/22 | 5.2% | $ 1,230,482 | $ 7,320,000 |
| **Total Investment in CLO Rated-Note** | | | $ 1,230,482 | $ 7,320,000 |
| **Total Investment in CLO Fund Securities (31% of net asset value at fair value)** | | | $79,407,564 | $ 63,883,515 |

**Asset Manager Affiliates**

| Portfolio Company/Principal Business | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Asset Manager Affiliates (Katonah Debt Advisors and Trimaran Advisors) | Asset Management Company | 100.0% | $83,419,910 | $ 72,896,000 |
| **Total Investment in Asset Manager Affiliates (36% of net asset value at fair value)** | | | $83,419,910 | $ 72,896,000 |

**Time Deposits and Money Market Account**

| Time Deposits and Money Market Account | Investment | Yield | Par/Cost | Value[2] |
|---|---|---|---|---|
| JP Morgan Asset Account | Time Deposit | 0.0% | $ 17,098 | $ 17,098 |
| JP Morgan Business Money Market Account[9] | Money Market Account | 0.2% | 203,910 | 203,910 |
| US Bank Money Market Account | Money Market Account | 0.4% | 10,586,776 | 10,586,776 |
| **Total Investment in Time Deposit and Money Market Accounts (5% of net asset value at fair value)** | | | $ 10,807,784 | $ 10,807,784 |
| **Total Investments[5] (146% of net asset value at fair value)** | | | $358,094,887 | $298,570,562 |

(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 June 30, 2012.

(2) Reflects the fair market value of all existing investments as of June 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.

(5) The aggregate cost of investments for federal income tax purposes is approximately $358 million. The aggregate gross unrealized appreciation is approximately $10 million, the aggregate gross unrealized depreciation is approximately $70 million and the net unrealized depreciation is approximately $60 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 June 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).

(13) Investment is not a qualifying asset as defined under Section 55(a) of the 1940 Act.

## MANAGEMENT

Our business and affairs are managed under the direction of our Board of Directors. Our Board of Directors elects our officers who serve at its discretion. Our Board of Directors has eight members, three of whom are "interested persons" as defined in Section 2(a)(19) of the 1940 Act and five of whom are not interested persons, whom we refer to as our independent directors.

### Directors and Executive Officers

As of September 1, 2012, our executive officers, directors and key employees and their positions are as set forth below. The address for each executive officer and director is c/o KCAP Financial, Inc., 295 Madison Avenue, 6th Floor, New York, New York 10017.

| Name | Age | Position with Us |
|---|---|---|
| **Independent Directors[1]:** | | |
| Christopher Lacovara | 47 | Chairman |
| C. Turney Stevens, Jr. | 61 | Director |
| Albert G. Pastino | 70 | Director |
| C. Michael Jacobi | 70 | Director |
| Gary Cademartori | 70 | Director |
| **Non-Independent Directors:** | | |
| Dayl W. Pearson[2] | 57 | Director, President and Chief Executive Officer |
| Dean C. Kehler[3] | 55 | Director, Portfolio Manager of Trimaran Advisors |
| Jay R. Bloom[3] | 56 | Director, Portfolio Manager of Trimaran Advisors |
| **Executive Officers** | | |
| Edward U. Gilpin | 51 | Chief Financial Officer, Treasurer and Secretary |
| R. Jon Corless | 60 | Chief Investment Officer |
| Daniel P. Gilligan | 39 | Chief Compliance Officer, Director of Portfolio Administration of Katonah Debt Advisors |

(1) As used herein the term "Independent Directors" refers to directors who are not "interested persons" of the Company within the meaning of Section 2(a)(19) of the 1940 Act.

(2) Mr. Pearson is not an Independent Director because he is an officer of the Company.

(3) Messrs. Kehler and Bloom are not Independent Directors because they are employees of Trimaran Advisors, a wholly-owned portfolio company of the Company.

The following is a summary of certain biographical information concerning our directors, executive officers and key employees:

### Independent Directors

*Christopher Lacovara*

Mr. Lacovara has served on KCAP Financial's Board since December 2006 and is also the Chairman of the Board, the Chairman of the Valuation Committee of the Board. Mr. Lacovara served as a Vice President of KCAP Financial from and a member of the Management Committee of Katonah Debt Advisors December, 2006 until August, 2011. Mr. Lacovara is a Partner and member of the Investment Committee of Kohlberg & Co., a leading middle market private equity firm, which he joined in 1988. Kohlberg & Co. has invested approximately $2.5 billion of equity capital in over 100 middle market platform and add-on acquisitions with a combined transaction value of over $7 billion. From 1987 to 1988, he was an Associate in the Mergers and Acquisitions Department at Lazard Freres & Company. Prior to that he was a Financial Analyst in the Corporate Finance Department of Goldman, Sachs & Co. Mr. Lacovara received a A.B. in History from Harvard College, a B.E. in Engineering Sciences from Hofstra University and a Master of Science in Civil Engineering from Columbia University. Mr. Lacovara serves on the boards of directors of a number of private companies as well as on the boards of directors of AGY Holding Corp. and Katy Industries, Inc. As a result

of these and other professional experiences, Mr. Lacovara possesses particular knowledge and experience in corporate finance, corporate governance, strategic planning, business evaluation and oversight and financial analysis that strengthen the Board's collective qualifications, skills and experience.

*C. Turney Stevens*

Mr. Stevens has served on KCAP Financial's Board since December 2006 and serves on the Valuation Committee and the Compensation Committee and, since June 2011, also as the Chair of the Nominating and Corporate Governance Committee of the Board. Mr. Stevens is the Dean of the College of Business at Lipscomb University. Mr. Stevens retired as the Chairman and CEO of Harpeth Companies, LLC, a diversified financial services company that he founded and that is the parent company of Harpeth Capital, LLC and Harpeth Consulting, LLC. Prior to founding Harpeth in 1999, Mr. Stevens was a founder and Chairman of Printing Arts America, Inc. From 1986 to 1994, Mr. Stevens served in various capacities at Rodgers Capital Corporation, a middle market investment banking firm focused on mergers and acquisitions and private institutional equity transactions, including as President. In 1973, Mr. Stevens founded PlusMedia, Inc., a magazine publishing company that he later sold to a public company in 1982. Mr. Stevens began his career at Tennessee Securities, a Nashville investment banking firm, which was one of the region's leaders in helping to capitalize early-stage and growth-stage companies. Mr. Stevens graduated from David Lipscomb University in 1972 and received an Executive M.B.A. degree from the Owen Graduate School of Management at Vanderbilt University in 1981. He now serves as the Dean of the College of Business and Professor of Management at Lipscomb University. He is a 2007 graduate of the Directors' College at the Anderson School of Management at UCLA and is certified as a public company director by Institutional Shareholder Services. As a result of these and other professional experiences, Mr. Stevens possesses particular knowledge and experience in financial services, business management and investment banking that strengthen the Board's collective qualifications, skills and experience.

*Albert G. Pastino*

Mr. Pastino has served on KCAP Financial's Board since December 2006 and is the Chair of the Audit Committee and also serves on the Compensation Committee of the Board. Effective June 10, 2011, Mr. Pastino serves as lead independent director of the Board. Mr. Pastino is a Managing Director at Kildare Capital and was formerly the Senior Managing Director at Amper Investment Banking. Kildare Capital focuses on capital formation, mergers and acquisitions and strategic advisory assignments. After leaving an affiliate of Kohlberg & Co. in June 1997, Mr. Pastino worked as an investor, CFO and Chief Operating Officer at a variety of companies and was involved in all aspects of financial and general management, reporting and fundraising for a variety of companies, including Aptegrity, Inc., Bolt, Inc., AmTec, Inc. and Square Earth, Inc. From 1976 to 1986, he was a partner at Deloitte & Touche LLP and was in charge of its Emerging Business Practice. Mr. Pastino is a member of the Small Business Advisory Board of the Financial Accounting Standards Board, a member of the Board of New Eyes for the Needy, a not-for-profit organization headquartered in New Jersey. Mr. Pastino is a graduate of Saint Joseph's University and received an Executive M.B.A. degree from Fairleigh Dickinson University. He also attended the Harvard Business School Executive Management Program for Small Business and is a certified public accountant. As a result of these and other professional experiences, Mr. Pastino possesses particular knowledge and experience in corporate finance, strategic planning, and financial analysis that strengthen the Board's collective qualifications, skills and experience.

*C. Michael Jacobi*

Mr. Jacobi has served on KCAP Financial's Board since December 2006 and serves on the Audit Committee and, since June 2011, the Nominating and Corporate Governance Committee of the Board. Mr. Jacobi is also the owner and President of Stable House, LLC, a company engaged in real estate development. From 2001 to 2005, Mr. Jacobi served as the President, CEO and member of the board of directors of Katy Industries, Inc., a portfolio company of investment funds affiliated with Kohlberg & Co., which is involved in the manufacture and distribution of maintenance products. Mr. Jacobi was the President and CEO of Timex Corporation from 1993 to 1999, and he was a member of the board of directors of Timex Corporation from 1992 to 2000. Prior to 1993, he served Timex Corporation in senior positions in marketing, sales, finance and manufacturing.

Mr. Jacobi received a B.S. from the University of Connecticut, and he is a certified public accountant. Mr. Jacobi is currently Chairman of the board of directors of Sturm, Ruger & Co., Inc. and a member of the board of directors of Webster Financial Corporation and Corrections Corporation of America. He serves as the audit committee chairman of the board of directors of Webster Financial Corporation and Corrections Corporation of America. As a result of these and other professional experiences, Mr. Jacobi possesses particular knowledge and experience in corporate finance, accounting, investment management and corporate governance that strengthen the Board's collective qualifications, skills and experience.

*Gary Cademartori*

Mr. Cademartori has served on KCAP Financial's Board since December 2006, is the Chairman of the Compensation Committee of the Board and serves on the Audit Committee and, since June 2011, the Nominating and Corporate Governance Committee of the Board. Mr. Cademartori is also the managing partner of Prism Business Consulting, LLC, a company engaged in financial consulting and executive mentoring to create more value for companies involved in business change. Previously, Mr. Cademartori was a partner in Wall Street Technology Group, LLC from 2006 to 2011, a financial consultant for less than one year in 1998 and, from 1999 to 2005, a partner in Tatum CFO Partners, LLP, serving as an interim CFO and rendering financial consulting services for middle market Securities and Exchange Commission reporting and privately-held companies. From 1995 to 1998, Mr. Cademartori served in the capacity of CFO for Schrader-Bridgeport International, Inc. Between 1981 and 1995, Mr. Cademartori served as the CFO of Charter Power Systems, Inc., Athlone Industries, Inc., Formica Corporation, and Butler International, Inc., all of which were mid-sized companies listed on the New York Stock Exchange. Prior to 1981, Mr. Cademartori was an audit partner in Touche Ross & Co., an international accounting firm. Mr. Cademartori received his M.B.A. degree in Finance and International Business from Seton Hall University, and he is a certified public accountant. He serves on the Small Business Advisory Committee of the Financial Accounting Standards Board, and on the board of directors of Marotta Controls, Inc. As a result of these and other professional experiences, Mr. Cademartori possesses particular knowledge and experience in corporate finance, accounting, and business management that strengthen the Board's collective qualifications, skills and experience.

**Non-Independent Directors**

*Dayl W. Pearson, Director, President and CEO*

Mr. Pearson has served as KCAP Financial's President and Chief Executive Officer since December 2006 and has served on KCAP Financial's Board since June 2008. Mr. Pearson has more than 33 years of banking and finance experience and has focused primarily on middle market credit intensive transactions, completing over $5 billion of financings over the past 15 years. From 1997 to 2006, he was a Managing Director at CIBC in the Leveraged Finance and Sponsor Coverage Group specializing in middle market debt transactions. Mr. Pearson was responsible for originating and executing more than $3 billion of transactions including senior loans, high-yield securities, mezzanine investments and equity co-investments. Prior to joining CIBC, Mr. Pearson was instrumental in developing the middle market leveraged finance business of IBJ Schroder from 1992 through 1997. In 1995, he became responsible for the entire $500 million leveraged finance portfolio and was involved in approving all new senior and mezzanine commitments. Previously, he was a senior lending officer in First Fidelity Bank's middle market lending group primarily focused on restructurings, and prior to that Mr. Pearson invested in distressed securities. Mr. Pearson began his career at Chase Manhattan Bank after receiving a B.A. from Claremont Men's College and an M.B.A. from the University of Chicago. As a result of these and other professional experiences, Mr. Pearson possesses particular knowledge and experience in corporate finance, leverage finance, corporate credit and portfolio management that strengthen the Board's collective qualifications, skills and experience.

*Dean C. Kehler, Director, Portfolio Manager of Trimaran Advisors*

Mr. Kehler joined KCAP Financial's Board in February 2012. Mr. Kehler also serves as a Portfolio Manager of Trimaran Advisors, which was acquired by the Company in February 2012 and serves as investment advisor to several CLO funds, and is a member of Trimaran Advisors' investment committee. Mr. Kehler is also a Managing Partner of Trimaran Capital Partners, a manager of private investment funds. Prior to co-founding Trimaran Advisors, Mr. Kehler was a vice chairman of CIBC World Markets Corp. and co-head of the CIBC Argosy Merchant Banking Funds (Fund I). Prior to joining CIBC World Markets Corp.

in 1995, Mr. Kehler was a founder and Managing Director of The Argosy Group L.P. Before Argosy, Mr. Kehler was a Managing Director at Drexel Burnham Lambert Incorporated and also worked at Lehman Brothers Kuhn Loeb Incorporated. Mr. Kehler currently serves on the Board of Directors of Ashley Stewart Holdings, Inc., Inviva, Inc., Ironwood Global, LLC and El Pollo Loco, Inc. Mr. Kehler previously served as a director of Continental Airlines, Global Crossing, PrimeCo Wireless Communications, Urban Brands, Inc., Source Holdings, CNC Holding Corporation, Hills Department Stores, Inc., Jefferson National Financial, Charlie Brown Acquisition, Booth Creek Ski Holdings, TLC Beatrice International and Heating Oil Partners. Mr. Kehler also serves as Treasurer, Chair of the Finance Committee and a director of CARE USA, one of the world's largest private humanitarian organizations, and is the chair of the Board of Overseers of the University of Pennsylvania School of Nursing. Mr. Kehler earned his B.S. from The Wharton School of the University of Pennsylvania. Mr. Kehler possesses particular knowledge and experience in corporate finance, investment management, financial analysis and corporate governance that strengthen the Board's collective qualifications, skills and experience.

*Jay R. Bloom, Director, Portfolio Manager of Trimaran Advisors*

Mr. Bloom joined KCAP Financial's Board in February 2012. Mr. Bloom also serves as a Portfolio Manager of Trimaran Advisors, which was acquired by the Company in February 2012 and serves as investment advisor to several CLO funds, and is a member of Trimaran Advisors' investment committee. Mr. Bloom is also a Managing Partner of Trimaran Capital Partners, a manager of private investment funds. Prior to co-founding Trimaran Advisors, Mr. Bloom was a Vice Chairman of CIBC World Markets Corp. and Co-Head of the CIBC Argosy Merchant Banking Funds. Prior to joining CIBC World Markets Corp. in 1995, Mr. Bloom was a founder and Managing Director of The Argosy Group L.P. Before Argosy, Mr. Bloom was a Managing Director at Drexel Burnham Lambert Incorporated, and prior to that, he worked at Lehman Brothers Kuhn Loeb Incorporated. In addition, Mr. Bloom practiced law with Paul Weiss Rifkind Wharton & Garrison LLP. Mr. Bloom currently serves on the Board of Directors of Brite Media, Educational Services of America, Inc., El Pollo Loco, Inc. and Norcraft Companies, L.P. Mr. Bloom received his B.S. and M.B.A. from Cornell University, graduating *summa cum laude* , and his J.D. from Columbia University School of Law, where he was a member of the Board of Editors of the Columbia Law Review. Mr. Bloom possesses particular knowledge and experience in business management, investment banking and corporate governance that strengthen the Board's collective qualifications, skills and experience.

**Executive Officers**

*Edward U. Gilpin, Chief Financial Officer, Secretary and Treasurer*

Mr. Gilpin joined KCAP Financial in June 2012 and has over 28 years of experience. Prior to joining the company, Mr. Gilpin served as the Chief Financial Officer at Associated Renewable Inc., an end-to-end full service energy consulting and carbon management company, since December 2010. From January 2008 to May 2010, he served as Executive Vice President and Chief Financial Officer of Ram Holdings, Ltd., a provider of financial guaranty reinsurance, and prior to that he was the Executive Vice President, Chief Financial Officer and Director of ACA Capital Holdings, Inc., a holding company that provided financial guaranty insurance and asset management services, from December 2000 to January 2008. Prior to joining ACA Capital, Mr. Gilpin was Vice President in the Financial Institutions Group at Prudential Securities, Inc.'s investment banking division. From 1998 to 2000, Mr. Gilpin served in the capacity of Chief Financial Officer for an ACA Capital affiliated start-up venture, developing the financial plans and spearheading the capital raising process. From 1991 to 1998, Mr. Gilpin was with MBIA, Inc., a holding company whose subsidiaries provide financial guarantee insurance, fixed-income asset management, and other specialized financial services, where he held various positions in the finance area. His most recent position with MBIA was Director, Chief of Staff for MBIA Insurance Company's President. Mr. Gilpin began his career as an Assistant Vice President in the Mutual Funds Department of BHC Securities, Inc. Mr. Gilpin holds an M.B.A. from Columbia University and a B.S. from St. Lawrence University.

*R. Jon Corless, Chief Investment Officer*

Mr. Corless joined KCAP Financial and Katonah Debt Advisors, KCAP Financial's wholly-owned portfolio company, in 2006 as part of their middle market team. Mr. Corless has over 30 years of experience in high-yield and leveraged credits. Prior to joining the Company, Mr. Corless was a Credit Risk Manager for

Trimaran Debt Advisors, a CLO manager. Prior to joining Trimaran Debt Advisors, Mr. Corless spent 15 years as a Senior Credit Risk Manager for CIBC with risk management responsibility for media and telecommunications, high-yield, middle market, and mezzanine loan portfolios. Before joining CIBC, Mr. Corless worked at Bank of America NA in Corporate Finance and at Bankers Trust Company. Mr. Corless received a B.A. from Wesleyan University.

*Daniel P. Gilligan, Chief Compliance Officer; Director of Portfolio Administration of Katonah Debt Advisors*

Mr. Gilligan is the Company's Chief Compliance Officer and the Director of Portfolio Administration for Katonah Debt Advisors and KCAP Financial. While at Katonah Capital, L.L.C., a lending platform formed by affiliates of Kohlberg & Co., Mr. Gilligan was in charge of daily portfolio administration of its six CLOs. In addition, he was directly responsible for the wind down and sale of the respective six vehicles. Prior to joining Katonah Capital in 2004, Mr. Gilligan was a Relationship Officer in the Corporate Trust department for U.S. Bank (formerly State Street Corporate Trust Services). Prior to joining State Street in 1999, Mr. Gilligan was a Director of Management Services for Sodexho USA. Mr. Gilligan holds a B.A. from Fairfield University.

**Board of Directors**

The number of directors constituting our Board of Directors is presently set at eight directors.

Our Board of Directors is divided into three classes. Class I holds office for a term expiring at the annual meeting of stockholders to be held in 2013, and Class II holds office for a term expiring at the annual meeting of stockholders to be held in 2014, and Class III holds office for a term expiring at the annual meeting of stockholders to be held in 2015. Each director holds office for the term to which he or she is elected and until his or her successor is duly elected and qualifies. Messrs. Stevens, Cademartori and Kehler's current term expires in 2013, Messrs. Pastino, Jacobi and Bloom's current term expires in 2014 and Messrs. Lacovara and Pearson's current term expires in 2015. At each annual meeting of our stockholders, the successors to the class of directors whose terms expire at such meeting will be elected to hold office for a term expiring at the annual meeting of stockholders held in the third year following the year of their election and until their successors are duly elected and qualify.

In fiscal year 2011, the Board of Directors met seven times, and, except for the absence from one meeting of Mr. Cademartori and another director who no longer is a member of the Board of Directors, each of the meetings was attended by the full Board of Directors. Pursuant to our policy, we encourage, though we do not require, all members of the Board of Directors to attend the Company's annual meetings of shareholders. All of the Board members attended the Company's 2012 Annual Meeting of Shareholders.

***Committees of the Board of Directors***

*Audit Committee*. The Board has established an Audit Committee. The Audit Committee is composed of Messrs. Pastino, Cademartori and Jacobi. Mr. Pastino serves as Chairman of the Audit Committee. The Audit Committee's functions include providing assistance to the Board in fulfilling its oversight responsibility relating to the Company's financial statements and the financial reporting process, compliance with legal and regulatory requirements, the qualifications and independence of the Company's independent registered public accountant, the Company's system of internal controls, the internal audit function, the Company's code of ethics, retaining and, if appropriate, terminating the independent registered public accountant and approving audit and non-audit services to be performed by the independent registered public accountant. The Audit Committee Charter, as approved by the Board, can be found in the Corporate Governance section of the Company's website at *www.kcapinc.com.*

The Board has determined that all the members of the Audit Committee — Messrs. Pastino, Jacobi and Cademartori:

- are independent, as independence for audit committee members is defined in Section 10A(m)(3) and Section 10C(a) of the Exchange Act and the SEC rules promulgated thereunder and Rule 5605(a)(2) and Rule 5605(b) of The Nasdaq Global Select Market listing standards;
- meet the requirements of Item 407(d)(5) of Regulation S-K under the Securities Act of 1933, as amended, and the Exchange Act and are audit committee financial experts; and
- possess the requisite financial sophistication required under The Nasdaq Global Select Market listing standards.

The Audit Committee has adopted a policy under which, to the extent required by law, all auditing services and all permitted non-audit services to be rendered by the Company's independent registered public accountant are pre-approved.

In fiscal year 2011, the Audit Committee held four meetings, and each of the meetings was attended by the full Audit Committee.

*Valuation Committee*. The Board has established a Valuation Committee. The Valuation Committee is composed of Messrs. Lacovara, Stevens and Kehler. Mr. Lacovara serves as Chairman of the Valuation Committee. The Valuation Committee is responsible for reviewing and recommending to the full Board the fair value of debt and equity securities. The Valuation Committee may utilize the services of an independent valuation firm in arriving at fair value of these securities. The Board is ultimately and solely responsible for determining the fair value of portfolio investments. The Valuation Committee Charter, as approved by the Board, can be found in the Corporate Governance section of the Company's website at *www.kcapinc.com*.

In fiscal year 2011, the Valuation Committee held four meetings, and each of the meetings was attended by all of the members of the Valuation Committee then in office.

*Compensation Committee*. The Board has established a Compensation Committee. The Compensation Committee is composed of Messrs. Cademartori, Pastino and Stevens. As determined by the Board, each of the members of the Compensation Committee is an Independent Director and satisfies the independence requirements of The Nasdaq Global Select Market listing standards. Mr. Cademartori serves as Chairman of the Compensation Committee. The Compensation Committee determines compensation for Kohlberg Capital's executive officers, in addition to administering the Company's Amended and Restated 2006 Equity Incentive Plan and the Company's Amended and Restated Non-Employee Director Plan. The Compensation Committee Charter, as approved by the Board, can be found in the Corporate Governance section of the Company's website at *www.kcapinc.com*.

The Compensation Committee's functions include examining the levels and methods of compensation employed by the Company with respect to the Chief Executive Officer and non-CEO officers, making recommendations to the Board with respect to non-CEO officer compensation, reviewing and approving the compensation package of the Chief Executive Officer, making recommendations to the Board with respect to incentive compensation plans and equity-based plans, reviewing management succession plans, making administrative and compensation decisions under equity compensation plans approved by the Board and making recommendations to the Board with respect to grants thereunder, administering cash bonuses, and implementing and administering the foregoing. In accordance with its Charter, the Compensation Committee may delegate its authority to a subcommittee.

In fiscal year 2011, the Compensation Committee held three meetings, and each of the meetings was attended by the full Compensation Committee.

*Nominating and Corporate Governance Committee*. The Board established a Nominating and Corporate Governance Committee (the "Nominating Committee") in June 2011. The Nominating Committee is composed of Messrs. Cademartori, Jacobi and Stevens, who are a majority of the Independent Directors of the Company. Mr. Stevens serves as Chairman of the Nominating Committee. The Nominating Committee's responsibilities include (i) recommending director nominees for selection by the Board; (ii) overseeing the

governance of the Company; (iii) leading the Board in its annual review of the Board's performance; (iv) recommending to the Board director nominees for each committee; and (v) recommending for approval by the Board the compensation paid to each Independent Director for serving on the Board. The Nominating Committee Charter, as approved by the Board, can be found in the Corporate Governance section of the Company's website at *www.kcapinc.com*.

In fiscal year 2011, the Nominating Committee held three meetings, and, except for the absence of Mr. Cademartori from one meeting, each of the meetings was attended by the full Nominating Committee.

**Limitation on Liability of Directors and Officers and Indemnification**

Under our certificate of incorporation, we will fully indemnify any person who was or is involved in any actual or threatened action, suit or proceeding (whether civil, criminal, administrative or investigative) by reason of the fact that such person is or was one of our directors or officers or is or was serving at our request as a director or officer of another corporation, partnership, limited liability company, joint venture, trust or other enterprise, including service with respect to an employee benefit plan, against all expense, liability and loss (including attorneys' fees and related disbursements), judgments, fines, excise taxes or penalties under the Employee Retirement Income Security Act of 1974, as amended, penalties and amounts paid or to be paid in settlement, actually and reasonably incurred by such person in connection with such action, suit or proceeding, except with respect to any matter as to which such person shall have been finally adjudicated in a decision on the merits in any such action, suit or other proceeding not to have acted in good faith in the reasonable belief that such person's action was in our best interests or to be liable to us or our stockholders by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person's office. Our certificate of incorporation also provides that our directors will not be personally liable for monetary damages to us for breaches of their fiduciary duty as directors, except for a breach of their duty of loyalty to us or our stockholders, for acts or omissions not in good faith in the reasonable belief that the action was in the best interests of the Company or which involve intentional misconduct or a knowing violation of law, for authorization of illegal dividends or redemptions or for any transaction from which the director derived an improper personal benefit. So long as we are regulated under the 1940 Act, the above indemnification and limitation of liability will be limited by the 1940 Act or by any valid rule, regulation or order of the SEC thereunder. The 1940 Act provides, among other things, that a company may not indemnify any director or officer against liability to it or its stockholders to which he or she might otherwise be subject by reason of his or her willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office.

Delaware law also provides that indemnification permitted under the law shall not be deemed exclusive of any other rights to which the directors and officers may be entitled under the corporation's bylaws, any agreement, a vote of stockholders or otherwise. We have entered into indemnification agreements with each of our directors and with each of our officers designated as officers for purposes of Section 16 of the Exchange Act.

Our certificate of incorporation permits us to secure insurance on behalf of any person who is or was or has agreed to become a director or officer of our company or is or was serving at our request as a director or officer of another enterprise for any liability arising out of his or her actions, regardless of whether the Delaware General Corporation Law would permit indemnification. We have obtained liability insurance for our officers and directors.

## EXECUTIVE COMPENSATION

### Overview of Executive Compensation Principles

Unless otherwise indicated, the discussion and analysis below relates to compensation of executive officers of both the Company.

Executive compensation in 2011 reflected both the financial market conditions as well as the Company's solid operating performance. In determining bonus awards for 2011 and salary increases for 2012, the Compensation Committee considered the following factors:

- Selection and maintenance of strong credit characteristics for the investment portfolio — limited defaulted assets in the investment portfolio and limited realized losses relative to the overall market for such investments;
- Payment of a dividend substantially out of current net investment income (as may be adjusted for non-recurring items), consistent with the Company's goal not to rely on capital gains;
- Slight increase in the dividend rate during 2011, reflecting current market conditions and operating performance; and
- Comparison to compensation levels at other similar companies operating in the financial industry during the recent period of financial instability.

In addition, at the Company's 2012 Annual Meeting of the Shareholders, the Company held a non-binding stockholder vote to approve the compensation paid to its named executive officers in 2011, commonly referred to as a "say-on-pay" vote. The Company's stockholders approved such compensation by a non-binding, advisory vote with approximately 92% of the votes submitted on the proposal voting in favor of the resolution. The Board considered the results of this vote and views this vote as confirmation that the Company's stockholders support the Company's executive compensation policies and decisions.

The Compensation Committee awarded 2011 performance bonuses to all of the named executive officers equal to or below their existing minimum target bonus amounts and also determined that none of these individuals would receive merit increases to base salary in 2012.

*Primary Objectives*

The primary objectives of the Compensation Committee of the Board with respect to executive compensation are to attract, retain and motivate the best possible executive talent. The focus is to tie short- and long-term cash and equity incentives to achievement of measurable corporate and individual performance objectives and to align executives' incentives with stockholder value creation. To achieve these objectives, the Compensation Committee maintains compensation plans that tie a substantial portion of executives' overall compensation to the Company's operational performance. The structure of the executives' base and incentive compensation is designed to encourage and reward the following:

- sourcing and pursuing attractively priced investment opportunities;
- participating in comprehensive due diligence with respect to the Company's investments;
- ensuring the most effective allocation of capital; and
- working efficiently and developing relationships with other professionals.

*Benchmarking of Compensation*

Management develops the Company's compensation plans by utilizing publicly available compensation data and subscription compensation survey data for national and regional companies in the middle market lending industry and in particular other publicly-traded, internally managed BDCs. The Company believes that the practices of this group of companies provide the Company with appropriate compensation benchmarks because these companies have similar organizational structures and tend to compete with the Company for executives and other employees. For benchmarking executive compensation, the Company typically reviews the compensation data the Company has collected from the complete group of companies, as well as a subset of the data from those companies that have a similar number of employees and a similar investment portfolio as the Company.

*Pay-for-Performance Philosophy*

Based on management's analyses and recommendations, the Compensation Committee has approved a pay-for-performance compensation philosophy, which is intended to bring base salaries and total executive compensation in line with approximately the fiftieth percentile of the companies with a similar number of employees represented in the compensation data the Company reviews. The Company works within the framework of this pay-for-performance philosophy to determine each component of an executive's initial compensation package based on numerous factors, including:

- the individual's particular background and circumstances, including training and prior relevant work experience;
- the individual's role with the Company and the compensation paid to similar persons in the companies represented in the compensation data that the Company reviews;
- the demand for individuals with the individual's specific expertise and experience at the time of hire;
- performance goals and other expectations for the position;
- comparison to other executives within the Company having similar levels of expertise and experience; and
- uniqueness of industry skills.

*Setting and Assessment of Performance Goals; Role of Chief Executive Officer*

The Compensation Committee has also implemented an annual performance management program, under which annual performance goals are determined and set forth in writing at the beginning of each calendar year for the Company as a whole and for each individual employee. Annual corporate goals are proposed by management and approved by the Board at the end of each calendar year for the following year. These corporate goals target the achievement of specific strategic, operational and financial milestones. Annual individual goals focus on contributions which facilitate the achievement of the corporate goals and are set during the first quarter of each calendar year. Individual goals are proposed by each employee and approved by his or her direct supervisor. The Chief Executive Officer's goals are approved by the Compensation Committee. Annual salary increases, annual bonuses and annual stock option awards granted to the Company's employees are tied to the achievement of these corporate and individual performance goals.

The performance goals for the Company's Chief Executive Officer and other executive management are considered in the context of the performance of the broader financial industry and are as follows:

- achievement of the Company's dividend objectives (emphasizing both growth and stability);
- growth of the Company's investment portfolio;
- maintenance of the credit quality and financial performance of the Company's investment portfolio;
- development of the Company's human resources; and
- development of the Company's financial and information systems.

The Company believes that the current performance goals are realistic "stretch" goals that should be reasonably attainable by management.

During the fourth calendar quarter, the Company evaluates individual and corporate performance against the written goals for the recently completed year. Consistent with the Company's compensation philosophy, each employee's evaluation begins with a written self-assessment, which is submitted to the employee's supervisor. The supervisor then prepares a written evaluation based on the employee's self-assessment, the supervisor's own evaluation of the employee's performance and input from others within the Company. This process leads to a recommendation for annual employee salary increases, annual stock-based compensation awards and bonuses, if any, which is then reviewed and approved by the Compensation Committee. The Company's executive officers, other than the Chief Executive Officer, submit their self-assessments to the Chief Executive Officer, who performs the individual evaluations and submits recommendations to the Compensation Committee for salary increases, bonuses and stock-based compensation awards. In the case of

the Chief Executive Officer, his individual performance evaluation is conducted by the Compensation Committee, which determines his compensation changes and awards. For all employees, including the Company's executive officers, annual base salary increases, annual stock-based compensation awards and annual bonuses, to the extent granted, are implemented during the first calendar quarter of the year.

**Our Compensation Policies and Practices as They Relate to Risk Management**

In accordance with the applicable disclosure requirements, to the extent that risks may arise from the Company's compensation policies and practices that are reasonably likely to have a material adverse effect on the Company, the Company is required to discuss those policies and practices for compensating the employees of the Company (including employees that are not named executive officers) as they relate to the Company's risk management practices and the possibility of incentivizing risk-taking.

The Compensation Committee has evaluated the policies and practices of compensating the Company's employees in light of the relevant factors, including the following:

- the financial performance targets of the Company's annual cash incentive program are the budgeted objectives that are reviewed and approved by the Board and/or the Compensation Committee;
- bonus payouts are not based solely on corporate performance, but also require achievement of individual performance objectives;
- bonus awards generally are not contractual entitlements, but are reviewed by the Compensation Committee and/or the Board and can be modified at their discretion;
- the financial opportunity in the Company's long-term incentive program is best realized through long-term appreciation of the Company's stock price, which mitigates excessive short-term risk-taking; and
- the allocation of compensation between cash and equity awards and the focus on stock-based compensation, including options and restricted stock awards generally vesting over a period of years, thereby mitigating against short-term risk taking.

Based on such evaluation, the Compensation Committee has determined that the Company's policies and practices are not reasonably likely to have a material adverse effect on the Company.

**Compensation Components**

The Company's compensation package consists of the following components, each of which the Company deems instrumental in motivating and retaining its executives:

*Base Salary*

Base salaries for the Company's executives are established based on the scope of their responsibilities and their prior relevant background, training and experience, taking into account competitive market compensation paid by the companies represented in the compensation data the Company reviews for similar positions and the overall market demand for such executives at the time of hire. As with total executive compensation, the Company believes that executive base salaries should generally target the fiftieth percentile of the range of salaries for executives in similar positions and with similar responsibilities in companies of similar size to the Company. An executive's base salary is also evaluated together with other components of the executive's compensation to ensure that the executive's total compensation is in line with the Company's overall compensation philosophy.

Base salaries are reviewed annually as part of the Company's performance management program and increased for merit reasons, based on the executive's success in meeting or exceeding individual performance objectives and an assessment of whether significant corporate goals were achieved. The Company also realigns base salaries with market levels for the same positions in companies of similar size to the Company represented in the compensation data the Company reviews if necessary and if the Company identifies significant market changes in the Company's data analysis. Additionally, the Company adjusts base salaries as warranted throughout the year for promotions or other changes in the scope or breadth of an executive's role or responsibilities.

*Annual Bonus*

The Company's compensation program includes eligibility for an annual performance-based cash bonus in the case of all executives and certain senior, non-executive employees. The amount of the cash bonus depends on the level of achievement of the stated corporate and individual performance goals. The terms of any bonus compensation that each of Messrs. Pearson, Corless, Wirth (the Company's former Chief Financial Officer, Treasurer and Secretary), Gilpin, Gilligan and Kratzman are or were entitled to are set forth in each of their respective employment agreements, descriptions of which are set forth below. See Executive Compensation — Employment Agreements.

The amounts of the annual cash bonuses paid to Messrs. Pearson, Corless, Wirth (the Company's former Chief Financial Officer, Treasurer and Secretary) and Gilpin are or were determined by the Compensation Committee of the Board. The amounts of the annual cash bonuses paid to Messrs. Kratzman and Gilligan are determined by the Management Committee of Katonah Debt Advisors. In each case, the annual bonus award is based on the individual performance of each of these individuals and on the performance of the Company against goals established annually by the Board, in the case of Messrs. Pearson, Corless, Wirth (the Company's former Chief Financial Officer, Treasurer and Secretary) and Gilpin, and by the Management Committee of Katonah Debt Advisors, in the case of Messrs. Kratzman and Gilligan, after consultation with the individual. All bonuses are subject to an annual increase, solely at the discretion of the Board or the Management Committee of Katonah Debt Advisors (as applicable), and in its discretion, the Compensation Committee or the Management Committee of Katonah Debt Advisors (as applicable) may award bonus payments to the Company's executives above or below the amounts specified in their respective employment agreements.

The annual bonus awards paid to the named executive officers with respect to 2011 (shown in the "Non-Equity Incentive Plan" column of the Summary Compensation Table below) were equal to or below their existing minimum target bonus amounts.

In addition, on March 18, 2011, the Compensation Committee granted one-time cash bonus awards to Messrs. Pearson, Wirth (the Company's former Chief Financial Officer, Treasurer and Secretary) and Corless in the amounts of $250,000, $200,000 and $100,000, respectively. These one-time cash bonus awards were in addition to the 2010 performance-based cash bonus awards and were paid in April 2011. These one-time bonus awards were made in recognition of, among other things, a satisfactory resolution of the Company's litigation against its former lenders and replacing such source of capital with an alternative source and the successful completion of the asset sales necessary to repay the former lenders in full ahead of the scheduled maturity of the credit facility. Such awards were made at the discretion of the Compensation Committee and were considered in the context of the overall performance of the Company and the performance and/or efforts of the individual in the extraordinary circumstances under which the Company was operating.

*Long-Term Incentives*

The Company believes that long-term performance is achieved through an ownership culture that encourages long-term participation by the Company's executive officers in equity-based awards. The Amended and Restated 2006 Equity Incentive Plan currently allows the grant to executive officers of stock options, restricted stock or other stock-based awards. The Company typically makes an initial equity award to certain new senior level employees and annual grants as part of the Company's overall compensation program. All grants of awards pursuant to the Amended and Restated 2006 Equity Incentive Plan are approved by the Board. The Amended and Restated 2006 Equity Incentive Plan is designed to allow, but not require, the grant of awards that qualify under an exception to the deduction limit of Section 162(m) of the Internal Revenue Code of 1986, as amended, for "performance-based compensation."

*Initial stock-based awards*. Executives who join the Company are awarded initial grants of options or restricted stock. Options awarded as part of these grants have an exercise price equal to the fair market value of our common stock on the grant date. The vesting schedule and other terms of these awards are determined by the Board. The amount of the initial award is determined based on the executive's position with the Company and an analysis of the competitive practices of companies similar in size to the Company represented in the compensation data that the Company reviews. The initial awards are intended to provide the executive with an incentive to build value in the organization over an extended period of time. The amount of

the initial award is also reviewed in light of the executive's base salary and other compensation to ensure that the executive's total compensation is in line with the Company's overall compensation philosophy. The grant date for awards for existing employees is the later of the date that the Board approved the grant or the date that the Company and the employee have reached a mutual understanding as to the amount and terms of such grant. For prospective employees, the grant date is the date upon which the Company and the employee have reached an agreement regarding the terms of employment and the terms of the award granted by the Board, and the employment has commenced (thus such date is typically the first day of employment). All of the grant dates are approved by the Board or the Compensation Committee.

*Annual stock-based awards*. The Company's practice is to make annual stock based awards as part of the Company's overall performance management program. However, in 2011, no awards of shares of the Company's restricted common stock were made to the named executive officers (with the exception of Mr. Kratzman, who received an award of restricted common stock pursuant to the terms of his employment agreement, as described below under "— Grants of Plan-Based Awards in Fiscal Year 2011"). The Compensation Committee believes that stock-based awards provide management with a strong link to long-term corporate performance and the creation of stockholder value. The Company intends that the annual aggregate value of these awards be set near competitive median levels for companies represented in the compensation data the Company reviews. As is the case when the amounts of base salary and initial equity awards are determined, a review of all components of the executive's compensation is conducted when determining annual equity awards to ensure that an executive's total compensation conforms to the Company's overall philosophy and objectives. A pool of stock-based awards is reserved for executives and other officers based on setting a target grant level for each employee category, with the higher ranked employees being eligible for a higher target grant. The Compensation Committee meets in the fourth quarter of each year to evaluate, review and recommend for the Board's approval the annual stock-based award design, level of award and prospective grant date of such award for each named executive officer and the Chief Executive Officer. For promotions or new hires, the Compensation Committee approves the award in advance of the grant date, and the stock-based grant is awarded on the determined date at the Company's closing market price per share. The Company uses a Binary Option Pricing Model (American, call option) to establish the expected value of all stock option grants.

*Other Compensation*

The Company maintain broad-based benefits and perquisites that are provided to all employees, including health, life and disability insurance and a 401(k) plan. The Company participates in a defined contribution plan for their executive officers and employees. In particular circumstances, the Company also utilizes cash signing bonuses when certain executives and senior non-executives join the Company. Such cash signing bonuses typically either vest during a period of less than a year or are repayable in full to the Company if the employee recipient voluntarily terminates employment with the Company prior to the first anniversary of the date of hire. Whether a signing bonus is paid and the amount thereof are determined on a case-by-case basis under the specific hiring circumstances. For example, the Company will consider paying signing bonuses to compensate for amounts forfeited by an executive upon terminating prior employment, to assist with relocation expenses and/or to create an additional incentive for an executive to join the Company in a position where there is high market demand.

*Termination-Based Compensation*

*Severance*. The terms of any severance based compensation that each of Messrs. Pearson, Corless, Gilpin, Gilligan and Kratzman are entitled to are set forth in each of their respective employment agreements, descriptions of which are set forth below. See Executive Compensation — Employment Agreements. For a discussion of severance payments for Mr. Wirth, our former Chief Financial Officer, Treasurer and Secretary, see "Termination of Employment Provisions in Employment Agreements" below.

*Acceleration of vesting of equity-based awards*. In general, all unvested options and unvested shares of restricted common stock held by an employee are forfeited immediately upon that employee's termination, whether or not for cause. Under the Amended and Restated 2006 Equity Incentive Plan, however, the Board may, if it so chooses, provide in the case of any award for post-termination exercise provisions, including a provision that accelerates all or a portion of any award, but in no event may any award be exercised after its expiration date.

*Conclusion*

The compensation policies of the Company are designed to motivate and retain their respective senior executive officers and to ultimately reward them for outstanding individual and corporate performance.

**Summary Compensation Table**

The following table shows the compensation paid or accrued during the fiscal years ended December 31, 2011, December 31, 2010 and December 31, 2009 to the Company's named executive officers. With respect to Mr. Gilligan, the table shows his compensation since fiscal year 2010, the year when he became a named executive officer.

| Name and Principal Position | Year | Salary ($) | Bonus ($) | Stock Awards ($)[1] | Option Awards ($) | Non-Equity Incentive Plan Compensation ($)[2] | All Other Compensation ($) | Total ($) |
|---|---|---|---|---|---|---|---|---|
| Dayl W. Pearson | 2011 | 400,000[3][4] | — | — | — | 400,000[4] | 72,712[4][6] | |
| President and Chief Executive Officer | 2010 | 400,000[4][7] | 250,000[4][5] | — | — | 500,000[4] | 62,439[4] | 1,212,439[4] |
| | 2009 | 400,000[4][8] | — | — | — | 450,000[4] | 99,586[4] | 949,586[4] |
| E.A. Kratzman[13] | 2011 | 400,000[3][11] | — | 500,000 | — | 650,000[11] | 189,528[6] | [11] |
| Former Vice President; President of Katonah Debt Advisors | 2010 | 400,000[4][11] | — | 500,000 | — | 1,100,000[11] | 122,890 | 2,122,890[11] |
| | 2009 | 400,000[8][11] | — | 500,000 | — | 650,000[11] | 95,510 | 1,645,510[11] |
| R. Jon Corless | 2011 | 250,000[3][4][9] | — | — | — | 200,000[4] | 40,049[4][6] | |
| Chief Investment Officer | 2010 | 250,000[4][7] | 100,000[4][5] | — | — | 200,000[4] | 17,781[4] | 567,781[4] |
| | 2009 | 250,000[4][8] | — | — | — | 200,000[4] | 28,068[4] | 478,068[4] |
| Daniel P. Gilligan[14] | 2011 | 160,000[3][10][11] | — | — | — | 125,000[11] | 33,651[6] | [11] |
| Chief Compliance Officer; Director of Portfolio Administration | 2010 | 150,000[4][11][12] | — | — | — | 125,000[11] | 7,997 | 282,997[11] |
| Michael I. Wirth[15] | 2011 | 325,000[3][4] | — | — | — | 200,000[4] | 56,399[4][6] | |
| Former Chief Financial Officer, Treasurer and Secretary | 2010 | 325,000[4][7] | 200,000[4][5] | — | — | 400,000 | 38,436[4] | 963,436[4] |
| | 2009 | 325,000[4][8] | — | 259,195[4] | — | 375,000[4] | 58,334[4] | 758,334[4] |

(1) Represents the grant date fair market value of restricted stock grants in accordance with Financial Accounting Standards Board Accounting Standards Codification — *Compensation — Stock Compensation* (Topic 718) (January 2010) ("*ASC 718*"). Grant date fair value is based on the closing price of Common Stock on the date of grant.

(2) Annual performance-based cash bonus. As described in "— Executive Compensation — Compensation Components — Annual Bonus" above, the annual bonuses of the named executive officers are derived based on the performance of the Company and the individual executive relative to pre-established objectives for the year. The threshold, target and/or maximum amounts for the year 2011 bonus opportunity of each named executive officer are reported in the Grants of Plan-Based Awards in Year 2011 table below.

(3) Represents actual cash salaries paid during 2011.

(4) With respect to these periods, Messrs. Pearson, Wirth and Corless had their compensation allocated between KCAP Financial and Katonah Debt Advisors.

(5) One-time cash bonus awards granted with respect to fiscal year 2010 in March 2011. As described in "— Executive Compensation — Compensation Components — Annual Bonus" above, these one-time cash bonus awards were in addition to the 2010 performance-based cash bonus awards reflected in the "Non-Equity Incentive Plan Compensation" column of this table and were paid in April 2011.

(6) See the 2011 All Other Compensation Table below for a breakdown of these amounts, which consist of:

- cash dividends on restricted stock granted or received upon conversion of previously granted options;
- amounts received pursuant to the Employee Savings and Profit Sharing Plan (the "***Savings Plan***");
- contributions received pursuant to a 401(k) plan;
- life insurance premiums; and
- disability insurance premiums.

The Savings Plan is a defined benefit plan, and the Company matches an individual's contribution up to a pre-set amount according to a specific formula.

**2011 All Other Compensation Table**

| Name | Dividends on Restricted Stock ($) | Savings Plan ($) | 401(k) Plan ($) | Life Insurance Premiums ($) | Disability Insurance Premiums ($) | Total ($) |
|---|---|---|---|---|---|---|
| Dayl W. Pearson | 33,563 | 27,477 | 4,900 | 84 | 6,688 | 72,712 |
| Michael I. Wirth[15] | 15,125 | 27,477 | 4,900 | 84 | 8,813 | 56,399 [13] |
| E.A. Kratzman[13] | 155,064 | 27,477 | 4,900 | 84 | 2,003 | 189,528 |
| R. Jon Corless | 3,400 | 27,477 | 4,900 | 84 | 4,188 | 40,049 |
| Daniel P. Gilligan[14] | 1,190 | 27,477 | 4,900 | 84 | — | 33,651 |

(7) Represents actual cash salaries paid during 2010.

(8) Represents actual cash salaries paid during 2009.

(9) Mr. Corless's base salary was raised from $250,000 to $265,000 effective January 1, 2012.

(10) Mr. Gilligan's base salary was raised from $160,000 to $175,000 effective January 1, 2012.

(11) Messrs. Kratzman and Gilligan received their salary and performance-based bonus from Katonah Debt Advisors.

(12) Mr. Gilligan's base salary was raised from $150,000 to $160,000 effective January 1, 2011.

(13) Mr. Kratzman was a named executive officer during fiscal year 2011. The Company and Mr. Kratzman agreed that he would no longer serve as Vice President of the Company effective April 17, 2012. Katonah Debt Advisors and Mr. Kratzman mutually agreed that Mr. Kratzman would separate from service with Katonah Debt Advisors effective August 31, 2012.

(14) Mr. Gilligan became a named executive officer during fiscal year 2010.

(15) The Company and Mr. Wirth mutually agreed that Mr. Wirth would separate from service with the Company on July 1, 2012.

**Grants of Plan-Based Awards in Fiscal Year 2011**

The following table shows information regarding grants of plan-based cash and equity awards during the fiscal year ended December 31, 2011 held by the executive officers named in the Summary Compensation Table.

| Name | Grant Date | Estimated Possible Payouts Under Non-Equity Incentive Plan Awards[1] | | | All Other Stock Awards: Number of Shares of Stock (#) | Grant Date Fair Value of Option Awards |
|---|---|---|---|---|---|---|
| | | Threshold ($) | Target ($) | Maximum ($) | | |
| Dayl W. Pearson | — | — | 500,000[2] | [2] | — | — |
| Michael I. Wirth[5] | — | — | 400,000[2] | [2] | — | — |
| E. A. Kratzman[6] | 10/07/11 | — | — | — | 86,805[3] | 500,000[4] |
| | — | — | 650,000 | 1,175,000 | — | — |
| R. Jon Corless | — | — | 225,000[2] | [2] | — | — |
| Daniel P. Gilligan | — | — | 125,000[2] | [2] | — | — |

(1) The actual bonus awards earned with respect to 2011 and paid out in 2012 are reported under "Non-Equity Incentive Plan Compensation" in the Summary Compensation Table above. Annual performance-based bonuses to Messrs. Pearson, Wirth and Corless are allocated between Kohlberg Capital and Katonah Debt Advisors. Messrs. Kratzman and Gilligan receive their annual performance-based bonus from Katonah Debt Advisors.

(2) Bonus awards in any year (which could potentially exceed the minimum target) are determined by the Compensation Committee of the Board and are based on performance of the individual and that of the Company against goals established annually by the Board.

(3) Awards of restricted stock granted under the Amended and Restated 2006 Equity Incentive Plan. In accordance with the terms of his employment agreement with the Company, the shares of restricted stock granted to Mr. Kratzman will vest in two equal installments on each of the third and fourth anniversaries of October 7, 2011, the grant date. Pursuant to the employment agreement, Mr. Kratzman is entitled to receive an annual grant of shares of the Company's restricted common stock having a value of $500,000. There are no additional criteria (performance-based or otherwise) that would have to be met as a condition to vesting.

(4) Represents the grant date fair value of the shares of restricted stock in accordance with ASC 718. Grant date fair value of the shares of restricted stock is based on the closing price of Common Stock on the date of grant.

(5) The Company and Mr. Wirth mutually agreed that Mr. Wirth would separate from service with the Company on July 1, 2012.

(6) The Company and Mr. Kratzman agreed that he would no longer serve as Vice President of the Company effective April 17, 2012. Katonah Debt Advisors and Mr. Kratzman mutually agreed that Mr. Kratzman would separate from service with Katonah Debt Advisors effective August 31, 2012.

**Employment Agreements**

The Company and/or Katonah Debt Advisors have or had entered into employment agreements with Messrs. Pearson, Wirth (our former Chief Financial Officer, Secretary and Treasurer), Gilpin, Corless, Kratzman and Gilligan. Each of Messrs. Pearson, Wirth (our former Chief Financial Officer, Secretary and Treasurer), Gilpin and Corless receives or received his salary, bonus, stock awards and benefits pursuant to their employment agreements with the Company. Messrs. Kratzman and Gilligan receive their salary, bonus and benefits pursuant to employment agreements with Katonah Debt Advisors.

*Employment Agreements with Dayl W. Pearson, Michael I. Wirth, R. Jon Corless and Edward U. Gilpin*

As amended on August 5, 2009, each of the employment agreements of Messrs. Pearson, Wirth and Corless with the Company provided for an initial term ending on December 31, 2010 (subject to automatic one-year renewals thereafter as provided in their previous agreements) unless either party provided prior written notice (not later than 30 days prior to the expiration of the term) of his or its decision not to extend the term of the employment agreement. Under their respective employment agreements, Messrs. Pearson, Wirth and Corless were entitled to receive an annual base salary of $400,000, $325,000 and $250,000, respectively, and were eligible to earn annual discretionary performance-based cash bonuses of no less than $450,000, 375,000 and $200,000, respectively, to be paid, in each case, on or about January 31 of the succeeding calendar year. The employment agreements provided that if the executive's employment was terminated by the Company without cause or by the executive for good reason (each as defined in the applicable employment agreement) or as a result of death or disability, the executive (or his designated beneficiary or estate) would be entitled to receive (i) his base salary and contributions toward health insurance premiums for the remaining term of the agreement (or, if greater, six months after such termination); provided, that if the remaining term of the agreement exceeded six months, the Company could have elected to cease continuation of base salary and contributions toward health insurance premiums at any point following the six-month anniversary of such termination so long as the Company released the executive from his remaining non-competition and non-solicitation obligations as of such date; (ii) any base salary earned but not paid through the date of termination; (iii) vacation time accrued but not used to that date; and (iv) any bonus compensation to which the executive is entitled in respect of the year of termination, prorated to the date of termination, all on the condition that the executive sign a release of claims. In addition to the benefits described above, the executive was entitled to a further six months of base salary and contributions toward health insurance premiums (i.e., for a total of one year) if he was terminated by the Company within 90 days following a change in control involving the Company (defined to include the acquisition by any person (or group) of the beneficial ownership of 33% or more of the then outstanding shares of the Company's common stock or the voting power of the Company's then outstanding voting securities; the failure of the incumbent board of directors (or successors designated thereby) to constitute a majority of the Company's board of directors; the approval by shareholders of a merger, consolidation or other reorganization transaction in which the Company's shareholders do not, at closing, own more than 50% of the combined voting power of the surviving entity; and a liquidation or dissolution of the Company or a sale of all or substantially all of its assets).

On June 1, 2012, Mr. Gilpin entered into an employment agreement with the Company providing for an initial term ending on December 31, 2013, subject to automatic one-year renewals thereafter (unless either party provides prior written notice not later than 30 days prior to the expiration of the term of his or its decision not to extend the term of employment). Under the employment agreement, Mr. Gilpin is entitled to receive an annual base salary of $350,000 (subject to increase from time to time in the discretion of the Board of Directors) and an annual cash bonus of not less than $400,000 for 2012 to be paid on or before January 31, 2013. Subsequently, Mr. Gilpin will be eligible to earn annual performance-based cash bonuses with a targeted amount of $400,000 to be paid on or before January 31 of the succeeding calendar year based on his performance and that of the Company against goals established annually by the Board. In addition, Mr. Gilpin will be entitled to receive a one-time grant of restricted shares of the Company's stock having a value of $150,000 on the date of grant pursuant to the Company's 2006 Amendment and Restated Equity Incentive Plan, and will be eligible to participate in all employee benefit plans of the Company available to employees. The employment agreement also provides that if Mr. Gilpin's employment is terminated by the Company without cause or by him for good reason (each as defined in Mr. Gilpin's employment agreement) or as a result of death or disability, he (or his designated beneficiary or estate) will be entitled to receive (i) his base salary and contributions toward health insurance premiums for the remaining term of the agreement (or, if greater, twelve months after such termination); provided that the Company may elect to cease continuation of base salary and contributions toward health insurance premiums at any point following the six-month anniversary of such termination so long as the Company releases Mr. Gilpin from his remaining non-competition and non-solicitation obligations as of such date; (ii) any base salary earned but not paid through the date of termination; (iii) vacation time accrued but not used to that date; (iv) any unpaid guaranteed bonus; (v) any bonus compensation to which he is entitled in respect of the year of termination, prorated to the date of termination; and (vi) in the case of a termination by the Company without cause or by Mr. Gilpin for good reason, continued annual bonuses at 50% of the target amount during the period of base salary continuation, pro rated with respect to partial years, all on the condition that he sign a release of claims and subject to his compliance with his non-compete, non-solicitation, and confidentiality obligations. In addition, following a change in control, Mr. Gilpin will be entitled to the benefits described above if he terminates for any reason in the 90 days after the change in control, and the Company's ability to elect to cease the continuation of base salary and contributions to health insurance premiums applies after twelve months rather than six months. A change in control is defined to include the acquisition by any person (or group) of the beneficial ownership of 33% or more of the then outstanding shares of the Company's common stock or the voting power of the Company's then outstanding voting securities; the failure of the incumbent Board of Directors (or successors designated thereby) to constitute a majority of the Company's Board of Directors; the approval by shareholders of a merger, consolidation or other reorganization transaction in which the Company's shareholders do not, at closing, own more than 50% of the combined voting power of the surviving entity; and a liquidation or dissolution of the Company or a sale of all or substantially all of its assets.

As amended on June 27, 2012, each of the employment agreements of Messrs. Pearson and Corless with the Company provides for an initial term ending on December 31, 2013 (subject to automatic one-year renewals thereafter as provided in their previous agreements) unless either party provides prior written notice (not later than 30 days prior to the expiration of the term) of his or its decision not to extend the term of the employment agreement. Under their respective employment agreements, Messrs. Pearson and Corless are entitled to receive an annual base salary of $400,000 and $265,000, respectively, and are eligible to earn annual discretionary performance-based cash bonuses with targeted amounts of $500,000 and $225,000, respectively, to be paid, in each case, on or about January 31 of the succeeding calendar year. As amended, the employment agreements provide that if the executive's employment is terminated by the Company without cause or by the executive for good reason (each as defined in the applicable employment agreement) or as a result of death or disability, the executive (or his designated beneficiary or estate) will be entitled to receive (i) his base salary and contributions toward health insurance premiums for the remaining term of the agreement (or, if greater, six months after such termination); provided, that if the remaining term of the agreement exceeds six months, the Company may elect to cease continuation of base salary and contributions toward health insurance premiums at any point following the six-month anniversary of such termination so long as the Company releases the executive from his remaining non-competition and non-solicitation obligations as of such date; (ii) any base salary earned but not paid through the date of termination; (iii)

vacation time accrued but not used to that date; and (iv) any bonus compensation to which the executive is entitled in respect of the year of termination, prorated to the date of termination, all on the condition that the executive sign a release of claims. In addition to the benefits described above, the executive will be entitled to a further six months of base salary and contributions toward health insurance premiums (*i.e.*, for a total of one year) if he is terminated by the Company within 90 days following a change in control involving the Company (defined to include the acquisition by any person (or group) of the beneficial ownership of 33% or more of the then outstanding shares of the Company's common stock or the voting power of the Company's then outstanding voting securities; the failure of the incumbent board of directors (or successors designated thereby) to constitute a majority of the Company's board of directors; the approval by shareholders of a merger, consolidation or other reorganization transaction in which the Company's shareholders do not, at closing, own more than 50% of the combined voting power of the surviving entity; and a liquidation or dissolution of the Company or a sale of all or substantially all of its assets).

*Employment Agreements with E.A. Kratzman*

As amended effective January 1, 2008, Mr. Kratzman's employment agreement with the Company, Mr. Kratzman provided that he was entitled to receive an annual grant of shares of the Company's restricted common stock having a value of $500,000 as long as he remained an officer of the Company. Such restricted shares vest 50% on the third anniversary of the grant date and 50% on the fourth anniversary of the grant date and were subject to the terms set out in a restricted stock award agreement between Mr. Kratzman and the Company.

As amended on August 5, 2009, Mr. Kratzman's employment agreement with Katonah Debt Advisors provided for an initial term ending on December 31, 2011 (subject to automatic one-year renewals thereafter as previously provided unless terminated in writing by either party prior to the expiration of the term). In addition to his base salary and annual bonus, Mr. Kratzman was entitled to receive up to three special bonuses of $150,000, each upon the receipt by Katonah Debt Advisors of all of the deferred subordinated fees from Katonah VII, VII and IX CLO Funds, respectively, and each such special bonus was paid during 2010 following the receipt of such applicable deferred fees. The employment agreement provided that if Mr. Kratzman's employment is terminated by Katonah Debt Advisors without cause, by him for good reason (each as defined in the employment agreement) or as a result of death or disability, he (or his designated beneficiary or estate) will be entitled to receive (i) his base salary and contributions toward health insurance premiums for the remaining term of the agreement; provided, that if the remaining term of the agreement exceeds one year, Katonah Debt Advisors may elect to cease continuation of base salary and contributions toward health insurance premiums at any point following the one-year anniversary of such termination so long as Katonah Debt Advisors releases Mr. Kratzman from his remaining non-competition and non-solicitation obligations as of such date; (ii) any base salary earned but not paid through the date of termination; (iii) vacation time accrued but not used to that date; and (iv) any bonus compensation to which Mr. Kratzman is entitled in respect of the year of termination, prorated to the date of termination (but in all cases based on an annual amount of no less than $650,000), all on the condition that he sign a release of claims. In addition to the benefits described above, Mr. Kratzman would have been entitled to an extra six months of his base salary and contributions toward health insurance premiums (i.e., for a total of 18 months) if he was terminated by Katonah Debt Advisors within 90 days following a change in control involving the Company (defined to include the acquisition by any person (or group) of the beneficial ownership of 33% or more of the then outstanding shares of the Company's common stock or the voting power of the Company's then outstanding voting securities; the failure of the incumbent board of directors (or successors designated thereby) to constitute a majority of the Company's board of directors; the approval by shareholders of a merger, consolidation or other reorganization transaction in which the Company's shareholders do not, at closing, own more than 50% of the combined voting power of the surviving entity; and a liquidation or dissolution of the Company or a sale of all or substantially all of its assets).

As amended on June 27, 2012, Mr. Kratzman's employment agreement with Katonah Debt Advisors provides for an initial term ending on December 31, 2013 (subject to automatic one-year renewals thereafter as provided in his previous agreement) unless either party provides prior written notice (not later than 30 days prior to the expiration of the term) of his or its decision not to extend the term of the employment agreement, or to otherwise terminate the employment agreement. Under the employment agreement, Mr. Kratzman is

entitled to receive an annual base salary of $400,000 and is eligible to earn an annual discretionary bonus, which shall be targeted at $1,175,000, payable in the succeeding calendar year on or before January 31. Any such bonus compensation will be determined by the Board, based on Mr. Kratzman's performance and that of Katonah Debt Advisors' against goals established annually by the Board after consultation with Mr. Kratzman. The Board reserves the right to reduce or eliminate any such bonus based on the financial circumstances of Katonah Debt Advisors in addition to Mr. Kratzman's performance against the aforementioned goals. The employment agreement provides that if Mr. Kratzman's employment is terminated by Katonah Debt Advisors without cause or by the executive for good reason (each as defined in Mr. Kratzman's employment agreement) or as a result of death or disability, Mr. Kratzman (or his designated beneficiary or estate) will be entitled to receive (i) his base salary and contributions toward health insurance premiums for the remaining term of the agreement; provided, that if the remaining term of the agreement exceeds six months, Katonah Debt Advisors may elect to cease continuation of base salary and contributions toward health insurance premiums at any point following the six-month anniversary of such termination so long as Katonah Debt Advisors releases the executive from his remaining non-competition and non-solicitation obligations as of such date; (ii) any base salary earned but not paid through the date of termination; (iii) vacation time accrued but not used to that date; and (iv) any bonus compensation to which the executive is entitled in respect of the year of termination, prorated to the date of termination, all on the condition that the executive sign a release of claims. In addition to the benefits described above, the executive will be entitled to a further six months of base salary and contributions toward health insurance premiums (*i.e.*, for a total of one year) if he is terminated by Katonah Debt Advisors within 90 days following a change in control involving the Company (defined to include the acquisition by any person (or group) of the beneficial ownership of 33% or more of the then outstanding shares of the Company's common stock or the voting power of the Company's then outstanding voting securities; the failure of the incumbent board of directors (or successors designated thereby) to constitute a majority of the Company's board of directors; the approval by shareholders of a merger, consolidation or other reorganization transaction in which the Company's shareholders do not, at closing, own more than 50% of the combined voting power of the surviving entity; and a liquidation or dissolution of the Company or a sale of all or substantially all of its assets). Finally, if Mr. Kratzman's employment is terminated by Katonah Debt Advisors without cause, but not in event of termination for any other reason, Katonah Debt Advisors will also pay Mr. Kratzman an annual bonus equal to 50% of the targeted bonus of $1,175,000 for the period during which he receives the severance payments noted above, prorated to the date when such severance payments cease.

The Company and Mr. Kratzman agreed that he would no longer serve as Vice President of the Company effective April 17, 2012. Katonah Debt Advisors and Mr. Kratzman mutually agreed that Mr. Kratzman would separate from service with Katonah Debt Advisors effective August 31, 2012. Upon Mr. Kratzman's execution of a release agreement and the satisfaction of certain other conditions, he will be entitled to receive the severance benefits provided for by his June 27, 2012 employment agreement with Katonah Debt Advisor.

*Employment Agreements with Daniel P. Gilligan*

As amended on August 13, 2009, Mr. Gilligan's employment agreement with Katonah Debt Advisors provides for Mr. Gilligan to be employed as a Director of Portfolio Administration of Katonah Debt Advisors. The agreement provides for an indefinite term ending upon Mr. Gilligan's resignation, death or removal with or without cause. The agreement provides for an annual base salary of $150,000 (which was increased to $160,000 effective January 1, 2011) and a target annual performance-based bonus from Katonah Debt Advisors of $125,000. The employment agreement provides that if Mr. Gilligan's employment is terminated by Katonah Debt Advisors without cause or as a result of death or disability, he (or his designated beneficiary or estate) will be entitled to receive (i) his base salary and contributions toward health insurance premiums; provided, that Katonah Debt Advisors may elect to cease continuation of base salary and contributions toward health insurance premiums at any point six months (or one year if Mr. Gilligan is terminated within 90 days of the completion of a change of control) after such termination; (ii) any base salary earned but not paid through the date of termination; (iii) vacation time accrued but not used to that date; and (iv) any bonus compensation to which Mr. Gilligan is entitled in respect of the year of termination, prorated to the date of termination, all on the condition that he sign a release of claims. His employment agreement also contains non-competition covenants and provisions governing termination, death and disability.

As amended on June 27, 2012, Mr. Gilligan's employment agreement with Katonah Debt Advisors provides for an initial term ending on December 31, 2013 (subject to automatic one-year renewals thereafter as provided in their previous agreements) unless either party provides prior written notice (not later than 30 days prior to the expiration of the term) of his or its decision not to extend the term of the employment agreement. Under the employment agreement, Mr. Gilligan is entitled to receive an annual base salary of $175,000 and is eligible to earn an annual discretionary bonus, which shall be targeted at $125,000, to be paid, in each case, on or about January 31 of the succeeding calendar year. The employment agreement provides that if the executive's employment is terminated by Katonah Debt Advisors without cause or by the executive for good reason (each as defined in the applicable employment agreement) or as a result of death or disability, the executive (or his designated beneficiary or estate) will be entitled to receive (i) his base salary and contributions toward health insurance premiums for the remaining term of the agreement; provided, that if the remaining term of the agreement exceeds six months, Katonah Debt Advisors may elect to cease continuation of base salary and contributions toward health insurance premiums at any point following the six-month anniversary of such termination so long as Katonah Debt Advisors releases the executive from his remaining non-competition and non-solicitation obligations as of such date; (ii) any base salary earned but not paid through the date of termination; (iii) vacation time accrued but not used to that date; and (iv) any bonus compensation to which the executive is entitled in respect of the year of termination, prorated to the date of termination, all on the condition that the executive sign a release of claims. In addition to the benefits described above, the executive will be entitled to a further six months of base salary and contributions toward health insurance premiums (*i.e.*, for a total of one year) if he is terminated by Katonah Debt Advisors within 90 days following a change in control involving the Company (defined to include the acquisition by any person (or group) of the beneficial ownership of 33% or more of the then outstanding shares of Common Stock or the voting power of the Company's then outstanding voting securities; the failure of the incumbent board of directors (or successors designated thereby) to constitute a majority of the Company's board of directors; the approval by shareholders of a merger, consolidation or other reorganization transaction in which the Company's shareholders do not, at closing, own more than 50% of the combined voting power of the surviving entity; and a liquidation or dissolution of the Company or a sale of all or substantially all of its assets).

**Outstanding Equity Awards at 2011 Fiscal Year-End**

The following table shows unvested stock awards outstanding on December 31, 2011, the last day of the Company's fiscal year, held by each of the named executive officers. There were no stock options awards held by any of the named executive officers outstanding on December 31, 2011.

| Name | Number of Shares or Units of Stock That Have Not Vested (#)[1] | Market Value of Shares or Units That Have Not Vested ($)[2] |
|---|---|---|
| Dayl W. Pearson | 20,886 | 131,791 |
| Michael I. Wirth[3] | 8,354 | 52,714 |
| E.A. Kratzman[4] | 269,099 | 1,868,384 |
| R. Jon Corless | — | — |
| Daniel P. Gilligan | — | — |

(1) The remaining unvested shares of restricted stock granted to Mr. Pearson will vest on the fourth anniversary of July 1, 2008, the grant date. The remaining unvested shares of restricted stock granted to Mr. Wirth will vest on the fourth anniversary of July 1, 2008, the grant date. The remaining unvested shares of restricted stock granted to Mr. Kratzman will vest, with respect to 20,886 shares, on the fourth anniversary of July 1, 2008, the grant date; with respect to 84,889 shares, in two equal installments on each of the third and fourth anniversaries of August 5, 2009, the grant date; with respect to 103,519 shares, in two equal installments on each of the third and fourth anniversaries of July 22, 2010, the grant date; and with respect to 86,805 shares, in two equal installments on each of the third and fourth anniversaries of October 7, 2011, the grant date.

(2) Computed by multiplying the number of unvested outstanding shares of restricted stock by $6.31, the closing market price of Common Stock on December 31, 2011, the end of the last completed fiscal year.

(3) The Company and Mr. Wirth mutually agreed that Mr. Wirth would separate from service with the Company on July 1, 2012.

(4) The Company and Mr. Kratzman agreed that he would no longer serve as Vice President of the Company effective April 17, 2012. Katonah Debt Advisors and Mr. Kratzman mutually agreed that Mr. Kratzman would separate from service with Katonah Debt Advisors effective August 31, 2012.

**Option Exercises and Stock Vested in Fiscal Year 2011**

The named executive officers did not hold or exercise any stock options during the fiscal year ended December 31, 2011. The shares of restricted stock held by the named executive officers that became vested in the fiscal year ended December 31, 2011 are set forth in the table below.

| Name | Stock Awards | |
|---|---|---|
| | Number of Shares Acquired on Vesting ($)[1] | Value Realized on Vesting ($)[2] |
| Dayl W. Pearson | 37,551 | 305,290 |
| Michael I. Wirth[3] | 18,354 | 149,218 |
| E.A. Kratzman[4] | 20,885 | 167,795 |
| R. Jon Corless | 6,666 | 54,195 |
| Daniel P. Gilligan | 2,334 | 18,975 |

(1) Represents shares of restricted stock that became vested on July 1, 2011.

(2) Computed by multiplying the number of shares of restricted stock that vested by $8.13, the closing market price of KCAP Financial's common stock on June 13, 2011, the vesting date.

(3) The Company and Mr. Wirth mutually agreed that Mr. Wirth would separate from service with the Company on July 1, 2012.

(4) The Company and Mr. Kratzman agreed that he would no longer serve as Vice President of the Company effective April 17, 2012. Katonah Debt Advisors and Mr. Kratzman mutually agreed that Mr. Kratzman would separate from service with Katonah Debt Advisors effective August 31, 2012.

**Pension Benefits**

The Company does not have any benefit plans, other than qualified defined contribution plans or nonqualified defined contribution plans.

**Nonqualified Deferred Compensation**

The Company does not have any defined contribution or other plans that provide for the deferral of compensation on a basis that is not tax-qualified.

**Potential Payments Upon Termination or Change of Control**

***Termination of Employment and Change of Control Arrangements***

*Change of Control Arrangements in the Company's Amended and Restated 2006 Equity Incentive Plan*

Under the Amended and Restated 2006 Equity Incentive Plan, in the event of a Covered Transaction (as defined below), all outstanding, unexercised options, restricted stock awards and other stock-based awards granted under the Amended and Restated 2006 Equity Incentive Plan will terminate and cease to be exercisable, and all other awards to the extent not fully vested (including awards subject to conditions not yet satisfied or determined) will be forfeited, provided that the Board may in its sole discretion on or prior to the effective date of the Covered Transaction take any (or any combination of) the following actions, as to some or all outstanding awards:

- make any outstanding option exercisable in full;

- remove any performance or other conditions or restrictions on any award;
- in the event of a Covered Transaction under the terms of which holders of the shares of the Company will receive upon consummation thereof a payment for each such share surrendered in the Covered Transaction (whether cash, non-cash or a combination of the foregoing), make or provide for a payment (with respect to some or all of the awards) to the participant equal in the case of each affected award to the difference between (A) the fair market value of a share of common stock times the numbers of shares subject to such outstanding award (to the extent then exercisable at prices not in excess of the fair market value) and (B) the aggregate exercise price of all shares subject to such outstanding award, in each case on such payment terms (which need not be the same as the terms of payment to holders of shares) and other terms, and subject to such conditions, as the Board determines; and
- with respect to an outstanding award held by a participant who, following the Covered Transaction, will be employed by or otherwise providing services to an entity which is a surviving or acquiring entity in the Covered Transaction or any affiliate of such an entity, at or prior to the effective time of the Covered Transaction, in its sole discretion and in lieu of the action described in the three preceding bullets, arrange to have such surviving or acquiring entity or affiliate assume any award held by such participant outstanding hereunder or grant a replacement award which, in the judgment of the Board is substantially equivalent to any award being replaced.

Under the Amended and Restated 2006 Equity Incentive Plan, a "Covered Transaction" is a (i) sale of shares of the Company's common stock, consolidation, merger, or similar transaction or series of related transactions in which KCAP Financial is not the surviving corporation or which results in the acquisition of all or substantially all of the Company's then outstanding shares of common stock by a single person or entity or by a group of persons and/or entities acting in concert; (ii) a sale or transfer of all or substantially all of the Company's assets; or (iii) a dissolution or liquidation of the Company. Where a Covered Transaction involves a tender offer that is reasonably expected to be followed by a merger described in clause (i) (as determined by the Board), the Covered Transaction shall be deemed to have occurred upon consummation of the tender offer.

*Termination of Employment Provisions in the Company's Amended and Restated 2006 Equity Incentive Plan*

Unless the Board expressly provides otherwise, immediately upon the cessation of employment or services of a participant in the Amended and Restated 2006 Equity Incentive Plan, all awards to the extent not already vested terminate and all awards requiring exercise cease to be exercisable and terminate, except that:

- When a participant's employment or services are ceased for Cause (as defined below), all options, vested and unvested, immediately terminate;
- For vested options held by a participant immediately prior to his or her death, to the extent then exercisable, the options remain exercisable for the lesser of a period of 180 days following the participant's death or the period ending on the latest date on which those options could have been exercised had there been no cessation of employment or services; and
- In all other cases, all vested options held by the participant immediately prior to the cessation of his or her employment, to the extent then exercisable, remain exercisable for the lesser of a period of 90 days or the period ending on the latest date on which that option could have been exercised had there been no cessation of employment or services.

Under the Amended and Restated 2006 Equity Incentive Plan, "*Cause*" has the same meaning as provided in the employment agreement between the participant and the Company or its affiliate, provided that if the participant is not a party to any such agreement, "*Cause*" means (i) the participant's chronic alcoholism or drug addiction; (ii) fraud, embezzlement, theft, dishonesty, or any deliberate misappropriation of any material amount of money or other assets or property of the Company or any of its affiliates by the participant; (iii) willful failure to perform, or gross negligence in the performance of, the participant's duties and responsibilities to the Company and its affiliates; (iv) the participant's material breach of any agreement between the participant and the Company or its affiliates, except where the breach is caused by incapacity or disability of the participant; (v) a charge, indictment or conviction of, or plea of nolo contendere by, the participant to a felony or other crime involving moral turpitude; (vi) the participant's material breach of his

fiduciary duties as an officer, trustee or director of the Company or any of its affiliates; (vii) the participant's willful refusal or failure to carry out a lawful and reasonable written directive of the Board or its designee, which failure or refusal does not cease within 15 days after written notice of such failure is given to the participant by the Company; or (viii) the participant's willful misconduct which has, or could be reasonably expected to have, a material adverse effect upon the business, interests or reputation of the Company or any of its affiliates.

The Board may provide in the case of any award for post-termination exercise provisions different from those set forth above, including, without limitation, terms allowing a later exercise by a former employee (or, in the case of a former employee who is deceased, the person or persons to whom the award is transferred by will or the laws of descent and distribution) as to all or any portion of the award not exercisable immediately prior to termination of employment or other service, but in no case may an award be exercised after the latest date on which it could have been exercised had there been no cessation of employment or services.

*Termination of Employment Provisions in Employment Agreements*

The termination provisions are set forth in the discussion of the employment agreements above.

The following table sets forth estimated payment obligations to each of the named executive officers, assuming a termination on December 31, 2011.

| Name | Termination by Company Without Cause ($)[1] | Termination by Company for Cause ($)[2] | Change of Control ($) | Voluntary Termination ($)[3] | Disability ($) | Death ($) |
|---|---|---|---|---|---|---|
| **Dayl W. Pearson** | | | | | | |
| Severance Payment | 400,000 | — | 850,000 | — | 400,000 | 400,000 |
| Base Salary | — | — | — | — | — | — |
| Accrued and unpaid base salary | — | — | — | — | — | — |
| Accrued and unpaid bonus | 450,000 | — | 450,000 | — | 450,000 | 450,000 |
| Accrued and unused vacation time[4] | 0 - 30,769 | 0 - 30,769 | 0 - 30,769 | 0 - 30,769 | 0 - 30,769 | 0 - 30,769 |
| Insurance benefits[5] | 27,072 | — | 27,072 | — | 27,072 | 27,072 |
| **TOTAL:** | 877,072 - 907,841 | 0 - 30,769 | 1,327,072 - 1,357,841 | 0 - 30,769 | 877,072 - 907,841 | 877,072 - 907,841 |
| **E.A. Kratzman[7]** | | | | | | |
| Severance Payment | 400,000 | — | 1,250,000 - 1,600,000 | — | 400,000 | 400,000 |
| Base Salary | — | — | — | — | — | — |
| Accrued and unpaid base salary | — | — | — | — | — | — |
| Accrued and unpaid bonus | 650,000 - 1,000,000 | — | 650,000 - 1,000,000 | — | 650,000 - 1,000,000 | 650,000 - 1,000,000 |
| Accrued and unused vacation time[4] | 0 - 30,769 | 0 - 30,769 | 0 - 30,769 | 0 - 30,769 | 0 - 30,769 | 0 - 30,769 |
| Insurance benefits[5] | 27,072 | — | 27,072 | — | 27,072 | 27,072 |
| **TOTAL:** | 1,077,072 - 1,457,841 | 0 - 30,769 | 1,927,072 - 2,657,841 | 0 - 30,769 | 1,077,072 - 1,457,841 | 1,077,072 - 1,457,841 |
| **R. Jon Corless** | | | | | | |
| Severance Payment | 250,000 | — | 450,000 | — | 250,000 | 250,000 |
| Base Salary | — | — | — | — | — | — |
| Accrued and unpaid base salary | — | — | — | — | — | |
| Accrued and unpaid bonus | 200,000 | — | 200,000 | — | 200,000 | 200,000 |
| Accrued and unused vacation time[4] | 0 - 20,385 | 0 - 20,385 | 0 - 20,385 | 0 - 20,385 | 0 - 20,385 | 0 - 20,385 |
| Insurance benefits[5] | 27,072 | — | 27,072 | — | 27,072 | 27,072 |
| **TOTAL:** | 492,072 - 512,457 | 0 - 20,385 | 692,072 - 712,457 | 0 - 20,385 | 492,072 - 512,457 | 492,072 - 512,457 |
| **Daniel P. Gilligan** | | | | | | |
| Severance Payment | 175,000 | — | 300,000 | — | 175,000 | 175,000 |
| Base Salary | — | — | — | — | — | — |
| Accrued and unpaid base salary | — | — | — | — | — | — |
| Accrued and unpaid bonus | 125,000 | — | 125,000 | — | 125,000 | 125,000 |
| Accrued and unused vacation time[4] | 0 - 13,462 | 0 - 13,462 | 0 - 13,462 | 0 - 13,462 | 0 - 13,462 | 0 - 13,462 |
| Insurance benefits[5] | 27,072 | — | 27,072 | — | 27,072 | 27,072 |
| **TOTAL:** | 327,072 - 340,534 | 0 - 13,462 | 452,072 - 465,534 | 0 - 13,462 | 327,072 - 340,534 | 327,072 - 340,534 |
| **Michael I. Wirth[6]** | | | | | | |
| Severance Payment | 325,000 | — | 700,000 | — | 325,000 | 325,000 |
| Base Salary | — | — | — | — | — | — |
| Accrued and unpaid base salary | — | — | — | — | — | — |
| Accrued and unpaid bonus | 375,000 | — | 375,000 | — | 375,000 | 375,000 |
| Accrued and unused vacation time[4] | 0 - 25,000 | 0 - 25,000 | 0 - 25,000 | 0 - 25,000 | 0 - 25,000 | 0 - 25,000 |
| Insurance benefits[5] | 27,072 | — | 27,072 | — | 27,072 | 27,072 |
| **TOTAL:** | 727,072 - 752,072 | 0 - 25,000 | 1,102,072 - 1,127,072 | 0 - 25,000 | 727,072 - 752,072 | 727,072 - 752,072 |

(1) Termination without cause or by the employee for good reason in the case of Messrs. Pearson, Wirth and Corless by the Company and, in the case of Messrs. Kratzman and Gilligan, by Katonah Debt Advisors. This column reflects payments to the employee for base salaries and health insurance premiums for the remaining term of their employment agreements.

(2) In the case of Messrs. Kratzman and Gilligan, by Katonah Debt Advisors.

(3) Voluntary termination other than for good reason.

(4) Accrued and unused vacation time is a range of minimum and maximum amounts payable, depending on the amount of vacation time used at the time of termination.

(5) Insurance benefits are based on the December 2011 monthly payment for health and dental coverage.

(6) The Company and Mr. Wirth mutually agreed that Mr. Wirth would separate from service with the Company on July 1, 2012.

(7) The Company and Mr. Kratzman agreed that he would no longer serve as Vice President of the Company effective April 17, 2012. Katonah Debt Advisors and Mr. Kratzman mutually agreed that Mr. Kratzman would separate from service with Katonah Debt Advisors effective August 31, 2012.

The Company and Mr. Wirth mutually agreed that Mr. Wirth would separate from service with the Company on July 1, 2012. Pursuant to Mr. Wirth's employment agreement with the Company, he will continue to receive his salary, and the Company will continue to contribute to the premium cost of his health insurance, until December 31, 2012. In addition, Mr. Wirth will receive a pro rated bonus of $187,500 for 2012, which will be paid to him on or about January 31, 2013. Finally, Mr. Wirth's remaining unvested restricted stock will vest in accordance with its terms on July 1, 2012.

**Director Compensation in Fiscal Year 2011**

The following table sets forth a summary of the compensation earned by the Company's directors (other than Mr. Pearson, who is also a named executive officer and whose compensation is reflected in the Summary Compensation Table above) in 2011:

| Name | Fees Earned or Paid in Cash ($) | Stock Awards ($)[1][2] | Option Awards ($)[3] | All Other Compensation ($) | Total ($) |
|---|---|---|---|---|---|
| **Independent Directors** | | | | | |
| Gary Cademartori | 53,250 | 7,960 | — | — | 61,210 |
| C. Michael Jacobi | 48,000 | 7,960 | — | — | 12,760 |
| Albert G. Pastino | 61,250 | 7,960 | — | — | 69,210 |
| C. Turney Stevens | 52,750 | 7,960 | — | — | 60,710 |
| Christopher Lacovara[4] | — | — | — | — | |
| **Non-Independent Directors** | | | | | |
| Samuel P. Frieder[5] | — | — | — | — | — |

(1) On June 10, 2011, each of Messrs. Cademartori, Jacobi, Pastino and Stevens was granted an award of 1,000 shares of restricted stock under the Amended and Restated Non-Employee Director Plan. Each of these awards had a grant date fair value of $7.96. The number of unvested restricted stock units held by each director listed in the table above at March 1, 2012 was as follows: Mr. Cademartori (500); Mr. Jacobi (500), Mr. Pastino (500), Mr. Stevens (500), Mr. Lacovara (0), Mr. Frieder (0).

(2) Amounts reflect the grant date fair value of such stock awards in accordance with ASC 718.

(3) The following table sets forth the option awards outstanding and held by our independent directors with respect to our common stock as of December 31, 2011:

| Name | Option Awards Outstanding (#) |
|---|---|
| Gary Cademartori | 15,000 |
| C. Michael Jacobi | 15,000 |
| Albert G. Pastino | 15,000 |
| C. Turney Stevens | 15,000 |
| Christopher Lacovara | — |

Such awards consist of an option to purchase 5,000 shares granted to each of the Independent Directors on each of June 13, 2008, June 13, 2009 and July 22, 2010. The exercise prices of such options are $11.97, $4.93 and $4.83 per share, respectively, and each such option expires on the 10th anniversary of the applicable grant date. All of such option awards have fully vested.

(4) Subsequent to the 2011 year end, the Board determined that Mr. Lacovara qualified as an Independent Director in light of his resignation as an officer of the Company in September 2011.

(5) Mr. Frieder resigned as a director effective February 29, 2012. Until his resignation as an officer of the Company in September 2011, Mr. Frieder did not qualify as an Independent Director. The Board made no determination as to whether Mr. Frieder qualified as an Independent Director following his resignation as an officer of the Company. Messrs. Bloom and Kehler are not listed in this table because they became directors of the Company effective February 29, 2012.

***Director Compensation Policy***

As compensation for serving on the Board, each of the Independent Directors who served in such capacity in 2011 received an annual fee of $37,000. In addition, each of the Independent Directors receives $1,500 per Board meeting attended in person and $750 per Board meeting attended telephonically. Employee directors and Non-Independent Directors do not receive compensation for serving on the Board. Independent Directors who serve on Board committees receive cash compensation in addition to the compensation they receive for service on the Board. The chairperson of the Company's Audit Committee receives an additional $10,000 per year, the lead independent director receives an additional $5,000 per year, and the chairperson of each other committee of the Board receives an additional $5,000 per year and all committee members receive an additional $500 for each committee meeting they attend. The Company also reimburses its directors for their reasonable out-of-pocket expenses incurred in attending meetings of the Board.

Pursuant to the Amended and Restated Non-Employee Director Plan, the Independent Directors and other directors who are not officers or employees of the Company ("Non-Employee Directors") may be issued options to purchase our common stock as a portion of their compensation for service on the Board in accordance with the terms of exemptive relief granted by the SEC in April 2008. A description of the Amended and Restated Non-Employee Director Plan is provided under "— Equity Incentive Plans — Amended and Restated Non-Employee Director Plan" below.

Effective retroactively as of July 1, 2012, each Independent Director will receive an annual fee of $60,000 and, effective January 1, 2012, the non-executive Chairman of the Board of Directors will receive an additional annual fee of $40,000.

**Employee Incentive Plans**

***Amended and Restated 2006 Equity Incentive Plan***

The 2006 Equity Incentive Plan was originally approved by the Board of Managers of Kohlberg Capital, LLC on November 27, 2006 and by the members of Kohlberg Capital, LLC on December 11, 2006, prior to the conversion of Kohlberg Capital, LLC into Kohlberg Capital Corporation, and subsequent conversion of Kohlberg Capital Corporation into KCAP Financial, Inc. Effective June 13, 2008, the 2006 Equity Incentive Plan was amended and restated pursuant to a vote of the Company's shareholders at the 2008 Annual Shareholder Meeting. Under the Amended and Restated 2006 Equity Incentive Plan, the Company may grant options to acquire shares and, to the extent permitted by exemptive or other relief that may be granted by the SEC or its staff, other share-based awards, including without limitation restricted shares and options to acquire restricted shares. There are 2,000,000 shares of common stock currently reserved for issuance under the Amended and Restated 2006 Equity Incentive Plan. As of June 30, 2011, 283,866 shares of restricted stock were outstanding, 240,124 shares of restricted stock had vested, 23,668 shares of restricted stock had been forfeited, no options were outstanding and 1,476,010 shares were available for future grants under the Amended and Restated 2006 Equity Incentive Plan.

In accordance with the terms of the Amended and Restated 2006 Equity Incentive Plan, the Board has authorized the Compensation Committee to administer the Amended and Restated 2006 Equity Incentive Plan, but has retained the authority to make grants. In accordance with the provisions of the Amended and Restated 2006 Equity Incentive Plan, the Compensation Committee will determine the terms of options and other awards, including:

- the determination of which employees will be granted options, restricted stock and other awards;
- the number of shares subject to options, shares of restricted stock and other awards;
- the exercise price of each option, which may not be less than fair market value (or, if no fair market value exists at the time of issuance, the current net asset value) of the shares subject to the award on the date of grant;
- the schedule upon which options become exercisable or upon which a restricted stock award vests (including any performance criteria applicable to restricted stock awards);
- the termination or cancellation provisions applicable to options and restricted stock awards;
- the terms and conditions of other awards, including conditions for repurchase, termination or cancellation, issue price and repurchase price; and
- all other terms and conditions upon which each award may be granted in accordance with the Amended and Restated 2006 Equity Incentive Plan.

No participant may receive awards of options for over 1,000,000 shares of common stock or over 500,000 shares of restricted stock in any fiscal year. The aggregate number of shares of restricted stock that may be issued under the Amended and Restated 2006 Equity Incentive Plan may not exceed 10% of the outstanding shares on June 13, 2008, the effective date of the Amended and Restated 2006 Equity Incentive Plan, plus 10% of the number of shares issued or delivered by the Company (other than pursuant to compensation plans) during the term of the Amended and Restated 2006 Equity Incentive Plan. No one person may be granted more than 25% of the shares of restricted stock reserved for issuance under the Amended and Restated 2006 Equity Incentive Plan. In addition, the amount of voting securities that would result from the exercise of all of the Company's outstanding warrants, options and rights, together with any restricted stock issued by the Company, at the time of issuance may not exceed 25% of the outstanding voting securities of the Company, except that if the amount of voting securities that would result from the exercise of all the Company's outstanding warrants, options and rights issued to the Company's directors, officers and employees, together with any restricted stock issued by the Company, would exceed 15% of the outstanding voting securities of the Company, the total amount of voting securities that would result from the exercise of all outstanding warrants, options and rights, together with any restricted stock issued by the Company, at the time of issuance may not exceed 20% of the outstanding voting securities of the Company.

The Board or any committee to which the Board delegates authority may, with the consent of any adversely affected Amended and Restated 2006 Equity Incentive Plan participants and to the extent permitted by law, reprice or otherwise amend outstanding awards consistent with the terms of the Amended and Restated 2006 Equity Incentive Plan. No share may be repriced other than in accordance with the 1940 Act and the applicable shareholder approval requirements of The NASDAQ Global Select Market.

In the case of a stock dividend, stock split, recapitalization or other similar change, the number and kind of shares subject to options, shares of restricted stock and other stock-based awards then outstanding or subsequently granted under the Amended and Restated 2006 Equity Incentive Plan, the exercise price of such awards, the maximum number of shares that may be delivered under the Amended and Restated 2006 Equity Incentive Plan, and other relevant provisions shall be appropriately adjusted by the Board. The Board may also adjust the number of shares subject to outstanding awards, the exercise price of outstanding awards, and the terms of outstanding awards to take into consideration material changes in accounting practices or principles, extraordinary dividends, consolidations or mergers, acquisitions or dispositions of securities or property (with the exception of those that qualify as "Covered Transaction," in which case the Board may take any one or more of the actions described above under "—Potential Payments Upon Termination or Change of Control—Termination of Employment and Change of Control Arrangements—Change of Control Arrangements in the Company's Amended and Restated 2006 Equity Incentive Plan"), or any other event if it

is determined by the Board that such adjustment is appropriate to avoid distortion in the operation of the Amended and Restated 2006 Equity Incentive Plan. However, the exercise price of options granted under the Amended and Restated 2006 Equity Incentive Plan will not be adjusted unless the Company receives an exemptive order from the SEC or written confirmation from the SEC staff that the Company may do so.

***Amended and Restated Non-Employee Director Plan***

The 2008 Non-Employee Director Plan was originally adopted by the Board and was approved by a vote of the Company's shareholders at the 2008 Annual Shareholder Meeting (the "Prior Plan"). Effective June 10, 2011, the Prior Plan was amended and restated pursuant to a vote of the Company's shareholders at the 2011 Annual Shareholder Meeting (as amended, the "Amended and Restated Non-Employee Director Plan"). Pursuant to such amendment, the Company is permitted to 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 have remained outstanding in accordance with the terms of the Amended and Restated Non-Employee Director Plan. There are 100,000 shares of common stock currently reserved for issuance under the Amended and Restated Non-Employee Director Plan. Following the amendment of the Amended and Restated Non-Employee Director Plan, 60,000 shares were subject to outstanding options, and there were no additional options available for future grants under the Amended and Restated Non-Employee Director Plan. Any options outstanding as of the date of the 2011 Annual Shareholder Meeting are governed in all respects by the terms of the Prior Plan.

Under the Amended and Restated Non-Employee Director Plan, the Non-Employee Directors automatically receive 1,000 shares of restricted stock on the date of each annual meeting of shareholders during the term of the plan. The shares immediately vest as to one-half of the restricted stock grant and as to the remaining one-half of the restricted stock grant on the earlier of (i) the first anniversary of such grant, or (ii) the date immediately preceding the next annual meeting of shareholders (or meeting in lieu of the annual meeting of shareholders), so that vesting for one hundred percent (100%) of the restricted stock grant occurs one year after the date of grant; provided that the participant is then and since the date of grant has continuously been a Non-Employee Director. In addition, a Non-Employee Director who is appointed to serve on the Board outside of the annual election cycle would automatically be granted a pro rata portion of the restricted stock grant on the date of such appointment to the Board. The grants of restricted stock to Non-Employee Directors under the Amended and Restated Non-Employee Director Plan will be automatic (subject to the authority of the Board to prevent or limit the granting of restricted stock).

In accordance with the terms of the Amended and Restated Non-Employee Director Plan, the Board has authorized the Compensation Committee to administer the Amended and Restated Non-Employee Director Plan.

Unless the Board expressly provides otherwise, immediately upon the cessation of the Non-Employee Director's service (unless upon such termination or within 90 days thereafter such Non-Employee Director becomes an officer or employee of the Company or rejoins the Board as a Non-Employee Director), all awards of restricted stock, to the extent not already vested, will be forfeited. However, if the Non-Employee Director ceases providing services as a Non-Employee Director but within 90 days of such cessation becomes an officer or employee of the Company or rejoins the Board as a Non-Employee Director, such person shall vest in any unvested restricted shares on the later of (i) the next annual shareholders meeting (in accordance the terms of the Amended and Restated Non-Employee Director Plan) or (ii) the date on which such person becomes an officer or employee of the Company or rejoins the Board as a Non-Employee Director.

Unless the Board expressly provides otherwise, immediately upon the cessation of the Non-Employee Director's service, all options award under the Prior Plan, to the extent not already vested, terminate, except that:

- When the Non-Employee Director's services are ceased for Cause (as defined below), all options, vested and unvested, immediately terminate;

- For vested options held by the Non-Employee Director immediately prior to his or her death, to the extent then exercisable, the options remain exercisable for the lesser of a period of 180 days following the Non-Employee Director's death or the period ending on the latest date on which those options could have been exercised had there been no cessation of services; and
- In all other cases, all vested options held by the Non-Employee Director immediately prior to the cessation of his or her services, to the extent then exercisable, remain exercisable for the lesser of a period of 90 days or the period ending on the latest date on which that option could have been exercised had there been no cessation of services.

Under the Prior Plan, "Cause" means (i) commission of a felony or of a crime involving moral turpitude, (ii) gross dereliction of duty or (iii) any breach of duty that is materially injurious to the business or reputation of the Company.

The Board may provide in the case of any option award granted under the Prior Plan for post-termination exercise provisions different from those set forth above, including, without limitation, terms allowing a later exercise by a former Non-Employee Director (or, in the case of a former Non-Employee Director who is deceased, the person or persons to whom the award is transferred by will or the laws of descent and distribution) as to all or any portion of the option award not exercisable immediately prior to termination of service, but in no case may an award be exercised after the latest date on which it could have been exercised had there been no cessation of services.

The Amended and Restated Non-Employee Director Plan has provisions relating to repricing or other amendments of outstanding awards, stock dividends, stock splits, recapitalizations or other similar changes, and "Covered Transactions" analogous to those described under "— Amended and Restated 2006 Equity Incentive Plan" above.

***Equity Compensation Plan Information***

During the year ended December 31, 2011, the Company did not grant any options to purchase shares of Common Stock or restricted stock awards under the Amended and Restated 2006 Equity Incentive Plan to its employees (other than the award of restricted stock to Mr. Kratzman described in the Grants of Plan-Based Awards in Fiscal Year 2011 table above) and no options were outstanding thereunder. During the year ended December 31, 2011, the Company issued a total of 4,000 shares of restricted stock to certain of its Independent Directors under the Amended and Restated Non-Employee Director Plan, and a options to purchase a total of 60,000 shares were outstanding under the Prior Plan (described above) as of December 31, 2011. The options have an estimated remaining contractual life of seven years and four months. During the year ended December 31, 2011, no options were granted, exercised or forfeited under the Prior Plan.

The following table summarizes certain information regarding the Amended and Restated 2006 Equity Incentive Plan and the Amended and Restated Non-Employee Director Plan as of December 31, 2011:

| Plan Category | Number of Securities to Be Issued Upon Exercise of Outstanding Options, Warrants and Rights | Weighted Average Exercise Price of Outstanding Options, Warrants and Rights | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) |
|---|---|---|---|
| | (a) | (b) | (c) |
| Equity Compensation Plans Approved by Security Holders[1] | 60,000 | $ 7.24 | 1,491,010[2][3] |
| Equity Compensation Plans Not Approved by Security Holders | — | — | — |
| **Total** | 60,000 | 7.24 | 1,491,010 |

(1) The Company's Amended and Restated 2006 Equity Incentive Plan and Amended and Restated Non-Employee Director Plan.

(2) Subject to the following additional limitations: The aggregate number of shares of restricted stock that may be issued under the Amended and Restated 2006 Equity Incentive Plan, the Amended Restated Non-Employee Director Plan, and any other Company executive compensation plan, collectively, may not exceed 10% of the outstanding shares of common stock of the Company on the effective date of the Amended and Restated Non-Employee Director Plan plus 10% of the number of shares of the Company's common stock issued or delivered by the Company (other than pursuant to compensation plans) during the term of the Amended and Restated Non-Employee Director Plan. No one person may be granted more than 25% of the shares of restricted stock reserved for issuance under the Amended and Restated 2006 Equity Incentive Plan. For purposes of calculating compliance with this limit, the Company will count as restricted stock all shares of the Company's common stock that are issued pursuant to the Amended and Restated Non-Employee Director Plan less any shares that are forfeited back to the Company and cancelled as a result of forfeiture restrictions not lapsing. In addition, the amount of voting securities that would result from the exercise of all of the Company's outstanding warrants, options and rights, together with any restricted stock issued by the Company, at the time of issuance may not exceed 25% of the outstanding voting securities of the Company, except that if the amount of voting securities that would result from the exercise of all the Company's outstanding warrants, options and rights issued to the Company's directors, officers and employees, together with any restricted stock issued by the Company, would exceed 15% of the outstanding voting securities of the Company, the total amount of voting securities that would result from the exercise of all outstanding warrants, options and rights, together with any restricted stock issued by the Company, at the time of issuance may not exceed 20% of the outstanding voting securities of the Company.

(3) The 1,476,010 shares issuable under the Company's Amended and Restated 2006 Equity Incentive Plan may be issued in the form of options, restricted stock or other stock-based awards. The 36,000 shares issuable under the Company's Amended and Restated Non-Employee Director Plan may currently be issued in the form of restricted stock.

## CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

We have procedures in place for the review, approval and monitoring of transactions involving the Company and certain persons related to the Company. As a BDC, the Company is prohibited under the 1940 Act from participating in certain transactions with certain of its affiliates without meeting certain requirements, such as the prior approval of the Independent Directors and, in some cases, the SEC. The affiliates with which the Company may be prohibited from transacting include its officers, directors and employees and any person who owns 5% or more of our outstanding voting securities or controlling or under common control with the Company.

## CONTROL PERSONS AND PRINCIPAL STOCKHOLDERS

No person is deemed to control us, as such term is defined in the 1940 Act.

The following table sets forth, as of July 30, 2012, information with respect to the beneficial ownership of our common stock by:

- each person known to us to beneficially own more than 5% of the outstanding shares of our common stock;
- each of our directors and each named executive officer; and
- all of our directors and executive officers as a group.

Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission (the "SEC") and includes voting or investment power with respect to the securities. Common Stock subject to options that are currently exercisable or exercisable within 60 days of July 30, 2012 are deemed to be outstanding and beneficially owned by the person holding such options. Such shares, however, are not deemed outstanding for the purposes of computing the percentage ownership of any other person. Percentage of beneficial ownership is based on 26,664,132 shares of Common Stock outstanding as of July 30, 2012.

Unless otherwise indicated, to our knowledge, each shareholder listed below has sole voting and investment power with respect to the shares beneficially owned by the shareholder, except to the extent authority is shared by spouses under applicable law, and maintains an address of c/o KCAP Financial, Inc., 295 Madison Avenue, 6th Floor, New York, New York 10017.

| Name and Address | Number of Shares | Percentage of Class | Dollar Range of Equity Securities[1] |
|---|---|---|---|
| ***Principal Shareholders:*** | | | |
| Zazove Associates, LLC[2]<br>100 E. Pratt Street, Baltimore, Maryland 21202 | 4,140,095 | 13.4% | N/A |
| Virginia Retirement System[3]<br>1200 East Main Street, Richmond, Virginia 23219 | 2,313,618 | 8.0% | N/A |
| Whitebox Advisors, LLC[4]<br>3033 Excelsior Boulevard, Suite 300,<br>Minneapolis, MN 55416 | 1,540,832 | 5.8% | N/A |
| ***Directors and Executive Officers:*** | | | |
| **Independent Directors** | | | |
| C. Michael Jacobi[5] | 31,167 | * | >$100,000 |
| Christopher Lacovara[6] | 598,903 | 2.2% | >$100,000 |
| Albert G. Pastino[5] | 20,687 | * | >$100,000 |
| C. Turney Stevens[5] | 18,500 | * | >$100,000 |
| Gary Cademartori[5] | 19,694 | * | >$100,000 |

| Name and Address | Number of Shares | Percentage of Class | Dollar Range of Equity Securities[1] |
|---|---|---|---|
| **Non-Independent Directors** | | | |
| Jay R. Bloom[7] | 1,800,000 | 6.8% | >$100,000 |
| Dean C. Kehler[8] | 1,800,000 | 6.8% | >$100,000 |
| Dayl W. Pearson | 101,516 | * | >$100,000 |
| **Executive Officers** | | | |
| R. Jon Corless | 42,154 | * | >$100,000 |
| Daniel P. Gilligan | 9,052 | * | $50,001 - $100,000 |
| Edward U. Gilpin[9] | 23,847 | * | >$100,000 |
| Directors and Executive Officers as a Group (12 persons) | 4,441,673 | 16.7% | >$100,000 |

* Less than 1%.

(1) Based on the closing price of the Company's Common Stock on July 30, 2012 ($7.75).

(2) The information regarding Zazove Associates, LLC is based solely on information included in Amendment No. 1 to Schedule 13G filed by Zazove Associates, LLC with the SEC on January 5, 2012. Zazove Associates, LLC indicated that it has the sole power to vote or to direct the vote of, and the sole power to dispose or to direct the disposition of, 4,140,095 shares of our Common Stock issuable upon conversion of our 8.75% convertible notes due March 15, 2016. Includes 2,313,618 of such shares of our Common Stock that are held in an account managed by Zazove Associates, LLC for the benefit of The Virginia Retirement System. Zazove Associates, LLC provides investment advisory services to The Virginia Retirement System and has discretionary authority with regard to the account that holds such shares of our Common Stock.

(3) The information regarding Virginia Retirement System is based solely on information included in Schedule 13G filed by Virginia Retirement System with the SEC on February 14, 2012. Virginia Retirement System indicated that it has the sole power to vote or to direct the vote of, and the sole power to dispose or to direct the disposition of, 2,313,618 shares of our Common Stock issuable upon conversion of our 8.75% convertible notes due March 15, 2016. Such shares of our Common Stock are held in an account managed by Zazove Associates, LLC, a registered investment adviser under Section 203 of the Advisers Act, for the benefit of The Virginia Retirement System.

(4) Based on information contained in a Schedule 13G that Whitebox Advisors LLC ("WA") filed with the SEC on February 14, 2012. WA, acting as an investment advisor, has shared voting and dispositive power with respect to 1,540,832 shares. Whitebox Multi-Strategy Advisors, LLC ("WMSA"), Whitebox Multi-Strategy Partners, L.P. ("WMSP"), Whitebox Multi-Strategy Fund, L.P. ("WMSFLP") and Whitebox Multi-Strategy Fund Ltd. ("WMSFLTD") have shared voting and dispositive power with respect to 611,117 shares. Whitebox Concentrated Convertible Arbitrage Advisors, LLC ("WCCAA"), Whitebox Concentrated Convertible Arbitrage Partners, L.P. ("WCCAP"), Whitebox Concentrated Convertible Arbitrage Fund, L.P. ("WCCAFLP") and Whitebox Concentrated Convertible Arbitrage Fund, Ltd. ("WCCAFLTD") have shared voting and dispositive power with respect to 464,146 shares. Pandora Select Advisors, LLC ("PSA"), Pandora Select Partners, L.P. ("PSP"), Pandora Select Fund, L.P. ("PSFLP") and Pandora Select Fund, Ltd. ("PSFLTD") have shared voting and dispositive power with respect to 355,557 shares. WA, WMSA, WMSFLP, WMSFLTD, WCCAA, WCCAFLP, WCCAFLTD, PSA, PSFLP and PSFLTD may be deemed to possess indirect beneficial ownership of the shares beneficially owned by each of WMSP, WCCAP, PSP and HFR. WA, WMSA, WMSFLP, WMSFLTD, WCCAA, WCCAFLP, WCCAFLTD, PSA, PSFLP and PSFLTD each disclaim indirect beneficial ownership of the shares except to the extent of their pecuniary interest therein.

(5) Includes (a) 15,000 shares of Common Stock issuable pursuant to options granted under the 2008 Non-Employee Director Plan that are currently exercisable to each of Messrs. Jacobi, Pastino, Stevens and Cademartori; and (b) 1,000 shares of Common Stock issuable as restricted stock granted under the Amended and Restated Non-Employee Director Plan to each of Messrs. Jacobi, Pastino, Stevens and Cademartori.

(6) Excludes shares of Common Stock held by the KKAT Entities. Mr. Lacovara is a member of the KKAT Entities and therefore may have a pecuniary interest in certain of the shares held by the KKAT Entities. Mr. Lacovara disclaims beneficial ownership of the shares held by the KKAT Entities except to the extent of their respective pecuniary interests therein.

(7) Mr. Bloom acquired the 1,800,000 shares as consideration for his indirect sale of certain property and limited liability company interests in Trimaran Advisors, L.L.C. to KCAP Financial on February 29, 2012. Mr. Bloom indicated that he has sole dispositive and voting power over 725,000 shares which were delivered at the closing of the transaction. The remaining 1,075,000 shares are held in an escrow account and may be released pursuant to its terms and conditions. Upon any such release, Mr. Bloom would have full voting control and full dispositive control over such released shares.

(8) Mr. Kehler acquired the 1,800,000 shares as consideration for his indirect sale of certain property and limited liability company interests in Trimaran Advisors, L.L.C. to KCAP Financial on February 29, 2012. Mr. Kehler indicated that he has sole dispositive and voting power over 725,000 shares which were delivered at the closing of the transaction. The remaining 1,075,000 shares are held in an escrow account and may be released pursuant to its terms and conditions. Upon any such release, Mr. Kehler would have full voting control and full dispositive control over such released shares.

(9) Shares of restricted stock granted under the Amended and Restated 2006 Equity Incentive Plan to Mr. Gilpin. One half of the restricted stock award will vest on each of the third and fourth anniversaries of the grant date, June 15, 2012.

## REGULATION

The following discussion is a general summary of some of the material prohibitions and restrictions governing BDCs generally. It does not purport to be a complete description of all the laws and regulations affecting BDCs.

A BDC is a unique kind of investment company that primarily focuses on investing in or lending to private or relatively small publicly traded companies and making managerial assistance available to them. A BDC provides stockholders with the ability to retain the liquidity of a publicly traded stock, while sharing in the possible benefits of investing privately-owned companies. The 1940 Act contains prohibitions and restrictions relating to transactions between BDCs and their directors and officers and principal underwriters and certain other related persons and requires that a majority of the directors be persons other than "interested persons," as that term is defined in the 1940 Act. We have implemented certain procedures, both written and unwritten, to ensure that we do not engage in any prohibited transactions with any persons affiliated with us. If such affiliations are found to exist, we seek Board and/or committee review and approval or exemptive relief for such transactions, as appropriate.

In addition, the 1940 Act provides that we may not change the nature of our business so as to cease to be, or to withdraw our election as, a BDC unless approved by a majority of our outstanding voting securities. A majority of the outstanding voting securities of a company is defined under the 1940 Act as the lesser of (i) 67% or more of such company's shares present at a meeting or represented by proxy if more than 50% of the outstanding shares of such company are present or represented by proxy or (ii) more than 50% of the outstanding shares of such company.

### Qualifying Assets

Under the 1940 Act, a BDC may not acquire any asset other than assets of the type listed in Section 55(a) of the 1940 Act, or "qualifying assets," unless, at the time the acquisition is made, "qualifying assets" represent at least 70% of the company's total assets. The principal categories of "qualifying assets" relevant to our business are the following:

- Securities of an "eligible portfolio company" purchased in transactions not involving any public offering. An "eligible portfolio company" is defined in the 1940 Act as any issuer which:

(a) is organized under the laws of, and has its principal place of business in, the United States;

(b) is not an investment company (other than a small business investment company wholly-owned by the BDC) or a company that would be an investment company but for certain exclusions under the 1940 Act; and

(c) satisfies any of the following:

(i) does not have outstanding any class of securities with respect to which a broker or dealer may extend margin credit;

(ii) is controlled by a BDC or a group of companies including a BDC and the BDC has an affiliated person who is a director of the eligible portfolio company;

(iii) is a small and solvent company having total assets of not more than $4 million and capital and surplus of not less than $2 million; or

(iv) does not have any class of securities listed on a national securities exchange (or, if it has a class of securities listed on a national securities exchange, has an aggregate market value of outstanding voting and non-voting common equity of less than $250 million).

- Securities of any eligible portfolio company that we control;
- Securities purchased in a private transaction from a U.S. issuer that is not an investment company and is in bankruptcy and subject to reorganization;
- Securities received in exchange for or distributed on or with respect to securities described above, or pursuant to the conversion of warrants or rights relating to such securities;

- Cash, cash equivalents, U.S. government securities or high-quality debt securities maturing in one year or less from the time of investment; and
- Under certain circumstances, securities of companies that were eligible portfolio companies at the time of the initial investment but that are not eligible portfolio companies at the time of the follow-on investment.
- Our Asset Manager Affiliates constitute "qualifying assets" under the 1940 Act because (i) they were acquired by us in transactions not involving any public offering, (ii) are organized under the laws of and have their principal place of business in the United States, (iii) are not investment companies or companies that would be investment companies but for certain exclusions under the 1940 Act and (iv) do not have any class of securities listed on a national securities exchange.

**Significant Managerial Assistance**

A BDC must be organized and have its principal place of business in the United States and must be operated for the purpose of making investments in the types of securities described above. However, to count portfolio securities as "qualifying assets" for the purpose of the 70% test discussed above, the BDC must either control the issuer of the securities or must offer to make available to the issuer of the securities (other than small and solvent companies described above) significant managerial assistance; except that, where the BDC purchases such securities in conjunction with one or more other persons acting together, one of the other persons in the group may make available such managerial assistance. Making available significant managerial assistance means, among other things, any arrangement whereby the BDC, through its directors, officers or employees, offers to provide, and, if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of a portfolio company through monitoring of portfolio company operations, selective participation in board and management meetings, consulting with and advising a portfolio company's officers or other organizational or financial guidance.

**Temporary Investments**

Pending investment in other types of "qualifying assets," as described above, our investments may consist of cash, cash equivalents, U.S. government securities or high quality debt securities maturing in one year or less from the time of investment, which we refer to, collectively, as temporary investments, so that at least 70% of our assets are "qualifying assets." Typically, we invest in U.S. treasury bills or in repurchase agreements, provided that such agreements are fully collateralized by cash or securities issued by the U.S. government or its agencies. A repurchase agreement involves the purchase by an investor, such as us, of a specified security and the simultaneous agreement by the seller to repurchase it at an agreed upon future date and at a price which is greater than the purchase price by an amount that reflects an agreed-upon interest rate. There is no percentage restriction on the proportion of our assets that may be invested in such repurchase agreements. However, if more than 25% of our total assets constitute repurchase agreements that are treated, under applicable tax rules, as being issued by a single counterparty, we would not meet the diversification tests imposed on us by the Code to qualify for tax treatment as a RIC for U.S. federal income tax purposes. Thus, we do not intend to enter into repurchase agreements treated as issued, under applicable tax rules, by a single counterparty in excess of this limit. We monitor the creditworthiness of the counterparties with which we enter into repurchase agreement transactions.

**Senior Securities; Coverage Ratio**

We are permitted, under specified conditions, to issue multiple classes of indebtedness and one class of stock senior to our common stock if our asset coverage, as defined in the 1940 Act, is at least equal to 200% immediately after each such issuance. In addition, with respect to certain types of senior securities, we must make provisions to prohibit any dividend distribution to our stockholders or the repurchase of certain of our securities, unless we meet the applicable asset coverage ratios at the time of the dividend distribution or repurchase. We may also borrow amounts up to 5% of the value of our total assets for temporary purposes.

**Common Stock**

We are not generally able to issue and sell our common stock at a price below net asset value per share. We may, however, sell our common stock at a price below the current net asset value of the common stock if our Board of Directors determines that such sale is in our best interests and that of our stockholders, and our

stockholders approve such sale. In any such case, the price at which our securities are to be issued and sold may not be less than a price which, in the determination of our Board of Directors, closely approximates the market value of such securities (less any distributing commission or discount). We obtained shareholder approval to sell our common stock at a price below net asset value at our 2012 annual meeting of stockholders and such approval is effective for a period expiring on the earlier of June 22, 2013, the one-year anniversary of the date of the shareholder approval, or the date of our 2013 annual meeting of stockholders. We may also make rights offerings to our stockholders at prices per share less than the net asset value per share, subject to applicable requirements of the 1940 Act.

**Code of Ethics**

We adopted and maintain a code of ethics pursuant to Rule 17j-1 under the 1940 Act that establishes procedures for personal investments and restricts certain personal securities transactions. Personnel subject to the code may invest in securities for their personal investment accounts, including securities that may be purchased or held by us, so long as such investments are made in accordance with the code's requirements. A copy of the code of ethics is available on the Corporate Governance section of the Company's website at *http://www.kcapinc.com*. Our code of ethics may also be reviewed and copied at the Public Reference Room of the SEC at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Copies of the code of ethics may be obtained, after paying a duplicating fee, by electronic request at the following e-mail address: publicinfo@sec.gov, or by writing the SEC's Public Reference Section, Washington, D.C. 20549-0102. In addition, our code of ethics is available on the SEC's website at *http://www.sec.gov*.

**Privacy Principles**

We are committed to maintaining the privacy of our stockholders and safeguarding their non-public personal information. The following information is provided to help you understand what personal information we collect, how we protect that information and why, in certain cases, we may share information with select other parties.

Generally, we do not receive any non-public personal information relating to our stockholders, although some non-public personal information of our stockholders may become available to us. We do not disclose any non-public personal information about our stockholders or former stockholders to anyone, except as is necessary to service stockholder accounts, such as to a transfer agent, or as otherwise permitted by law.

We restrict access to non-public personal information about our stockholders to our employees with a legitimate business need for the information. We maintain physical, electronic and procedural safeguards designed to protect the non-public personal information of our stockholders.

**Proxy Voting Policy and Procedures**

Although most of the securities we hold are not voting securities, some of our investments may entitle us to vote proxies. We vote proxies relating to our portfolio securities in the best interest of our stockholders. We review on a case-by-case basis each proposal submitted to a stockholder vote to determine its impact on the portfolio securities held by us. Although we generally vote against proposals that we believe may have a negative impact on our portfolio securities, we may vote for such a proposal if we believe there exists a compelling long-term reason to do so.

Our proxy voting decisions are made by our Investment Committee, which is responsible for monitoring each of our investments. To ensure that our vote is not the product of a conflict of interest, we require that (1) anyone involved in the decision making process disclose to our Chief Compliance Officer any potential conflict that he or she is aware of and any contact that he or she has had with any interested party regarding a proxy vote; and (2) employees involved in the decision making process or vote administration are prohibited from revealing how we intend to vote on a proposal to reduce any attempted influence from interested parties.

**Other**

We may be prohibited under the 1940 Act from conducting certain transactions with our affiliates without the prior approval of our directors who are not interested persons and, in some cases, the prior approval of the SEC.

We will be periodically examined by the SEC for compliance with the 1940 Act.

We are required to provide and maintain a bond issued by a reputable fidelity insurance company to protect us against larceny and embezzlement. Furthermore, as a BDC, we are prohibited from indemnifying any director or officer against any liability to our stockholders arising from willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person's office.

We are required to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws and to review these policies and procedures annually for their adequacy and the effectiveness of their implementation. We have a designated Chief Compliance Officer who is responsible for administering these policies and procedures.

## MATERIAL UNITED STATES FEDERAL INCOME TAX CONSIDERATIONS

The following discussion is a general summary of the material United States federal income tax considerations (and, in the case of a non-U.S. holder (as defined below), the material United States federal estate tax consequences) applicable to an investment in the Notes. This summary does not purport to be a complete description of the income and estate tax considerations applicable to such an investment. The discussion is based upon the Internal Revenue Code of 1986, as amended (the "Code"), Treasury Regulations, and administrative and judicial interpretations, each as of the date of this prospectus and all of which are subject to change, potentially with retroactive effect. You should consult your own tax advisor with respect to tax considerations that pertain to your purchase of our Notes.

This discussion deals only with Notes held as capital assets within the meaning of Section 1221 of the Code and does not purport to deal with persons in special tax situations, such as financial institutions, insurance companies, controlled foreign corporations, passive foreign investment companies and regulated investment companies (and shareholders of such corporations), dealers in securities or currencies, traders in securities, former citizens of the United States, persons holding the Notes as a hedge against currency risks or as a position in a "straddle," "hedge," "constructive sale transaction" or "conversion transaction" for tax purposes, entities that are tax-exempt for United States federal income tax purposes, retirement plans, individual retirement accounts, tax-deferred accounts, persons subject to the alternative minimum tax, pass-through entities (including partnerships and entities and arrangements classified as partnerships for United States federal income tax purposes) and beneficial owners of pass-through entities, or persons whose functional currency is not the U.S. dollar. It also does not deal with beneficial owners of the Notes other than original purchasers of the Notes who acquire the Notes in this offering for a price equal to their original issue price (*i.e.*, the first price at which a substantial amount of the notes is sold other than to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers). If you are considering purchasing the Notes, you should consult your own tax advisor concerning the application of the United States federal tax laws to you in light of your particular situation, as well as any consequences to you of purchasing, owning and disposing of the Notes under the laws of any other taxing jurisdiction.

For purposes of this discussion, the term "U.S. holder" means a beneficial owner of a Note that is, for United States federal income tax purposes, (i) an individual citizen or resident of the United States, (ii) a corporation or other entity treated as a corporation for United States federal income tax purposes, created or organized in or under the laws of the United States or of any political subdivision thereof, (iii) a trust (a) subject to the control of one or more United States persons and the primary supervision of a court in the United States, or (b) that existed on August 20, 1996 and has made a valid election (under applicable Treasury Regulations) to be treated as a domestic trust, or (iv) an estate the income of which is subject to United States federal income taxation regardless of its source. The term "non-U.S. holder" means a beneficial owner of a Note that is neither a U.S. holder nor a partnership (including an entity or arrangement treated as a partnership for U.S. federal income tax purposes). An individual may, subject to exceptions, be deemed to be a resident alien, as opposed to a non-resident alien, by, among other ways, being present in the United States (i) on at least 31 days in the calendar year, and (ii) for an aggregate of at least 183 days during a three-year period ending in the current calendar year, counting for such purposes all of the days present in the current year, one-third of the days present in the immediately preceding year, and one-sixth of the days present in the second preceding year. Resident aliens are subject to United States federal income tax as if they were United States citizens.

If a partnership (including an entity or arrangement treated as a partnership for U.S. federal income tax purposes) holds any Notes, the United States federal income tax treatment of a partner of the partnership generally will depend upon the status of the partner, the activities of the partnership and certain determinations made at the partner level. Partners of partnerships holding Notes should consult their own tax advisors.

### Taxation of Note Holders

Under present law, we are of the opinion that the Notes will constitute indebtedness of us for United States federal income tax purposes, which the below discussion assumes. We intend to treat all payments made with respect to the Notes consistent with this characterization.

Payments or accruals of interest on a Note generally will be taxable to a U.S. holder as ordinary interest income at the time they are received (actually or constructively) or accrued, in accordance with the U.S. holder's regular method of tax accounting.

Upon the sale, exchange, redemption, retirement or other taxable disposition of a Note, a U.S. holder generally will recognize capital gain or loss equal to the difference between the amount realized on the sale, exchange, redemption, retirement or other taxable disposition (excluding amounts representing accrued and unpaid interest, which are treated as ordinary income) and the U.S. holder's adjusted tax basis in the Note. A U.S. holder's adjusted tax basis in a Note generally will equal the U.S. holder's initial investment in the Note. Capital gain or loss generally will be long-term capital gain or loss if the Note was held for more than one year. Long-term capital gains recognized by individuals and certain other non-corporate U.S. holders generally are eligible for reduced rates of taxation. The distinction between capital gain or loss and ordinary income or loss is also important in other contexts; for example, for purposes of the limitations on a U.S. holder's ability to offset capital losses against ordinary income.

Newly enacted legislation may require certain noncorporate U.S. holders to pay a 3.8% Medicare tax on, among other things, interest on and capital gains from the sale, exchange, redemption or retirement of the Notes. This legislation would apply for taxable years beginning after December 31, 2012. U.S. holders should consult their own tax advisors regarding the effect, if any, of this legislation on their ownership and disposition of the Notes.

***Taxation of Non-U.S. Holders***. A non-U.S. holder generally will not be subject to United States federal income or withholding taxes on payments of principal or interest on a Note provided that (i) income on the Note is not effectively connected with the conduct by the non-U.S. holder of a trade or business within the United States, (ii) the non-U.S. holder is not a controlled foreign corporation related to the Company through stock ownership, (iii) in the case of interest income, the recipient is not a bank receiving interest described in Section 881(c)(3)(A) of the Code, (iv) the non-U.S. holder does not own (actually or constructively) 10% or more of the total combined voting power of all classes of stock of the Company, and (v) the non-U.S. holder provides a statement in the year in which a payment occurs or in the preceding 3 years, on an Internal Revenue Service (IRS) Form W-8BEN (or other applicable form) signed under penalties of perjury that includes its name and address and certifies that the non-U.S. holder is the beneficial owner and is not a United States person in compliance with applicable requirements, or satisfies documentary evidence requirements for establishing that it is a non-U.S. holder.

A non-U.S. holder that is not exempt from tax under these rules generally will be subject to United States federal income tax withholding on payments of interest on the Notes at a rate of 30% unless (i) the income is effectively connected with the conduct of a United States trade or business, so long as the non-U.S. holder has provided an IRS Form W-8ECI or substantially similar substitute form stating that the interest on the Notes is effectively connected with the non-U.S. holder's conduct of a trade or business in the U.S. in which case the interest will be subject to United States federal income tax on a net income basis as applicable to U.S. holders generally (unless an applicable income tax treaty provides otherwise), or (ii) an applicable income tax treaty provides for a lower rate of, or exemption from, withholding tax.

In the case of a non-U.S. holder that is a corporation and that receives income that is effectively connected with the conduct of a United States trade or business, such income may also be subject to a branch profits tax (which is generally imposed on a non-U.S. corporation on the actual or deemed repatriation from the United States of earnings and profits attributable to a United States trade or business) at a 30% rate. The branch profits tax may not apply (or may apply at a reduced rate) if the non-U.S. holder is a qualified resident of a country with which the United States has an income tax treaty.

To claim the benefit of an income tax treaty or to claim exemption from withholding because income is effectively connected with a United States trade or business, the non-U.S. holder must timely provide the appropriate, properly executed IRS forms. The non-U.S. holder must inform the recipient of any changes on these forms within 30 days of such change. These forms may be required to be periodically updated. Also, a non-U.S. holder who is claiming the benefits of a treaty may be required to obtain a United States taxpayer identification number and to provide certain documentary evidence issued by foreign governmental authorities to prove residence in the foreign country.

Generally, a non-U.S. holder will not be subject to United States federal income or withholding taxes on any amount that constitutes capital gain upon the sale, exchange, redemption, retirement or other taxable disposition of a Note, provided that (i) the gain is not effectively connected with the conduct of a trade or business in the United States by the non-U.S. holder (and, if required by an applicable income tax treaty, is not attributable to a United States "permanent establishment" maintained by the non-U.S. holder) and (ii) that the non-U.S. holder is not an individual who is present in the U.S. for 183 days or more in the taxable year of the sale, exchange, or other taxable disposition and meets certain other conditions (unless such holder is eligible for relief under an applicable income tax treaty). Certain other exceptions may be applicable, and a non-U.S. holder should consult its tax advisor in this regard.

A Note that is held by an individual who, at the time of death, is not a citizen or resident of the United States (as specially defined for United States federal estate tax purposes) generally will not be subject to the United States federal estate tax, unless, at the time of death, (i) such individual directly or indirectly, actually or constructively, owns ten percent or more of the total combined voting power of all classes of our stock entitled to vote within the meaning of Section 871(h)(3) of the Code and the Treasury Regulations thereunder or (ii) such individual's interest in the Notes is effectively connected with the individual's conduct of a United States trade or business.

***Information Reporting and Backup Withholding***. A U.S. holder (other than an "exempt recipient," including a corporation and certain other persons who, when required, demonstrate their exempt status) may be subject to backup withholding at a rate of 28% (which rate currently is scheduled to increase to 31% for taxable years beginning on or after January 1, 2013) on, and to information reporting requirements with respect to, payments of principal and interest on, and proceeds from the sale, exchange, redemption or retirement of, the Notes. In general, if a non-corporate U.S. holder subject to information reporting fails to furnish a correct taxpayer identification number or otherwise fails to comply with applicable backup withholding requirements, backup withholding at the applicable rate may apply.

The amount of interest we pay to a non-U.S. holder on notes will be reported to such non-U.S. Holder and to the IRS annually on an IRS Form 1042-S even if the non-U.S. holder is exempt from the 30% withholding tax described above. Copies of the information returns reporting those payments and the amounts withheld may also be made available to the tax authorities in the country where the non-U.S. holder is resident under provisions of an applicable income tax treaty or agreement.

In addition, backup withholding tax and certain other information reporting requirements apply to payments of principal and interest on, and proceeds from the sale, exchange, redemption or retirement of, the Notes, unless an exemption applies. Backup withholding and information reporting will not apply to payments we make to a non-U.S. holder if such non-U.S. holder has provided to the applicable withholding agent under penalties of perjury the required certification of their non-U.S. person status as discussed above (and the applicable withholding agent does not have actual knowledge or reason to know that they are a U.S. person) or if the non-U.S. holder is an exempt recipient.

If a non-U.S. holder sells or redeems a note through a U.S. broker or the U.S. office of a foreign broker, the proceeds from such sale or redemption will be subject to information reporting and backup withholding unless such non-U.S. holder provides a withholding certificate or other appropriate documentary evidence establishing that such non-U.S. holder is not a United States person to the broker and such broker does not have actual knowledge or reason to know that such non-U.S. holder is a United States person, or the non-U.S. holder is an exempt recipient eligible for an exemption from information reporting and backup withholding. If a non-U.S. holder sells or redeems a note through the foreign office of a broker who is a United States person or has certain enumerated connections with the U.S., the proceeds from such sale or redemption will be subject to information reporting unless the non-U.S. holder provides to such broker a withholding certificate or other documentary evidence establishing that the non-U.S. holder is not a United States person and such broker does not have actual knowledge or reason to know that such evidence is false, or the non-U.S. holder is an exempt recipient eligible for an exemption from information reporting. In circumstances where information reporting by the foreign office of such a broker is required, backup withholding will be required only if the broker has actual knowledge that the non-U.S. holder is a United States person.

You should consult your tax advisor regarding the qualification for an exemption from backup withholding and information reporting and the procedures for obtaining such an exemption, if applicable. Any amounts withheld under the backup withholding rules from a payment to a beneficial owner generally would be allowed as a refund or a credit against such beneficial owner's United States federal income tax provided the required information is timely furnished to the IRS.

**Foreign Account Tax Compliance Act**

Legislation enacted in 2010 imposes a withholding tax of 30% on payments of interest or gross proceeds from the disposition of a debt instrument paid after December 31, 2012 to certain non-U.S. entities, including certain non-U.S. financial institutions and investment funds, unless such non-U.S. entity complies with certain reporting requirements regarding its United States account holders and its United States owners. The date for implementation of these rules generally was extended by the IRS to January 1, 2014 for payments of fixed and determinable annual or periodic (FDAP) income, including interest, and to January 1, 2015 for other "withholdable payments," including payments of gross proceeds. After these dates, payments of interest on, or gross proceeds from the sale or redemption of, the notes made to a non-U.S. entity generally will be subject to the new information reporting regime; however, the new withholding obligations will only apply to obligations issued after March 18, 2012, and proposed Treasury regulations would extend this grandfathering provision to obligations that are outstanding on January 1, 2013. Congress delegated broad authority to the U.S. Treasury Department to promulgate regulations to implement the new withholding and reporting regime. It cannot be predicted whether or how these proposed Treasury regulations (if finalized) or any regulations promulgated by the U.S. Treasury Department pursuant to this broad delegation of regulatory authority will affect holders of the notes. Prospective purchasers of the notes should consult their own tax advisors regarding the new withholding and reporting provisions.

***You should consult your own tax advisor with respect to the particular tax consequences to you of an investment in the Notes, including the possible effect of any pending legislation or proposed regulations.***

**Our Taxation as a Regulated Investment Company**

As a regulated investment company ("RIC"), we generally will not have to pay corporate-level federal income taxes on any net ordinary income or realized capital gains that we distribute to our stockholders as dividends. To qualify as a RIC, we must, among other things, meet certain source-of-income and asset diversification requirements (as described below). In addition, in order to maintain our qualification as a RIC, we must distribute to our stockholders, for each taxable year, at least 90% of our "investment company taxable income," which is generally our net ordinary income plus the excess of realized net short-term capital gains over realized net long-term capital losses (the "Annual Distribution Requirement").

***Taxation as a Regulated Investment Company***

If we:

- qualify as a RIC; and
- satisfy the Annual Distribution Requirement,

then we will not be subject to U.S. federal income tax on the portion of our income we distribute (or are deemed to distribute) to stockholders. We will be subject to U.S. federal income tax at the regular corporate rates on any income or capital gains not distributed (or deemed distributed) to our stockholders.

We will be subject to a 4% nondeductible U.S. federal excise tax on certain undistributed income unless we distribute in a timely manner an amount at least equal to the sum of (1) 98% of our net ordinary income for each calendar year, (2) 98.2% of our capital gain net income for the one-year period ending October 31 in that calendar year and (3) any income recognized, but not distributed, in preceding years (the "Excise Tax Avoidance Requirement"). We generally will endeavor in each taxable year to make sufficient distributions to our stockholders to avoid the 4% excise tax on our income. However, 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 the 4% excise tax on such income. Any such carryover taxable income must be distributed through a dividend declared prior to filing the final tax return related to the year which generated such taxable income. We may, in the future, make actual distributions to our stockholders of our net capital gains.

In order to qualify as a RIC for U.S. federal income tax purposes, we must, among other things:

- continue to qualify as a business development company under the 1940 Act at all times during each taxable year;
- derive in each taxable year at least 90% of our gross income from dividends, interest, payments with respect to loans of certain securities, gains from the sale of stock or other securities, net income from certain "qualified publicly traded partnerships," or other income derived with respect to our business of investing in such stock or securities (the "90% Income Test"); and
- diversify our holdings so that at the end of each quarter of the taxable year:
  - at least 50% of the value of our assets consists of cash, cash equivalents, U.S. Government securities, securities of other RICs, and other securities if such other securities of any one issuer do not represent more than 5% of the value of our assets or more than 10% of the outstanding voting securities of the issuer; and
  - no more than 25% of the value of our assets is invested in the securities, other than U.S. government securities or securities of other RICs, of one issuer, of two or more issuers that are controlled, as determined under applicable Code rules, by us and that are engaged in the same or similar or related trades or businesses or of certain "qualified publicly traded partnerships" (the "Diversification Tests").

We may be required to recognize taxable income in circumstances in which we do not receive cash. For example, if we hold debt obligations that are treated under applicable tax rules as having original issue discount (such as debt instruments with PIK interest or, in certain cases, increasing interest rates or issued with warrants), we must include in income each year a portion of the original issue discount that accrues over the life of the obligation, regardless of whether cash representing such income is received by us in the same taxable year. We may also have to include in income other amounts that we have not yet received in cash, such as PIK interest and deferred loan origination fees that are paid after origination of the loan or are paid in non-cash compensation such as warrants or stock. Because any original issue discount or other amounts accrued will be included in our net ordinary income for the year of accrual, we may be required to make a distribution to our stockholders in order to satisfy the Annual Distribution Requirement, even though we will not have received any corresponding cash amount.

Although we do not presently expect to do so, we are authorized to borrow funds, to sell assets and to make taxable distributions of our stock and debt securities in order to satisfy distribution requirements. Our ability to dispose of assets to meet our distribution requirements may be limited by (1) the illiquid nature of our portfolio and/or (2) other requirements relating to our status as a RIC, including the Diversification Tests. If we dispose of assets in order to meet the Annual Distribution Requirement or the Excise Tax Avoidance Requirement, we may make such dispositions at times that, from an investment standpoint, are not advantageous. If we are unable to obtain cash from other sources to satisfy the Annual Distribution Requirement, we may fail to qualify as a RIC and become subject to tax as an ordinary corporation.

Under the 1940 Act, we are not permitted to make distributions to our stockholders while our debt obligations and other senior securities are outstanding unless certain "asset coverage" tests are met. If we are prohibited to make distributions, we may fail to qualify as a RIC and become subject to tax as an ordinary corporation.

Certain of our investment practices may be subject to special and complex U.S. federal income tax provisions that may, among other things: (i) disallow, suspend or otherwise limit the allowance of certain losses or deductions; (ii) convert lower taxed long-term capital gain into higher taxed short-term capital gain or ordinary income; (iii) convert an ordinary loss or a deduction into a capital loss (the deductibility of which is more limited); (iv) cause us to recognize income or gain without a corresponding receipt of cash; (v) adversely affect the time as to when a purchase or sale of securities is deemed to occur; (vi) adversely alter the characterization of certain complex financial transactions; and (vii) produce income that will not be qualifying income for purposes of the 90% Income Test described above. We will monitor our transactions and may make certain tax decisions in order to mitigate the potential adverse effect of these provisions.

If we fail to satisfy the Annual Distribution Requirement or otherwise fail to qualify as a RIC in any taxable year, we will be subject to tax in that year on all of our taxable income, regardless of whether we

make any distributions to our stockholders. If we fail to maintain RIC tax treatment for any reason and are subject to corporate income tax, the resulting corporate taxes could substantially reduce our net assets and the amount of income available to make interest and principal payments on the Notes. In contrast, assuming we qualify as a RIC, our corporate-level federal income tax should be substantially reduced or eliminated.

## DESCRIPTION OF THE NOTES

The Notes will be issued under an indenture and the first supplemental indenture thereto, each dated as of , 2012, between us and U.S. Bank National Association, as trustee. We refer to the indenture, as well as any supplements thereto, as the indenture and to U.S. Bank National Association as the trustee. The Notes are governed by the indenture, as required by federal law for all bonds and notes of companies that are publicly offered. An indenture is a contract between us and the financial institution acting as trustee on your behalf, and is subject to and governed by the Trust Indenture Act of 1939, as amended. The trustee has two main roles. First, the trustee can enforce your rights against us if we default. There are some limitations on the extent to which the trustee acts on your behalf, described in the second paragraph under " — Events of Default — Remedies if an Event of Default Occurs." Second, the trustee performs certain administrative duties for us with respect to our Notes.

Because this section is a summary, it does not describe every aspect of the Notes and the indenture. We urge you to read the indenture because it, and not this description, defines your rights as a holder of the Notes. The indenture has been attached as an exhibit to the registration statement of which this prospectus is a part and filed with the SEC. See "Available Information" for information on how to obtain a copy of the indenture.

We are permitted, under specified conditions, to issue multiple classes of indebtedness if our asset coverage, as defined in the 1940 Act, is at least equal to 200% immediately after each such issuance. In addition, while any indebtedness and senior securities remain outstanding, we must make provisions to prohibit the distribution to our stockholders or the repurchase of such securities or shares unless we meet the applicable asset coverage ratios at the time of the distribution or repurchase. We may also borrow amounts up to 5% of the value of our total assets for temporary purposes without regard to asset coverage.

### General

The Notes will mature on September 30, 2019. The principal payable at maturity will be 100% of the aggregate principal amount. The interest rate of the Notes is % per year and will be paid every March 30, June 30, September 30, and December 30, beginning December 30, 2012, and the regular record dates for interest payments will be every March 15, June 15, September 15 and December 15, commencing December 15, 2012. If an interest payment date falls on a non-business day, the applicable interest payment will be made on the next business day and no additional interest will accrue as a result of such delayed payment. The initial interest period will be the period from and including , 2012, to, but excluding, the initial interest payment date, and the subsequent interest periods will be the periods from and including an interest payment date to, but excluding, the next interest payment date or the stated maturity date, as the case may be.

We will issue the Notes in denominations of $25 and integral multiples of $25 in excess thereof. The Notes will not be subject to any sinking fund and holders of the Notes will not have the option to have the Notes repaid prior to the stated maturity date.

The indenture does not contain any provisions that give you protection in the event we issue a large amount of debt or we are acquired by another entity.

We have the ability to issue indenture securities with terms different from the Notes and, without the consent of the holders thereof, to reopen the Notes and issue additional Notes.

### Optional Redemption

The Notes may be redeemed in whole or in part at any time or from time to time at our option on or after September 30, 2015 upon not less than 30 days nor more than 60 days written notice by mail prior to the date fixed for redemption thereof, at a redemption price of 100% of the outstanding principal amount of the Notes to be redeemed plus accrued and unpaid interest payments otherwise payable thereon for the then-current quarterly interest period accrued to the date fixed for redemption.

You may be prevented from exchanging or transferring the Notes when they are subject to redemption. In case any Notes are to be redeemed in part only, the redemption notice will provide that, upon surrender of such Note, you will receive, without a charge, a new Note or Notes of authorized denominations representing

the principal amount of your remaining unredeemed Notes. Any exercise of our option to redeem the Notes will be done in compliance with the 1940 Act.

If we redeem only some of the Notes, the trustee will determine the method for selection of the particular Notes to be redeemed, in accordance with the 1940 Act and in accordance with the rules of any national securities exchange or quotation system on which the Notes are listed. Unless we default in payment of the redemption price, on and after the date of redemption, interest will cease to accrue on the Notes called for redemption.

**Global Securities**

Each Note will be issued in book-entry form and represented by a global security that we deposit with and register in the name of The Depository Trust Company, New York, New York, known as DTC, or its nominee. A global security may not be transferred to or registered in the name of anyone other than the depositary or its nominee, unless special termination situations arise. As a result of these arrangements, the depositary, or its nominee, will be the sole registered owner and holder of all the Notes represented by a global security, and investors will be permitted to own only beneficial interests in a global security. For more information about these arrangements, see "— Book-Entry Procedures" below.

*Termination of a Global Security*

If a global security is terminated for any reason, interests in it will be exchanged for certificates in non-book-entry form (certificated securities). After that exchange, the choice of whether to hold the certificated Notes directly or in street name will be up to the investor. Investors must consult their own banks or brokers to find out how to have their interests in a global security transferred on termination to their own names, so that they will be holders.

**Payment and Paying Agents**

We will pay interest to the person listed in the trustee's records as the owner of the Notes at the close of business on a particular day in advance of each due date for interest, even if that person no longer owns the Note on the interest due date. That day, usually about two weeks in advance of the interest due date, is called the "record date." Because we will pay all the interest for an interest period to the holders on the record date, holders buying and selling the Notes must work out between themselves the appropriate purchase price. The most common manner is to adjust the sales price of the Notes to prorate interest fairly between buyer and seller based on their respective ownership periods within the particular interest period. This prorated interest amount is called "accrued interest."

*Payments on Global Securities*

We will make payments on the Notes so long as they are represented by a global security in accordance with the applicable policies of the depositary as in effect from time to time. Under those policies, we will make payments directly to the depositary, or its nominee, and not to any indirect holders who own beneficial interests in the global security. An indirect holder's right to those payments will be governed by the rules and practices of the depositary and its participants, as described under "— Book-Entry Procedures."

*Payments on Certificated Securities*

In the event the Notes become represented by certificated securities, we will make payments on the Notes as follows. We will pay interest that is due on an interest payment date to the holder of the Notes as shown on the trustee's records as of the close of business on the regular record date at our office in New York, New York. We will make all payments of principal and premium, if any, by check at the office of the applicable trustee in New York, New York and/or at other offices that may be specified in a notice to holders against surrender of the Note.

Alternatively, at our option, we may pay any cash interest that becomes due on the Notes by mailing a check to the holder at his, her or its address shown on the trustee's records as of the close of business on the regular record date or by transfer to an account at a bank in the United States, in either case, on the due date.

*Payment When Offices Are Closed*

If any payment is due on the Notes on a day that is not a business day, we will make the payment on the next day that is a business day. Payments made on the next business day in this situation will be treated under

the indenture as if they were made on the original due date. Such payment will not result in a default under the Notes or the indenture, and no interest will accrue on the payment amount from the original due date to the next day that is a business day.

**Book-entry and other indirect holders should consult their banks or brokers for information on how they will receive payments on the Notes.**

**Events of Default**

You will have rights if an Event of Default occurs in respect of the Notes and is not cured, as described later in this subsection.

The term "Event of Default" in respect of the Notes means any of the following:

- we do not pay the principal of any Note on its due date;
- we do not pay interest on any Note within 30 days of its due date;
- we remain in breach of a covenant in respect of the Notes for 60 days after we receive a written notice of default stating we are in breach (the notice must be sent by either the trustee or holders of at least 25% of the principal amount of the Notes);
- the default by us with respect to any mortgage, agreement or other instrument under which there may be outstanding, or by which there may be secured or evidenced, any indebtedness for money borrowed in excess of $10 million in the aggregate (i) resulting in such indebtedness becoming or being declared due and payable or (ii) constituting a failure to pay the principal or interest of any such debt when due and payable at its stated maturity, upon required repurchase, upon declaration of acceleration or otherwise, unless such default is not cured within 30 days;
- a final judgment for the payment of $15 million or more (excluding any amounts covered by insurance) rendered against us, which judgment is not discharged or stayed within 60 days after (i) the date on which the right to appeal thereof has expired if no such appeal has commenced, or (ii) the date on which all rights to appeal have been extinguished;
- we file for bankruptcy or certain other events of bankruptcy, insolvency or reorganization occur and remain undischarged or unstayed for a period of 90 days; or
- the Notes have an asset coverage of less than 100% on the last business day of each of twenty-four consecutive calendar months.

An Event of Default for the Notes does not necessarily constitute an Event of Default for any other series of debt securities issued under the same or any other indenture. The trustee may withhold notice to the holders of the Notes of any default, except in the payment of principal or interest, if it in good faith considers the withholding of notice to be in the best interests of the holders.

*Remedies if an Event of Default Occurs*

If an Event of Default has occurred and is continuing, the trustee or the holders of not less than 25% in principal amount of the Notes may declare the entire principal amount of all the Notes to be due and immediately payable. If an Event of Default referred to in the second to last bullet point above with respect to us has occurred, the entire principal amount of all the Notes will automatically become due and immediately payable. This is called a declaration of acceleration of maturity. In certain circumstances, a declaration of acceleration of maturity may be canceled by the holders of a majority in principal amount of the Notes if (1) we have deposited with the trustee all amounts due and owing with respect to the Notes (other than principal that has become due solely by reason of such acceleration) and certain other amounts, and (2) any other Events of Default have been cured or waived.

Except in cases of default, where the trustee has some special duties, the trustee is not required to take any action under the indenture at the request of any holders unless the holders offer the trustee reasonable protection from expenses and liability (called an "indemnity"). If reasonable indemnity is provided, the holders of a majority in principal amount of the Notes may direct the time, method and place of conducting any lawsuit or other formal legal action seeking any remedy available to the trustee. The trustee may refuse to

follow those directions in certain circumstances. No delay or omission in exercising any right or remedy will be treated as a waiver of that right, remedy or Event of Default.

Before you are allowed to bypass the trustee and bring your own lawsuit or other formal legal action or take other steps to enforce your rights or protect your interests relating to the Notes, the following must occur:

- you must give the trustee written notice that an Event of Default has occurred and remains uncured;
- the holders of at least 25% in principal amount of all the Notes must make a written request that the trustee take action because of the default and must offer reasonable indemnity to the trustee against the cost and other liabilities of taking that action;
- the trustee must not have taken action for 60 days after receipt of the above notice and offer of indemnity; and
- the holders of a majority in principal amount of the Notes must not have given the trustee a direction inconsistent with the above notice during that 60-day period.

However, you are entitled at any time to bring a lawsuit for the payment of money due on your Notes on or after the due date.

**Book-entry and other indirect holders should consult their banks or brokers for information on how to give notice or direction to or make a request of the trustee and how to declare or cancel an acceleration of maturity.**

Each year, we will furnish to the trustee a written statement of certain of our officers certifying that to their knowledge we are in compliance with the indenture and the Notes, or else specifying any default.

*Waiver of Default*

The holders of a majority in principal amount of the Notes may waive may waive any past defaults other than other than:

- the payment of principal or interest; or
- in respect of a covenant that cannot be modified or amended without the consent of each holder.

**Merger or Consolidation**

Under the terms of the indenture, we are generally permitted to consolidate or merge with another entity. We are also permitted to sell all or substantially all of our assets to another entity. However, we may not take any of these actions unless all the following conditions are met:

- where we merge out of existence or convey or transfer our assets substantially as an entirety, the resulting entity must agree to be legally responsible for our obligations under the Notes;
- the merger or sale of assets must not cause a default on the Notes and we must not already be in default (unless the merger or sale would cure the default). For purposes of this no-default test, a default would include an Event of Default that has occurred and has not been cured, as described under “Events of Default” above. A default for this purpose would also include any event that would be an Event of Default if the requirements for giving us a notice of default or our default having to exist for a specific period of time were disregarded; and
- we must deliver certain certificates and documents to the trustee.

**Modification or Waiver**

There are three types of changes we can make to the indenture and the Notes issued thereunder.

*Changes Requiring Your Approval*

First, there are changes that we cannot make to your Notes without your specific approval. The following is a list of those types of changes:

- change the stated maturity of the principal of or interest on the Notes;

- reduce any amounts due on the Notes;
- reduce the amount of principal payable upon acceleration of the maturity of a Note following a default;
- change the place or currency of payment on a Note;
- impair your right to sue for payment;
- reduce the percentage of holders of Notes whose consent is needed to modify or amend the indenture; and
- reduce the percentage of holders of Notes whose consent is needed to waive compliance with certain provisions of the indenture or to waive certain defaults.

*Changes Not Requiring Approval*

The second type of change does not require any vote by the holders of the Notes. This type is limited to clarifications and certain other changes that would not adversely affect holders of the Notes in any material respect.

*Changes Requiring Majority Approval*

Any other change to the indenture and the Notes would require the following approval:

- if the change affects only the Notes, it must be approved by the holders of a majority in principal amount of the Notes; and
- if the change affects more than one series of debt securities issued under the same indenture, it must be approved by the holders of a majority in principal amount of all of the series affected by the change, with all affected series voting together as one class for this purpose.

In each case, the required approval must be given by written consent.

The holders of a majority in principal amount of all of the series of debt securities issued under an indenture, voting together as one class for this purpose, may waive our compliance with some of our covenants in that indenture. However, we cannot obtain a waiver of a payment default or of any of the matters covered by the bullet points included above under " — Changes Requiring Your Approval."

*Further Details Concerning Voting*

When taking a vote, we will use the following rules to decide how much principal to attribute to the Notes:

The Notes will not be considered outstanding, and therefore not eligible to vote, if we have deposited or set aside in trust money for their payment or redemption. The Notes will also not be eligible to vote if they have been fully defeased as described later under " — Defeasance — Full Defeasance."

We will generally be entitled to set any day as a record date for the purpose of determining the holders of the Notes that are entitled to vote or take other action under the indenture. However, the record date may not be more than 30 days before the date of the first solicitation of holders to vote on or take such action. If we set a record date for a vote or other action to be taken by holders of the Notes, that vote or action may be taken only by persons who are holders of the Notes on the record date and must be taken within eleven months following the record date.

**Book-entry and other indirect holders should consult their banks or brokers for information on how approval may be granted or denied if we seek to change the indenture or the Notes or request a waiver.**

**Defeasance**

The following provisions will be applicable to the Notes.

*Covenant Defeasance*

Under current U.S. federal tax law and the indenture, we can make the deposit described below and be released from some of the restrictive covenants in the indenture under which the Notes were issued. This is called "covenant defeasance." In that event, you would lose the protection of those restrictive covenants but

would gain the protection of having money and government securities set aside in trust to repay your Notes. In order to achieve covenant defeasance, we must do the following:

- Since the Notes are denominated in U.S. dollars, we must deposit in trust for the benefit of all holders of the Notes a combination of cash and U.S. government or U.S. government agency notes or bonds that will generate enough cash to make interest, principal and any other payments on the Notes on their various due dates;
- we must deliver to the trustee a legal opinion of our counsel confirming that, under current U.S. federal income tax law, we may make the above deposit without causing you to be taxed on the Notes any differently than if we did not make the deposit;
- we must deliver to the trustee a legal opinion of our counsel stating that the above deposit does not require registration by us under the 1940 Act, and a legal opinion and officers' certificate stating that all conditions precedent to covenant defeasance have been complied with;
- defeasance must not result in a breach or violation of, or result in a default under, of the indenture or any of our other material agreements or instruments; and
- no default or event of default with respect to the Notes shall have occurred and be continuing and no defaults or events of default related to bankruptcy, insolvency or reorganization shall occur during the next 90 days.

If we accomplish covenant defeasance, you can still look to us for repayment of the Notes if there were a shortfall in the trust deposit or the trustee is prevented from making payment. In fact, if one of the remaining Events of Default occurred (such as our bankruptcy) and the Notes became immediately due and payable, there might be a shortfall. Depending on the event causing the default, you may not be able to obtain payment of the shortfall.

*Full Defeasance*

If there is a change in U.S. federal tax law, as described below, we can legally release ourselves from all payment and other obligations on the Notes (called "full defeasance") if we put in place the following other arrangements for you to be repaid:

- Since the Notes are denominated in U.S. dollars, we must deposit in trust for the benefit of all holders of the Notes a combination of money and U.S. government or U.S. government agency notes or bonds that will generate enough cash to make interest, principal and any other payments on the Notes on their various due dates;
- we must deliver to the trustee a legal opinion confirming that there has been a change in current U.S. federal tax law or an IRS ruling that allows us to make the above deposit without causing you to be taxed on the Notes any differently than if we did not make the deposit. Under current U.S. federal tax law the deposit and our legal release from the Notes would be treated as though we paid you your share of the cash and notes or bonds at the time the cash and notes or bonds were deposited in trust in exchange for your Notes and you would recognize gain or loss on the Notes at the time of the deposit;
- we must deliver to the trustee a legal opinion of our counsel stating that the above deposit does not require registration by us under the 1940 Act, and a legal opinion and officers' certificate stating that all conditions precedent to defeasance have been complied with;
- defeasance must not result in a breach or violation of, or constitute a default under, of the indenture or any of our other material agreements or instruments; and
- no default or event of default with respect to the Notes shall have occurred and be continuing and no defaults or events of default related to bankruptcy, insolvency or reorganization shall occur during the next 90 days.

If we ever did accomplish full defeasance, as described above, you would have to rely solely on the trust deposit for repayment of the Notes. You could not look to us for repayment in the unlikely event of any

shortfall. Conversely, the trust deposit would most likely be protected from claims of our lenders and other creditors if we ever became bankrupt or insolvent.

**Other Covenants**

In addition to any other covenants described in this prospectus, the following covenants shall apply to the Notes:

- We agree that for the period of time during which the Notes are outstanding, we will not violate (regardless of whether we are subject to) Section 18(a)(1)(A) as modified by Section 61(a)(1) of the 1940 Act or any successor provisions. These provisions generally prohibit us from making additional borrowings, including through the issuance of additional debt securities, unless our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowings.
- We agree that for the period of time during which the Notes are outstanding, we will not violate (regardless of whether we are subject to) Section 18(a)(1)(B) as modified by Section 61(a)(1) of the 1940 Act or any successor provisions. These provisions generally prohibit us from declaring any cash dividend or distribution upon any class of our capital stock, or purchasing any such capital stock if our asset coverage, as defined in the 1940 Act, is below 200% at the time of the declaration of the dividend or distribution or the purchase and after deducting the amount of such dividend, distribution or purchase.
- If, at any time, we are not subject to the reporting requirements of Sections 13 or 15(d) of the Exchange Act to file any periodic reports with the SEC, we agree to furnish to holders of the Notes and the Trustee, for the period of time during which the Notes are outstanding, our audited annual consolidated financial statements, within 90 days of our fiscal year end, and unaudited interim consolidated financial statements, within 45 days of our fiscal quarter end (other than our fourth fiscal quarter). All such financial statements will be prepared, in all material respects, in accordance with applicable U.S. GAAP.

**Form, Exchange and Transfer of Certificated Registered Securities**

If registered Notes cease to be issued in book-entry form, they will be issued:

- only in fully registered certificated form;
- without interest coupons; and
- unless we indicate otherwise, in denominations of $25 and amounts that are multiples of $25.

Holders may exchange their certificated securities for Notes of smaller denominations or combined into fewer Notes of larger denominations, as long as the total principal amount is not changed and as long as the denomination is equal to or greater than $25.

Holders may exchange or transfer their certificated securities at the office of the trustee. We have appointed the trustee to act as our agent for registering Notes in the names of holders transferring Notes. We may appoint another entity to perform these functions or perform them ourselves.

Holders will not be required to pay a service charge to transfer or exchange their certificated securities, but they may be required to pay any tax or other governmental charge associated with the transfer or exchange. The transfer or exchange will be made only if our transfer agent is satisfied with the holder’s proof of legal ownership.

We may appoint additional transfer agents or cancel the appointment of any particular transfer agent. We may also approve a change in the office through which any transfer agent acts.

If any certificated securities of a particular series are redeemable and we redeem less than all the debt securities of that series, we may block the transfer or exchange of those debt securities during the period beginning 15 days before the day we mail the notice of redemption and ending on the day of that mailing, in order to freeze the list of holders to prepare the mailing. We may also refuse to register transfers or exchanges of any certificated securities selected for redemption, except that we will continue to permit transfers and exchanges of the unredeemed portion of any debt security that will be partially redeemed.

If a registered debt security is issued in book-entry form, only the depositary will be entitled to transfer and exchange the debt security as described in this subsection, since it will be the sole holder of the debt security.

**Resignation of Trustee**

The trustee may resign or be removed with respect to the Notes provided that a successor trustee is appointed to act with respect to the Notes. In the event that two or more persons are acting as trustee with respect to different series of indenture securities under the indenture, each of the trustees will be a trustee of a trust separate and apart from the trust administered by any other trustee.

**Indenture Provisions — Ranking**

The Notes will be our direct unsecured obligations and will rank:

- pari passu with our existing and future senior unsecured indebtedness, including our Convertible Senior Notes;
- senior to any of our future indebtedness that expressly provides it is subordinated to the Notes; and
- effectively subordinated to all of our existing and future secured indebtedness (including indebtedness that is initially unsecured to which we subsequently grant security), to the extent of the value of the assets securing such indebtedness; and
- structurally subordinated to all existing and future indebtedness and other obligations of any of our subsidiaries and portfolio companies with respect to which we hold equity investments, including, without limitation, the indebtedness of KCAP Funding, or the Asset Manager Affiliates.

Upon any distribution of our assets upon our dissolution, winding up, liquidation or reorganization, the payment of the principal of (and premium if any) and interest, if any, on any indenture securities denominated as subordinated debt securities is to be subordinated to the extent provided in the indenture in right of payment to the prior payment in full of all Designated Senior Indebtedness (as defined below). In addition, no payment on account of principal (or premium, if any), sinking fund or interest, if any, may be made on such subordinated debt securities at any time unless full payment of all amounts due in respect of the principal (and premium, if any), sinking fund and interest on Designated Senior Indebtedness has been made or duly provided for in money or money's worth.

In the event that, notwithstanding the foregoing, any payment by us is received by the trustee in respect of subordinated debt securities or by the holders of any of such subordinated debt securities, upon our dissolution, winding up, liquidation or reorganization before all Designated Senior Indebtedness is paid in full, the payment or distribution must be paid over to the holders of the Designated Senior Indebtedness or on their behalf for application to the payment of all the Designated Senior Indebtedness remaining unpaid until all the Designated Senior Indebtedness has been paid in full, after giving effect to any concurrent payment or distribution to the holders of the Designated Senior Indebtedness. Subject to the payment in full of all Designated Senior Indebtedness upon this distribution by us, the holders of such subordinated debt securities will be subrogated to the rights of the holders of the Designated Senior Indebtedness to the extent of payments made to the holders of the Designated Senior Indebtedness out of the distributive share of such subordinated debt securities.

**Book-Entry Procedures**

The Notes will be represented by global securities that will be deposited and registered in the name of The Depository Trust Company ("DTC") or its nominee. This means that, except in limited circumstances, you will not receive certificates for the Notes. Beneficial interests in the Notes will be represented through book-entry accounts of financial institutions acting on behalf of beneficial owners as direct and indirect participants in DTC. Investors may elect to hold interests in the Notes through either DTC, if they are a participant, or indirectly through organizations that are participants in DTC.

The Notes will be issued as fully registered securities registered in the name of Cede & Co. (DTC's partnership nominee) or such other name as may be requested by an authorized representative of DTC. One

fully-registered certificate will be issued for each issuance of the Notes, in the aggregate principal amount of such issue, and will be deposited with DTC. Interests in the Notes will trade in DTC's Same Day Funds Settlement System, and any permitted secondary market trading activity in such Notes will, therefore, be required by DTC to be settled in immediately available funds. None of the Company, the Trustee or the Paying Agent will have any responsibility for the performance by DTC or its participants or indirect participants of their respective obligations under the rules and procedures governing their operations.

DTC is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Exchange Act. DTC holds and provides asset servicing for over 3.5 million issues of U.S. and non-U.S. equity, corporate and municipal debt issues, and money market instruments from over 100 countries that DTC's participants ("Direct Participants") deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities through electronic computerized book-entry transfers and pledges between Direct Participants' accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC").

DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). DTC has Standard & Poor's Ratings Services' highest rating: AAA. The DTC Rules applicable to its participants are on file with the SEC. More information about DTC can be found at *www.dtcc.com* and *www.dtc.org*.

Purchases of the Notes under the DTC system must be made by or through Direct Participants, which will receive a credit for the Notes on DTC's records. The ownership interest of each actual purchaser of each security, or the "Beneficial Owner," is in turn to be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Notes are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in the Notes, except in the event that use of the book-entry system for the Notes is discontinued.

To facilitate subsequent transfers, all Notes deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co. or such other name as may be requested by an authorized representative of DTC. The deposit of the Notes with DTC and their registration in the name of Cede & Co. or such other DTC nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Notes; DTC's records reflect only the identity of the Direct Participants to whose accounts the Notes are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Redemption notices shall be sent to DTC. If less than all of the Notes within an issue are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such issue to be redeemed.

Redemption proceeds, distributions, and interest payments on the Notes will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from us or the Trustee on the payment date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC nor its nominee, the Trustee, or us, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of redemption proceeds, distributions, and interest payments to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of us or the Trustee, but disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

DTC may discontinue providing its services as securities depository with respect to the Notes at any time by giving reasonable notice to us or to the Trustee. Under such circumstances, in the event that a successor securities depository is not obtained, certificates are required to be printed and delivered. We may decide to discontinue use of the system of book-entry-only transfers through DTC (or a successor securities depository). In that event, certificates will be printed and delivered to DTC.

The information in this section concerning DTC and DTC's book-entry system has been obtained from sources that we believe to be reliable, but we take no responsibility for the accuracy thereof.

## UNDERWRITING

Stifel, Nicolaus & Company, Incorporated is acting as the representative of the underwriters for this offering. Subject to the terms and conditions set forth in an underwriting agreement dated , 2012 between us and the underwriters, we have agreed to sell to the underwriters, and the underwriters have severally agreed to purchase from us, the aggregate principal amount of Notes indicated in the table below:

| Underwriters | Principal Amount of Notes |
|---|---|
| Stifel, Nicolaus & Company, Incorporated | $ |
| Barclays Capital Inc. | |
| Janney Montgomery Scott LLC | |
| JMP Securities LLC | |
| Ladenburg Thalmann & Co. Inc. | |
| Sandler O'Neill & Partners, L.P. | |
| Wunderlich Securities, Inc. | |
| Total | $30,000,000 |

Stifel, Nicolaus & Company, Incorporated and Barclays Capital Inc. are acting as joint book-running managers of this offering.

The underwriting agreement provides that the obligations of the several underwriters are subject to certain conditions precedent such as the receipt by the underwriters of officers' certificates and legal opinions and approval of certain legal matters by their counsel. The underwriting agreement provides that the underwriters will purchase all of the Notes if any of these Notes are purchased. If an underwriter defaults, the underwriting agreement provides that, under the circumstances, the purchase commitments of the nondefaulting underwriters may be increased or the underwriting agreement may be terminated. We have agreed to indemnify the underwriters and certain of their controlling persons against certain liabilities, including liabilities under the Securities Act, or to contribute to payments the underwriters may be required to make in respect of those liabilities.

The underwriters have advised us that they currently intend to make a market in the Notes. However, the underwriters are not obligated to do so and may discontinue any market-making activities at any time without notice. No assurance can be given as to the liquidity of the trading market for the Notes. If an active public trading market for the Notes does not develop, the market price and liquidity of the Notes may be adversely affected.

The underwriters are offering the Notes, subject to their acceptance of the Notes from us and subject to prior sale. The underwriters reserve the right to withdraw, cancel or modify offers to the public and to reject orders in whole or in part.

### *Commissions and Expenses*

The underwriters have advised us that they propose to offer the Notes to the public at the public offering price set forth on the cover page of this prospectus and to certain dealers at a price less a concession not in excess of % of the aggregate principal amount of the Notes. The underwriters may allow, and the dealers may reallow, a discount from the concession not in excess of % of the aggregate principal amount of the Notes to certain broker dealers. After the public offering price, concessions and reallowance to dealers may be reduced by the representative. No such reduction will change the amount of proceeds to be received by us as set forth on the cover page of this prospectus.

The following table shows the public offering price, the underwriting discounts and commissions that we are to pay to the underwriters and the proceeds, before expenses, to us in connection with this offering (expressed as a percentage of the principal amount of the Notes). The information assumes either no exercise or full exercise of the underwriters' option to purchase additional Notes.

| | Per Note | Without Option | With Option |
|---|---|---|---|
| Public offering price | 100.00% | $ | $ |
| Underwriting discount (sales load) paid by us | % | $ | $ |
| Estimated proceeds to us, before expenses | % | $ | $ |

We estimate expenses payable by us in connection with this offering, other than the underwriting discounts and commissions referred to above, will be approximately $300,000.

***Listing***

We intend to list the Notes on the New York Stock Exchange. We expect trading in the Notes on the New York Stock Exchange to begin within 30 days after the original issue date under the trading symbol "KAP". We offer no assurances that an active trading market for the Notes will develop and continue after the offering.

***Option to Purchase Additional Notes***

We have granted to the underwriters an option, exercisable for 30 days from the date of this prospectus, to purchase up to an additional $4,500,000 aggregate principal amount of the Notes at the public offering price set forth on the cover of this prospectus less underwriting discounts and commissions. If the underwriters exercise this option, each will be obligated, subject to the specified conditions, to purchase a number of additional Notes proportionate to that underwriter's initial principal amount reflected in the table above. This option may be exercised only if the underwriters sell more Notes than the total amount set forth in the table above.

***No Sales of Similar Securities***

Subject to certain exceptions, we have agreed not to directly or indirectly, offer, pledge, sell, contract to sell, grant any option for the sale of, or otherwise transfer or dispose of any debt securities issued or guaranteed by the Company or any securities convertible into or exercisable or exchangeable for debt securities issued or guaranteed by the Company or file any registration statement under the Securities Act with respect to any of the foregoing for a period of 90 days after the date of this prospectus without first obtaining the written consent of Stifel, Nicolaus & Company, Incorporated, other than certain private sales of debt securities to a limited number of institutional investors. This consent may be given at any time without public notice.

The 90-day restricted period described in the preceding paragraph will be automatically extended if: (1) during the last 17 days of the 90-day restricted period we issue an earnings release or announce material news a material event; or (2) prior to the expiration of the 90-day restricted period, we announce that we will release earnings results during the 15-day period following the last day of the 90-day restricted period, in which case the restrictions described in the preceding paragraph will continue to apply until the expiration of the 18-day period beginning on the issuance of the earnings release of the announcement of the material news or material event.

***Stabilization***

The underwriters have advised us that, pursuant to Regulation M under the Exchange Act, certain persons participating in the offering may engage in transactions including over-allotment, covering transactions and stabilizing transactions, which may have the effect of stabilizing or maintaining the market price of the Notes at a level above that which might otherwise prevail in the open market. Over-allotment involves syndicate sales of securities in excess of the aggregate principal amount of securities to be purchased by the underwriters in the offering, which creates a short position for the underwriters. Covering transactions involve purchases of the securities in the open market after the distribution has been completed in order to cover short positions.

A stabilizing bid is a bid for the purchase of Notes on behalf of the underwriters for the purpose of fixing or maintaining the price of the Notes. A syndicate covering transaction is the bid for or the purchase of Notes on behalf of the underwriters to reduce a short position incurred by the underwriters in connection with the offering. Similar to other purchase transactions, the underwriter's purchases to cover the syndicate short sales may have the effect of raising or maintaining the market price of our Notes or preventing or retarding a decline in the market price of our Notes. As a result, the price of our Notes may be higher than the price that might otherwise exist in the open market. A penalty bid is an arrangement permitting the underwriters to reclaim the selling concession otherwise accruing to a syndicate member in connection with the offering if the Notes originally sold by such syndicate member are purchased in a syndicate covering transaction and therefore have not been effectively placed by such syndicate member.

Neither we, nor any of the underwriters makes any representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of the Notes. The underwriters are not obligated to engage in these activities and, if commenced, any of the activities may be discontinued at any time.

***Electronic Distribution***

A prospectus in electronic format may be made available by e-mail or on the web sites or through online services maintained by one or more of the underwriters and/or selling group members participating in this offering, or by their affiliates. In those cases, prospective investors may view offering terms online and, depending upon the particular underwriter or selling group member, prospective investors may be allowed to place orders online. The underwriters may agree with us to allocate a limited principal amount of the Notes for sale to online brokerage account holders. Any such allocation for online distributions will be made by the underwriters on the same basis as other allocations. Other than the prospectus in electronic format, information on the underwriters' web sites and any information contained in any other web site maintained by any of the underwriters or selling group members is not part of this prospectus or the registration statement of which this prospectus forms a part, has not been approved and/or endorsed by us or the underwriters and should not be relied on by investors.

***Other Relationships***

Certain of the underwriters and their affiliates have provided in the past and may provide from time to time in the future in the ordinary course of their business certain commercial banking, financial advisory, investment banking and other services to us, our portfolio companies or our affiliates for which they have received or will be entitled to receive separate fees. In particular, the underwriters or their affiliates may execute transactions with us, on behalf of us, any of our portfolio companies or our affiliates. In addition, the underwriters or their affiliates may act as arrangers, underwriters or placement agents for companies whose securities are sold to or whose loans are syndicated to us, our portfolio companies or our affiliates.

The underwriters or their affiliates may also trade in our securities, securities of our portfolio companies or other financial instruments related thereto for their own accounts or for the account of others and may extend loans or financing directly or through derivative transactions to us, any of our portfolio companies or our affiliates.

After the date of this prospectus, the underwriters and their affiliates may from time to time obtain information regarding specific portfolio companies or us that may not be available to the general public. Any such information is obtained by the underwriters and their affiliates in the ordinary course of their business and not in connection with the offering of the Notes. In addition, after the offering period for the sale of the Notes, the underwriters or their affiliates may develop analyses or opinions related to us or our portfolio companies and buy or sell interests in one or more of our portfolio companies on behalf of their proprietary or client accounts and may engage in competitive activities. There is no obligation on behalf of these parties to disclose their respective analyses, opinions or purchase and sale activities regarding any portfolio company or regarding us to our noteholders or any other persons.

In the ordinary course of their various business activities, the underwriters and their respective affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the

accounts of their customers. Such investments and securities activities may involve securities and/or instruments of ours or our affiliates. Certain of the underwriters and their affiliates that may have a lending relationship with us may routinely hedge their credit exposure to us consistent with their customary risk management policies. Typically, such underwriters and their affiliates would hedge such exposure by entering into transactions that consist of either the purchase of credit default swaps or the creation of short positions in our securities, including potentially the Notes offered hereby. Any such short positions could adversely affect future trading prices of the Notes offered hereby. The underwriters and their affiliates may also make investment recommendations and/or publish or express independent research views in respect of such securities or financial instruments and may hold, or recommend to clients that they acquire, long and/or short positions in such securities and instruments.

The principal business address of Stifel, Nicolaus & Company, Incorporated is 501 N. Broadway, St. Louis, Missouri 63102; Barclays Capital Inc. is 745 7th Avenue, New York, New York 10019; Janney Montgomery Scott LLC is 1717 Arch Street, Philadelphia, Pennsylvania 19103; JMP Securities LLC is Attn: Prospectus Department, 600 Montgomery Street, 10th Floor, San Francisco, California 94111; Ladenburg Thalmann & Co. Inc. is 520 Madison Ave., 9th Floor, New York, New York 10022; Sandler O'Neill & Partners, L.P. is 1251 Avenue of the Americas, 6th Floor, New York, New York 10020; and Wunderlich Securities, Inc. is 6000 Poplar Avenue, Suite 150, Memphis, Tennessee 38119.

***Settlement***

We expect that delivery of the Notes will be made against payment therefor on or about , 2012, which will be the fifth business day following the date of the pricing of the Notes. Under Rule 15c6-1 under the Exchange Act, trades in the secondary market generally are required to settle in three business days, unless the parties to any such trade expressly agree otherwise.

***Other Jurisdictions***

The Notes offered by this prospectus may not be offered or sold, directly or indirectly, nor may this prospectus or any other offering material or advertisements in connection with the offer and sale of any such Notes be distributed or published in any jurisdiction, except under circumstances that will result in compliance with the applicable rules and regulations of that jurisdiction. Persons into whose possession this prospectus comes are advised to inform themselves about and to observe any restriction relating to the offering and the distribution of this prospectus. This prospectus does not constitute an offer to sell or a solicitation of an offer to buy the Notes offered by this prospectus in any jurisdiction in which such an offer or a solicitation is unlawful.

## BROKERAGE ALLOCATION AND OTHER PRACTICES

Since we generally acquire and dispose of our investments in privately negotiated transactions, we infrequently use brokers in the normal course of our business. Subject to policies established by our Board of Directors, we generally do not execute transactions through any particular broker or dealer, but seek to obtain the best net results for us, taking into account such factors as price (including the applicable brokerage commission or dealer spread), size of order, difficulty of execution, operational facilities of the firm and the firm's risk and skill in positioning blocks of securities. While we generally seek reasonably competitive trade execution costs, we do not necessarily pay the lowest spread or commission available. Subject to applicable legal requirements, we may select a broker based partly upon brokerage or research services provided to us. In return for such services, we may pay a higher commission than other brokers would charge if we determine in good faith that such commission is reasonable in relation to the services provided, and our management and employees are authorized to pay such commission under these circumstances.

## CUSTODIAN, TRANSFER AND DIVIDEND PAYING AGENT AND REGISTRAR

Our investment securities are held under a custody agreement with U.S. Bank National Association. The address of the custodian is U.S. Bank National Association, Corporate Trust Services, One Federal Street, 3rd Floor, Boston, MA 02110. The transfer agent and registrar for our common stock, American Stock Transfer & Trust Company, acts as our transfer agent, dividend paying and reinvestment agent for our common stock. The principal business address of the transfer agent is 59 Maiden Lane, New York, New York 10038. U.S. Bank

National Association, our trustee under an indenture and the first supplemental indenture thereto relating to the Notes, is the paying agent, registrar and transfer agent relating to the Notes. The principal business address of our trustee is One Federal Street, 10th Floor, Boston, MA 02110.

## LEGAL MATTERS

Certain legal matters regarding the securities offered by this prospectus will be passed upon for us by Sutherland Asbill & Brennan LLP, Washington, D.C. Certain legal matters in connection with an offering will be passed upon for the underwriters by Fried, Frank, Harris, Shriver & Jacobson LLP, New York, New York.

## INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The audited financial statements and financial highlights, and management's assessment of the effectiveness of internal control over financial reporting included in this prospectus and elsewhere in the registration statement have been so included in reliance upon the reports of Grant Thornton LLP, independent registered public accountants, upon the authority of said firm as experts in accounting and auditing in giving said reports. The principal business address of Grant Thornton LLP is 175 West Jackson Boulevard, Chicago, Illinois 60604.

## AVAILABLE INFORMATION

As a public company, we file with or submit to the SEC annual, quarterly and current periodic reports, proxy statements and other information meeting the informational requirements of the Exchange Act. You may inspect and copy these reports, proxy statements and other information, as well as the registration statement of which this prospectus forms a part and the related exhibits and schedules, at the Public Reference Room of the SEC at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Copies of these reports, proxy and information statements and other information may be obtained, after paying a duplicating fee, by electronic request at the following e-mail address: publicinfo@sec.gov, or by writing the SEC's Public Reference Section, Washington, D.C. 20549-0102. In addition, the SEC maintains an Internet website that contains reports, proxy and information statements and other information filed electronically by us with the SEC at *http://www.sec.gov*.

## INDEX TO FINANCIAL STATEMENTS

## KCAP FINANCIAL, INC.

## BALANCE SHEETS

| | As of June 30, 2012 (unaudited) | As of December 31, 2011 |
|---|---|---|
| **ASSETS** | | |
| Investments at fair value: | | |
| Time deposits (cost: 2012 – $17,098; 2011 – $229,152) | $ 17,098 | $ 229,152 |
| Money market account (cost: 2012 – $10,790,686; 2011 – $31,622,134) | 10,790,686 | 31,622,134 |
| Debt securities (cost: 2012 – $167,900,019; 2011 – $134,311,238) | 143,264,021 | 114,673,506 |
| CLO Fund securities managed by non-affiliates (cost: 2012 – $12,696,312; 2011 – $12,756,449) | 2,984,620 | 3,110,367 |
| CLO Fund securities managed by affiliates (cost: 2012 – $66,711,252; 2011 – $53,772,033) | 60,898,895 | 45,327,950 |
| Equity securities (cost: 2012 – $16,559,610; 2011 – $16,559,610) | 7,719,242 | 6,040,895 |
| Asset manager affiliates (cost: 2012 – $83,419,910; 2011 – $44,338,301) | 72,896,000 | 40,814,000 |
| Total Investments at fair value (cost: 2012 – $358,094,887; 2011 – $293,588,917) | 298,570,562 | 241,818,004 |
| Cash | 1,617,867 | 2,555,259 |
| Restricted cash | 815,478 | — |
| Interest receivable | 897,319 | 522,578 |
| Accounts receivable | 2,004,321 | 859,156 |
| Due from affiliates | 391 | 3,517 |
| Other assets | 2,339,824 | 2,375,147 |
| Total assets | $306,245,762 | $248,133,661 |
| **LIABILITIES** | | |
| Borrowings | $ 21,500,000 | $ — |
| Convertible Senior Notes | 60,000,000 | 60,000,000 |
| Payable for open trades | 17,225,319 | — |
| Accounts payable and accrued expenses | 3,360,134 | 3,527,682 |
| Dividend payable | — | 4,080,037 |
| Total liabilities | $102,085,453 | $ 67,607,719 |
| **STOCKHOLDERS' EQUITY** | | |
| Common stock, par value $0.01 per share, 100,000,000 common shares authorized; 26,664,132 and 22,992,211 common shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively | $ 263,079 | $ 226,648 |
| Capital in excess of par value | 310,713,834 | 284,571,466 |
| Accumulated undistributed net investment income | 5,726,464 | 821,904 |
| Accumulated net realized losses | (52,497,979) | (52,802,400) |
| Net unrealized depreciation on investments | (60,045,089) | (52,291,676) |
| Total stockholders' equity | $204,160,309 | $180,525,942 |
| Total liabilities and stockholders' equity | $306,245,762 | $248,133,661 |
| NET ASSET VALUE PER COMMON SHARE | $ 7.66 | $ 7.85 |

See accompanying notes to financial statements.

**KCAP FINANCIAL, INC.**

**STATEMENTS OF OPERATIONS**
**(unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| **Investment Income:** | | | | |
| Interest from investments in debt securities | $ 2,671,291 | $ 2,054,042 | $ 5,172,904 | $ 4,022,948 |
| Interest from cash and time deposits | 845 | 7,748 | 3,408 | 13,585 |
| Dividends from investments in CLO Fund securities managed by non-affiliates | 458,538 | 499,919 | 877,703 | 989,299 |
| Dividends from investments in CLO Fund securities managed by affiliates | 5,028,886 | 2,811,583 | 8,642,525 | 5,667,738 |
| Dividends from affiliate asset managers | 1,200,000 | 650,000 | 2,025,000 | 650,000 |
| Capital structuring service fees | 122,044 | 28,260 | 161,605 | 29,508 |
| Other Income | — | — | — | 2,000,000 |
| Total investment income | 9,481,604 | 6,051,552 | 16,883,145 | 13,373,078 |
| **Expenses:** | | | | |
| Interest and amortization of debt issuance costs | 1,646,352 | 1,429,770 | 3,088,638 | 1,727,230 |
| Compensation | 1,073,975 | 1,335,127 | 2,021,710 | 2,176,569 |
| Professional fees | 245,671 | 295,127 | 1,162,331 | 1,065,092 |
| Insurance | 142,676 | 115,658 | 272,280 | 233,235 |
| Administrative and other | 369,109 | 217,624 | 695,085 | 530,239 |
| Total expenses | 3,477,783 | 3,393,306 | 7,240,044 | 5,732,365 |
| **Net Investment Income** | **6,003,821** | **2,658,246** | **9,643,101** | **7,640,713** |
| **Realized And Unrealized Gains (Losses) On Investments:** | | | | |
| Net realized gains (losses) from investment transactions | 1,688 | (11,933,091) | 304,421 | (13,759,815) |
| Net change in unrealized appreciation (depreciation) on: | | | | |
| Debt securities | (3,915,572) | 11,048,858 | (4,998,267) | 13,718,113 |
| Equity securities | 997,361 | (667,933) | 1,678,347 | (684,918) |
| CLO Fund securities managed by affiliates | 264,851 | (1,141,503) | 2,631,727 | 514,755 |
| CLO Fund securities managed by non-affiliates | (38,767) | 893,915 | (65,611) | 2,192,401 |
| Affiliate asset manager investments | (1,695,927) | 15,338 | (6,999,609) | 857,213 |
| Net realized and unrealized gains (losses) on investments | (4,386,366) | (1,784,416) | (7,448,992) | 2,837,749 |
| **Net Increase In Net Assets Resulting From Operations** | $ 1,617,455 | $ 873,830 | $ 2,194,109 | $ 10,478,462 |
| Net Increase In Net Assets Resulting from Operations per Common Share: | | | | |
| Basic: | $ 0.06 | $ 0.04 | $ 0.09 | $ 0.46 |
| Diluted: | $ 0.06 | $ 0.04 | $ 0.09 | $ 0.46 |
| Net Investment Income Per Common Share: | | | | |
| Basic: | $ 0.23 | $ 0.12 | $ 0.38 | $ 0.33 |
| Diluted: | $ 0.23 | $ 0.12 | $ 0.38 | $ 0.33 |
| Weighted Average Shares of Common Stock Outstanding – Basic | 26,633,122 | 22,827,652 | 25,451,974 | 22,809,547 |
| Weighted Average Shares of Common Stock Outstanding – Diluted | 26,633,122 | 22,827,652 | 25,451,974 | 22,823,404 |

See accompanying notes to financial statements.

## KCAP FINANCIAL, INC.

## STATEMENTS OF CHANGES IN NET ASSETS
**(unaudited)**

| | Six Months Ended June 30, | |
|---|---|---|
| | 2012 | 2011 |
| **Operations:** | | |
| Net investment income | $ 9,643,101 | $ 7,640,713 |
| Net realized gains (losses) from investment transactions | 304,421 | (13,759,815) |
| Net change in unrealized appreciation (depreciation) on investments | (7,753,413) | 16,597,564 |
| Net increase (decrease) in net assets resulting from operations | 2,194,109 | 10,478,462 |
| **Stockholder distributions:** | | |
| Dividends from net investment income to common stockholders | (4,731,232) | (3,819,771) |
| Dividends in excess of net investment income to restricted stockholders | (7,308) | — |
| Net decrease in net assets resulting from stockholder distributions | (4,738,540) | (3,819,771) |
| **Capital transactions:** | | |
| Issuance of common stock for: | | |
| Acquisition of affiliate asset manager | 25,560,000 | — |
| Issuance of common stock under dividend reinvestment plan | 280,095 | 548,767 |
| Vesting of restricted stock | 501 | 20 |
| Stock-based compensation | 338,202 | 458,773 |
| Net increase in net assets resulting from capital transactions | 26,178,798 | 1,007,560 |
| Net assets at beginning of period | 180,525,942 | 186,925,667 |
| Net assets at end of period (including undistributed net investment income of $5,726,464 in 2012 and $4,639,604 in 2011) | $204,160,309 | $194,591,918 |
| Net asset value per common share | $ 7.66 | $ 8.52 |
| Common shares outstanding at end of period | 26,664,132 | 22,841,172 |

See accompanying notes to financial statements.

**KCAP FINANCIAL, INC.**

**STATEMENTS OF CASH FLOWS**
**(unaudited)**

| | Six Months Ended June 30, | |
|---|---|---|
| | 2012 | 2011 |
| OPERATING ACTIVITIES: | | |
| Net increase in net assets resulting from operations | $ 2,194,109 | $ 10,478,463 |
| Adjustments to reconcile net increase in net assets resulting from operations to net cash provided by (used in) operations: | | |
| Net realized (gains) losses on investment transactions | (304,421) | 13,759,814 |
| Net change in unrealized (appreciation) depreciation on investments | 7,753,413 | (16,355,806) |
| Net accretion of interest | (1,005,102) | (68,085) |
| Amortization of debt issuance cost | — | 22,908 |
| Amortization of convertible notes offering cost | 283,105 | 139,345 |
| Purchases of investments | (69,597,548) | (87,354,521) |
| Capital contribution from (to) affiliate asset manager | (521,609) | 149,214 |
| Payment-in-kind interest income | (96,908) | (336,016) |
| Proceeds from sale and redemption of investments | 49,804,938 | 37,821,302 |
| Stock-based compensation expense | 338,202 | 458,773 |
| Changes in operating assets and liabilities: | | |
| (Increase) decrease in interest and dividends receivable | (374,740) | (344,703) |
| (Increase) decrease in accounts receivable | (1,145,165) | 79,462 |
| (Increase) decrease in other assets | (247,782) | 133,182 |
| Decrease in due from affiliates | 3,126 | — |
| Increase in due to affiliates | — | — |
| Increase (decrease) in accounts payable and accrued expenses | (167,548) | 835,035 |
| Net cash provided by operating activities | (13,083,930) | (40,581,633) |
| FINANCING ACTIVITIES: | | |
| Dividends paid in cash | (8,537,984) | (7,083,655) |
| Proceeds from issuance of debt | 22,500,000 | — |
| Cash paid on repayment of debt | (1,000,000) | (86,746,582) |
| Convertible senior notes offering costs | — | (2,370,144) |
| Issuance of Convertible Senior Notes | — | 60,000,000 |
| (Increase) Decrease in restricted cash | (815,478) | 67,023,170 |
| Net cash provided by (used in) financing activities | 12,146,538 | 30,822,789 |
| CHANGE IN CASH | (937,392) | (9,758,844) |
| CASH, BEGINNING OF PERIOD | 2,555,259 | 10,175,488 |
| CASH, END OF PERIOD | $ 1,617,867 | $ 416,644 |
| Supplemental Information: | | |
| Interest paid during the period | $ 2,781,731 | $ 252,335 |
| Dividends paid during the period under the dividend reinvestment plan | $ 280,596 | $ 548,787 |
| 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 June 30, 2012**
**(unaudited)**

**Debt Securities Portfolio**

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Advanced Lighting Technologies, Inc. *Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Subordinated Bond — 10.5% Cash, Due 6/19 | $ 3,000,000 | $ 2,925,037 | $ 2,925,000 |
| Alaska Communications Systems Holdings, Inc.[13] *Telecommunications* | Senior Secured Loan — Term Loan 5.5% Cash, Due 10/16 | 2,955,000 | 2,969,402 | 2,678,707 |
| Allison Transmission, Inc.[12] *Automobile* | Senior Secured Loan — Term B-2 Loan 3.8% Cash, Due 8/17 | 1,990,000 | 1,978,081 | 1,965,433 |
| Aramark Corporation[12] *Diversified/Conglomerate Service* | Senior Secured Loan — LC-3 Facility 3.5% Cash, Due 7/16 | 61,707 | 61,561 | 61,360 |
| Aramark Corporation[12] *Diversified/Conglomerate Service* | Senior Secured Loan — U.S. Term C Loan 3.7% Cash, Due 7/16 | 938,293 | 936,072 | 933,015 |
| Atlantic Broadband Finance, LLC[12] *Broadcasting and Entertainment* | Senior Secured Loan — Term Loan (First Lien) 5.3% Cash, Due 4/19 | 2,000,000 | 1,990,310 | 2,008,320 |
| Avis Budget Car Rental, LLC[12], [13] *Personal Transportation* | Senior Secured Loan — Tranche C Term Loan 4.3% Cash, Due 3/19 | 1,995,000 | 2,025,078 | 1,990,511 |
| Bankruptcy Management Solutions, Inc. *Diversified/Conglomerate Service* | Junior Secured Loan — Loan (Second Lien) 1.2% Cash, 7.0% PIK, Due 8/15 | 1,355,173 | 1,217,438 | 49,125 |
| Bankruptcy Management Solutions, Inc. *Diversified/Conglomerate Service* | Senior Secured Loan — Term Loan B 6.5% Cash, 1.0% PIK, Due 8/14 | 1,438,962 | 1,422,517 | 494,046 |
| Berry Plastics Holding Corporation[12] *Containers, Packaging and Glass* | Senior Secured Loan — Term C Loan 2.2% Cash, Due 4/15 | 1,989,501 | 1,952,878 | 1,923,599 |
| Bicent Power LLC[8] *Utilities* | Junior Secured Loan — Advance (Second Lien) 9.3% Cash, Due 12/14 | 3,967,474 | 3,967,474 | 61,496 |
| Blue Coat Systems, Inc. *Electronics* | Junior Secured Loan — Loan (Second Lien) 11.5% Cash, Due 8/18 | 2,250,000 | 2,283,750 | 2,283,750 |
| Burger King Corporation[12], [13] *Personal, Food and Miscellaneous Services* | Senior Secured Loan — Tranche B Term Loan 4.5% Cash, Due 10/16 | 1,947,389 | 1,943,962 | 1,942,764 |
| Burger King Corporation *Personal, Food and Miscellaneous Services* | Senior Secured Loan — Tranche B Term Loan 4.5% Cash, Due 10/16 | 849,548 | 849,548 | 847,531 |
| Caribe Media Inc. (fka Caribe Information Investments Incorporated) *Printing and Publishing* | Senior Secured Loan — Loan 10.0% Cash, Due 11/14 | 652,924 | 652,924 | 652,924 |
| Catalina Marketing Corporation[12] *Diversified/Conglomerate Service* | Senior Secured Loan — 2017 Term Loan 5.7% Cash, Due 9/17 | 1,704,212 | 1,668,829 | 1,610,174 |
| Chrysler Group LLC[12] *Automobile* | Senior Secured Loan — Tranche B Term Loan 6.0% Cash, Due 5/17 | 1,989,950 | 1,989,950 | 2,007,362 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| CoActive Technologies LLC (fka CoActive Technologies, Inc.) *Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Junior Secured Loan — Term Loan (Second Lien) 7.2% Cash, Due 1/15 | $ 2,000,000 | $ 1,985,906 | $ 1,505,200 |
| Del Monte Foods Company[12] *Beverage, Food and Tobacco* | Senior Secured Loan — Initial Term Loan 4.5% Cash, Due 3/18 | 1,927,154 | 1,905,270 | 1,903,073 |
| Del Monte Foods Company *Beverage, Food and Tobacco* | Senior Secured Loan — Initial Term Loan 4.5% Cash, Due 3/18 | 949,123 | 951,077 | 937,263 |
| eInstruction Corporation *Healthcare, Education and Childcare* | Junior Secured Loan — Term Loan (Second Lien) 11.5% Cash, Due 7/14 | 10,000,000 | 10,000,000 | 3,985,000 |
| ELO Touch Solutions, Inc.[12] *Electronics* | Senior Secured Loan — Term Loan (First Lien) 8.0% Cash, Due 6/18 | 2,000,000 | 1,920,000 | 1,945,000 |
| First Data Corporation[12] *Finance* | Senior Secured Loan — 2018 Dollar Term Loan 4.2% Cash, Due 3/18 | 2,000,000 | 1,788,204 | 1,840,130 |
| Fram Group Holdings Inc./Prestone Holdings Inc.[12] *Automobile* | Senior Secured Loan — Term Loan (First Lien) 6.5% Cash, Due 7/17 | 994,987 | 1,002,250 | 961,407 |
| Freescale Semiconductor, Inc.[13] *Electronics* | Senior Subordinated Bond — 10.125% – 12/2016 10.1% Cash, Due 12/16 | 1,036,000 | 1,038,255 | 1,090,390 |
| Getty Images, Inc.[12] *Printing and Publishing* | Senior Secured Loan — Initial Term Loan 5.3% Cash, Due 11/16 | 1,980,449 | 2,005,205 | 1,987,866 |
| Ginn LA Conduit Lender, Inc.[8] *Buildings and Real Estate[4]* | Senior Secured Loan — First Lien Tranche A Credit-Linked Deposit 7.8% Cash, Due 6/11 | 1,257,143 | 1,224,101 | 40,857 |
| Ginn LA Conduit Lender, Inc.[8] *Buildings and Real Estate[4]* | Senior Secured Loan — First Lien Tranche B Term Loan 7.8% Cash, Due 6/11 | 2,694,857 | 2,624,028 | 87,583 |
| Ginn LA Conduit Lender, Inc.[8] *Buildings and Real Estate[4]* | Junior Secured Loan — Loan (Second Lien) 11.8% Cash, Due 6/12 | 3,000,000 | 2,715,997 | 30,015 |
| Gymboree Corporation., The[12] *Retail Stores* | Senior Secured Loan — Term Loan 5.0% Cash, Due 2/18 | 1,467,299 | 1,393,383 | 1,392,298 |
| HMSC Corporation (aka Swett and Crawford) *Insurance* | Junior Secured Loan — Loan (Second Lien) 5.7% Cash, Due 10/14 | 5,000,000 | 4,934,081 | 4,131,500 |
| Hunter Defense Technologies, Inc. *Aerospace and Defense* | Junior Secured Loan — Term Loan (Second Lien) 7.0% Cash, Due 2/15 | 5,000,000 | 4,930,051 | 4,901,500 |
| Hunter Fan Company *Home and Office Furnishings, Housewares, and Durable Consumer Products* | Junior Secured Loan — Loan (Second Lien) 7.0% Cash, Due 10/14 | 3,000,000 | 3,000,000 | 2,741,400 |
| International Architectural Products, Inc.[8] *Mining, Steel, Iron and Non-Precious Metals* | Senior Secured Loan — Term Loan 8.8% Cash, Due 5/15 | 525,678 | 499,114 | 273,352 |
| Jones Stephens Corp. *Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Term Loan 7.0% Cash, Due 9/15 | 4,350,315 | 4,350,315 | 4,350,315 |
| KIK Custom Products Inc. *Personal and Non Durable Consumer Products (Mfg. Only)* | Junior Secured Loan — Loan (Second Lien) 5.2% Cash, Due 12/14 | 5,000,000 | 5,000,000 | 3,431,250 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Kaseman Holdings and Sallyport Holdings<br>*Aerospace and Defense* | Mezzanine Investment — Mezzanine Notes<br>14.5% Cash, Due 6/17 | $ 11,250,597 | $10,950,636 | $ 11,588,115 |
| LBREP/L-Suncal Master I LLC[8]<br>*Buildings and Real Estate[4]* | Senior Secured Loan — Term Loan (First Lien)<br>7.5% Cash, Due 1/10 | 3,401,921 | 3,401,921 | 359,923 |
| Legacy Cabinets, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Term Loan<br>1.0% Cash, 6.3% PIK, Due 5/14 | 508,384 | 463,380 | 508,384 |
| Lord & Taylor Holdings LLC (LT Propco LLC)[12]<br>*Retail Stores* | Senior Secured Loan — Term Loan<br>5.8% Cash, Due 1/19 | 1,300,208 | 1,306,498 | 1,302,783 |
| Merisant Company<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Loan<br>7.5% Cash, Due 1/14 | 4,570,471 | 4,557,714 | 4,570,471 |
| Metropolitan Health Networks, Inc.[13]<br>*Healthcare, Education and Childcare* | Junior Secured Loan — Term Loan (Second Lien)<br>13.5% Cash, Due 10/17 | 5,000,000 | 4,912,243 | 5,000,000 |
| Michael Foods Group, Inc. (f/k/a M-Foods Holdings, Inc.)[12]<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Term B Facility<br>4.3% Cash, Due 2/18 | 1,920,993 | 1,924,416 | 1,924,989 |
| Neiman Marcus Group Inc., The[12]<br>*Retail Stores* | Senior Secured Loan — Term Loan<br>4.8% Cash, Due 5/18 | 2,000,000 | 1,984,570 | 1,981,380 |
| Pegasus Solutions, Inc.<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Junior Secured Loan — Senior Subordinated Second Lien PIK Notes,<br>13.0% PIK, Due 4/14 | 1,587,800 | 1,587,800 | 1,587,800 |
| Perseus Holding Corp.<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Preferred Stock — Preferred Stock,<br>14.0% PIK, Due 4/14 | 400,000 | 400,000 | 395,720 |
| PetCo Animal Supplies, Inc.[12]<br>*Retail Stores* | Senior Secured Loan — New Loan<br>4.5% Cash, Due 11/17 | 2,000,000 | 2,000,000 | 1,988,500 |
| Pinnacle Foods Finance LLC[12]<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Extended Initial Term Loan<br>3.7% Cash, Due 10/16 | 1,134,339 | 1,132,921 | 1,125,128 |
| Potters Holdings, II, L.P.<br>*Diversified/Conglomerate Manufacturing* | Junior Secured Loan — Term B Loan (Second Lien)<br>10.3% Cash, Due 11/17 | 7,000,000 | 6,913,503 | 7,108,500 |
| TPF Generation Holdings, LLC[12]<br>*Utilities* | Senior Secured Loan — Synthetic LC Deposit (First Lien)<br>2.7% Cash, Due 12/13 | 169,532 | 169,148 | 168,896 |
| Trinseo Materials Operating S.C.A. (fka Styron S.A.R.L)[3], [13]<br>*Chemicals, Plastics and Rubber* | Senior Secured Loan — Term Loan<br>6.0% Cash, Due 8/17 | 1,979,899 | 1,830,002 | 1,859,878 |
| TriZetto Group, Inc. (TZ Merger Sub, Inc.)[12]<br>*Electronics* | Senior Secured Loan — Term Loan<br>4.8% Cash, Due 5/18 | 1,343,216 | 1,337,638 | 1,316,016 |
| TriZetto Group, Inc. (TZ Merger Sub, Inc.)<br>*Electronics* | Senior Secured Loan — Term Loan<br>4.8% Cash, Due 5/18 | 626,593 | 602,873 | 613,904 |
| TUI University, LLC<br>Healthcare, Education and Childcare | Senior Secured Loan — Term Loan (First Lien)<br>3.7% Cash, Due 10/14 | 3,040,242 | 2,989,272 | 2,582,382 |
| TWCC Holding Corp.[12]<br>*Broadcasting and Entertainment* | Senior Secured Loan — Term Loan<br>4.3% Cash, Due 2/17 | 1,966,350 | 1,980,375 | 1,967,992 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Twin-Star International, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Subordinated Bond — Senior Subordinated Note 13.0% Cash, Due 4/14 | $ 5,500,000 | $ 5,500,000 | $ 5,500,000 |
| Univar Inc.<br>*Chemicals, Plastics and Rubber* | Senior Secured Loan — Term B Loan 5.0% Cash, Due 6/17 | 2,969,849 | 2,969,849 | 2,921,248 |
| US Foods, Inc. (aka U.S. Foodservice, Inc.)[12]<br>*Personal, Food and Miscellaneous Services* | Senior Secured Loan — Extended Term Loan 5.8% Cash, Due 3/17 | 1,989,529 | 1,938,046 | 1,909,948 |
| Vertafore, Inc.[12]<br>*Electronics* | Senior Secured Loan — Term Loan (First Lien) 5.3% Cash, Due 7/16 | 1,243,691 | 1,238,640 | 1,239,804 |
| Vertafore, Inc.<br>*Electronics* | Senior Secured Loan — Term Loan (First Lien) 5.3% Cash, Due 7/16 | 736,221 | 717,683 | 733,920 |
| Warner Chilcott Company, LLC[13]<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-2 Loan 4.3% Cash, Due 3/18 | 452,560 | 453,538 | 451,182 |
| Warner Chilcott Corporation[13]<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-1 Loan 4.3% Cash, Due 3/18 | 905,120 | 907,077 | 902,364 |
| WC Luxco S.A.R.L. (Warner Chilcott)[3], [13]<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-3 Loan 4.3% Cash, Due 3/18 | 622,270 | 623,615 | 620,375 |
| Wesco Aircraft Hardware Corp.[13]<br>*Aerospace and Defense* | Senior Secured Loan — Tranche B Term Loan 4.3% Cash, Due 4/17 | 2,590,244 | 2,585,098 | 2,596,512 |
| Wholesome Sweeteners, Inc.<br>*Beverage, Food and Tobacco* | Junior Secured Loan — Subordinated Note (Second Lien) 12.0% Cash, 2.0% PIK, Due 10/17 | 6,583,333 | 6,536,072 | 6,583,333 |
| WireCo WorldGroup Inc.<br>*Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Senior Subordinated Bond — 11.75% – 05/2017 11.8% Cash, Due 5/17 | 8,000,000 | 7,920,000 | 7,920,000 |
| WM. Bolthouse Farms, Inc.[12]<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Term Loan (First Lien) 5.5% Cash, Due 2/16 | 1,953,675 | 1,963,443 | 1,964,058 |
| **Total Investment in Debt Securities (70% of net asset value at fair value)** | | $ 170,015,175 | $167,900,019 | $143,264,021 |

## Equity Portfolio

| Portfolio Company/Principal Business | Investment | Percentage Interest/Shares | Cost | Value[2] |
|---|---|---|---|---|
| Aerostructures Holdings L.P.[6]<br>*Aerospace and Defense* | Partnership Interests | 1.2% | $ 1,000,000 | $ 1,000 |
| Aerostructures Holdings L.P.[6]<br>*Aerospace and Defense* | Series A Preferred Interests | 1.2% | 250,961 | 187,593 |
| Bankruptcy Management Solutions, Inc.[6]<br>*Diversified/Conglomerate Service* | Common Stock | 1.2% | 218,592 | 1,000 |
| Bankruptcy Management Solutions, Inc.[6]<br>*Diversified/Conglomerate Service* | Warrants | 0.1% | — | — |
| Coastal Concrete Holding II, LLC[6]<br>*Buildings and Real Estate[4]* | Class A Units | 10.8% | 8,625,626 | 1,000 |
| eInstruction Acquisition, LLC[6]<br>*Healthcare, Education and Childcare* | Membership Units | 1.1% | 1,079,617 | 1,000 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment | Percentage Interest/Shares | Cost | Value[2] |
|---|---|---|---|---|
| FP WRCA Coinvestment Fund VII, Ltd.[3], [6], [13]<br>*Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Class A Shares | 1,500 | $ 1,500,000 | $ 3,287,250 |
| International Architectural Products, Inc.[6]<br>*Mining, Steel, Iron and Non-Precious Metals* | Common | 2.5% | 292,851 | 1,000 |
| Legacy Cabinets, Inc.[6]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Equity | 4.0% | 115,580 | 1,000 |
| Perseus Holding Corp.[6]<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Common | 0.2% | 400,000 | 88,005 |
| Plumbing Holdings Corporation[6]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Common | 7.8% | — | 549,542 |
| Plumbing Holdings Corporation<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Preferred Stock | 15.5% | 2,716,618 | 3,102,238 |
| Caribe Media Inc. (fka Caribe Information Investments Incorporated)[6]<br>*Printing and Publishing* | Common | 1.3% | 359,765 | 498,614 |
| **Total Investment in Equity Securities (4% of net asset value at fair value)** | | | $16,559,610 | $ 7,719,242 |

**CLO Fund Securities**

**CLO Equity Investments**

| Portfolio Company | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Grant Grove CLO, Ltd.[3], [10], [13] | Subordinated Securities | 22.2% | $ 4,899,382 | $ 2,982,620 |
| Katonah III, Ltd.[3], [10], [11], [13] | Preferred Shares | 23.1% | 4,476,930 | 1,000 |
| Katonah V, Ltd.[3], [10], [11], [13] | Preferred Shares | 26.7% | 3,320,000 | 1,000 |
| Katonah VII CLO Ltd.[3], [7], [10], [13] | Subordinated Securities | 16.4% | 4,578,293 | 2,291,282 |
| Katonah VIII CLO Ltd[3], [7], [10], [13] | Subordinated Securities | 10.3% | 3,452,605 | 2,104,917 |
| Katonah IX CLO Ltd[3], [7], [10], [13] | Preferred Shares | 6.9% | 2,073,387 | 1,524,070 |
| Katonah X CLO Ltd [3], [7], [10], [13] | Subordinated Securities | 33.3% | 11,891,547 | 9,117,423 |
| Katonah 2007-I CLO Ltd.[3], [7], [10], [13] | Preferred Shares | 100.0% | 31,053,938 | 26,703,361 |
| Trimaran CLO IV, Ltd.[3], [7], [10], [13] | Preferred Shares | 18.9% | 3,607,100 | 3,222,196 |
| Trimaran CLO V, Ltd.[3], [7], [10], [13] | Subordinate Notes | 20.8% | 2,753,500 | 2,799,198 |
| Trimaran CLO VI, Ltd.[3], [7], [10], [13] | Income Notes | 16.2% | 2,911,700 | 2,744,720 |
| Trimaran CLO VII, Ltd.[3], [7], [10], [13] | Income Notes | 10.5% | 3,158,700 | 3,071,728 |
| **Total Investment in CLO Equity Securities** | | | $78,177,082 | $ 56,563,515 |

See accompanying notes to financial statements.

**CLO Rated-Note Investment**

| Portfolio Company | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Katonah 2007-I CLO Ltd.[3], [7], [10], [13] | Class B-2L Notes Par Value of $10,500,000 5.2%, Due 4/22 | 5.2% | $ 1,230,482 | $ 7,320,000 |
| **Total Investment in CLO Rated-Note** | | | $ 1,230,482 | $ 7,320,000 |
| **Total Investment in CLO Fund Securities (31% of net asset value at fair value)** | | | $79,407,564 | $ 63,883,515 |

**Asset Manager Affiliates**

| Portfolio Company/Principal Business | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Asset Manager Affiliates (Katonah Debt Advisors and Trimaran Advisors) | Asset Management Company | 100.0% | $83,419,910 | $ 72,896,000 |
| **Total Investment in Asset Manager Affiliates (36% of net asset value at fair value)** | | | $83,419,910 | $ 72,896,000 |

**Time Deposits and Money Market Account**

| Time Deposits and Money Market Account | Investment | Yield | Par/Cost | Value[2] |
|---|---|---|---|---|
| JP Morgan Asset Account | Time Deposit | 0.0% | $ 17,098 | $ 17,098 |
| JP Morgan Business Money Market Account[9] | Money Market Account | 0.2% | 203,910 | 203,910 |
| US Bank Money Market Account | Money Market Account | 0.4% | 10,586,776 | 10,586,776 |
| **Total Investment in Time Deposit and Money Market Accounts (5% of net asset value at fair value)** | | | $ 10,807,784 | $ 10,807,784 |
| **Total Investments[5] (146% of net asset value at fair value)** | | | $358,094,887 | $298,570,562 |

(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 June 30, 2012.

(2) Reflects the fair market value of all existing investments as of June 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.

(5) The aggregate cost of investments for federal income tax purposes is approximately $358 million. The aggregate gross unrealized appreciation is approximately $10 million, the aggregate gross unrealized depreciation is approximately $70 million and the net unrealized depreciation is approximately $60 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

See accompanying notes to financial statements.

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 June 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).

(13) Investment is not a qualifying asset as defined under Section 55(a) of the 1940 Act.

See accompanying notes to financial statements.

**KCAP FINANCIAL, INC.**

**SCHEDULE OF INVESTMENTS**
**As of December 31, 2011**

**Debt Securities Portfolio**

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Advanced Lighting Technologies, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Revolving Loan<br>.5% Cash, Due 6/13 | $ — | $ — | $ — |
| Advanced Lighting Technologies, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Junior Secured Loan — Second Lien Term Loan Note<br>6.3% Cash, Due 6/14 | 5,000,000 | 4,997,622 | 4,965,000 |
| Alaska Communications Systems Holdings, Inc.<br>*Telecommunications* | Senior Secured Loan — Term Loan<br>5.5% Cash, Due 10/16 | 2,970,000 | 2,986,151 | 2,776,950 |
| Avis Budget Car Rental, LLC<br>*Personal Transportation* | Senior Secured Loan — Extended Term Loan<br>5.8% Cash, Due 4/14 | 2,974,338 | 2,993,092 | 2,983,648 |
| Bankruptcy Management Solutions, Inc.<br>*Diversified/Conglomerate Service* | Junior Secured Loan — Loan (Second Lien)<br>1.4% Cash, 7.0% PIK, Due 8/15 | 1,291,447 | 1,217,438 | 39,822 |
| Bankruptcy Management Solutions, Inc.<br>*Diversified/Conglomerate Service* | Senior Secured Loan — Term Loan B<br>6.5% Cash, 1.0% PIK, Due 8/14 | 1,442,478 | 1,434,611 | 331,777 |
| Bicent Power LLC<br>*Utilities* | Junior Secured Loan — Advance (Second Lien)<br>4.6% Cash, Due 12/14 | 4,000,000 | 4,000,000 | 137,500 |
| Burger King Corporation<br>*Personal, Food and Miscellaneous Services* | Senior Secured Loan — Tranche B Term Loan<br>4.5% Cash, Due 10/16 | 2,872,500 | 2,872,500 | 2,827,359 |
| Caribe Media Inc. (fka Caribe Information Investments Incorporated)<br>*Printing and Publishing* | Senior Secured Loan — Loan 10.0%<br>Cash, Due 11/14 | 684,774 | 684,774 | 684,774 |
| CoActive Technologies LLC (fka CoActive Technologies, Inc.)<br>*Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Junior Secured Loan — Term Loan (Second Lien)<br>7.3% Cash, Due 1/15 | 2,000,000 | 1,983,174 | 1,552,200 |
| Del Monte Foods Company<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Initial Term Loan<br>4.5% Cash, Due 3/18 | 2,985,000 | 2,991,687 | 2,843,212 |
| eInstruction Corporation<br>*Healthcare, Education and Childcare* | Junior Secured Loan — Term Loan (Second Lien)<br>11.5% Cash, Due 7/14 | 10,000,000 | 10,000,000 | 9,489,000 |
| Freescale Semiconductor, Inc.<br>*Electronics* | Senior Subordinated Bond — 10.3% Cash, Due 12/16 | 3,000,000 | 3,007,007 | 3,135,000 |
| Ginn LA Conduit Lender, Inc.[8]<br>*Buildings and Real Estate[4]* | Senior Secured Loan — First Lien Tranche A Credit-Linked Deposit<br>7.8% Cash, Due 6/11 | 1,257,143 | 1,224,101 | 91,142 |
| Ginn LA Conduit Lender, Inc.[8]<br>*Buildings and Real Estate[4]* | Senior Secured Loan — First Lien Tranche B Term Loan<br>7.8% Cash, Due 6/11 | 2,694,857 | 2,624,028 | 195,377 |
| Ginn LA Conduit Lender, Inc.[8]<br>*Buildings and Real Estate[4]* | Junior Secured Loan — Loan (Second Lien)<br>11.8% Cash, Due 6/12 | 3,000,000 | 2,715,997 | 15,000 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| HMSC Corporation (aka Swett and Crawford)<br>*Insurance* | Junior Secured Loan — Loan (Second Lien)<br>5.8% Cash, Due 10/14 | $ 5,000,000 | $ 4,919,522 | $ 3,753,000 |
| Hunter Defense Technologies, Inc.<br>*Aerospace and Defense* | Junior Secured Loan — Term Loan (Second Lien)<br>7.3% Cash, Due 2/15 | 5,000,000 | 4,916,872 | 5,000,000 |
| Hunter Fan Company<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Junior Secured Loan — Loan (Second Lien)<br>7.0% Cash, Due 10/14 | 3,000,000 | 3,000,000 | 2,724,300 |
| International Architectural Products, Inc.[8]<br>*Mining, Steel, Iron and Non-Precious Metals* | Senior Secured Loan — Term Loan 12.0% Cash, 3.3% PIK, Due 5/15 | 530,803 | 504,240 | 437,913 |
| Jones Stephens Corp.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Term Loan<br>7.0% Cash, Due 9/15 | 4,889,912 | 4,889,912 | 4,889,912 |
| Kaseman Holdings and Sallyport Holdings<br>*Aerospace and Defense* | Mezzanine Investment — Mezzanine Notes<br>14.5% Cash, Due 6/17 | 11,250,597 | 10,931,428 | 11,588,115 |
| KIK Custom Products Inc.<br>*Personal and Non Durable Consumer Products (Mfg. Only)* | Junior Secured Loan — Loan (Second Lien)<br>5.3% Cash, Due 12/14 | 5,000,000 | 5,000,000 | 3,250,000 |
| LBREP/L-Suncal Master I LLC[8]<br>*Buildings and Real Estate[4]* | Senior Secured Loan — Term Loan (First Lien)<br>7.5% Cash, Due 1/10 | 3,401,921 | 3,401,921 | 359,923 |
| Legacy Cabinets, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Term Loan 1.0% Cash, 6.3% PIK, Due 5/14 | 492,944 | 463,380 | 253,817 |
| Merisant Company<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Loan 7.5% Cash, Due 1/14 | 5,049,291 | 5,030,584 | 5,043,232 |
| Metropolitan Health Networks, Inc.<br>*Healthcare, Education and Childcare* | Junior Secured Loan — Term Loan (Second Lien)<br>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.)<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Term B Facility<br>4.3% Cash, Due 2/18 | 1,925,767 | 1,870,004 | 1,910,120 |
| Neiman Marcus Group Inc., The<br>*Retail Stores* | Senior Secured Loan — Term Loan<br>4.8% Cash, Due 5/18 | 2,000,000 | 1,885,086 | 1,932,500 |
| Pegasus Solutions, Inc.<br>*Leisure, Amusement, Motion Pictures, Entertainment* | 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.[6]<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Preferred Stock — Preferred Stock, 14.0% PIK | 400,000 | 400,000 | 400,000 |
| Potters Holdings, II, L.P.<br>*Diversified/Conglomerate Manufacturing* | Junior Secured Loan — Term B Loan (Second Lien)<br>10.3% Cash, Due 11/17 | 7,000,000 | 6,905,447 | 7,000,000 |
| Trinseo Materials Operating S.C.A. (fka Styron S.A.R.L)[3]<br>*Chemicals, Plastics and Rubber* | Senior Secured Loan — Term Loan 6.0% Cash, Due 8/17 | 1,989,950 | 1,824,534 | 1,728,779 |
| TriZetto Group, Inc. (TZ Merger Sub, Inc.)<br>*Electronics* | Senior Secured Loan — Term Loan<br>4.8% Cash, Due 5/18 | 1,979,757 | 1,898,410 | 1,950,554 |
| TUI University, LLC<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term Loan (First Lien)<br>3.5% Cash, Due 10/14 | 3,040,242 | 2,978,384 | 2,626,161 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Twin-Star International, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Subordinated Bond — Senior Subordinated Note 13.0% Cash, Due 4/14 | $ 5,500,000 | $ 5,500,000 | $ 5,500,000 |
| Univar Inc.<br>*Chemicals, Plastics and Rubber* | Senior Secured Loan — Term B Loan 5.0% Cash, Due 6/17 | 2,984,925 | 2,984,925 | 2,886,049 |
| Vantiv, LLC (fka Fifth Third Processing Solutions, LLC)<br>*Electronics* | Senior Secured Loan — Term B-1 Loan (First Lien) 4.5% Cash, Due 11/16 | 1,989,975 | 1,992,299 | 1,988,482 |
| Vertafore, Inc.<br>*Electronics* | Senior Secured Loan — Term Loan (First Lien) 5.3% Cash, Due 7/16 | 1,989,956 | 1,933,723 | 1,952,147 |
| Walker Group Holdings LLC<br>Cargo Transport | Junior Secured Loan — Term Loan B 13.3% Cash, Due 12/13 | 416,737 | 416,737 | 416,737 |
| Walker Group Holdings LLC<br>*Cargo Transport* | Junior Secured Loan — Term Loan B 13.3% Cash, Due 12/13 | 3,957,614 | 3,957,614 | 3,957,614 |
| Warner Chilcott Company, LLC<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-2 Loan 4.3% Cash, Due 3/18 | 454,851 | 455,921 | 449,450 |
| Warner Chilcott Corporation<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-1 Loan 4.3% Cash, Due 3/18 | 909,703 | 911,841 | 898,900 |
| WC Luxco S.A.R.L. (Warner Chilcott)[3]<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-3 Loan 4.3% Cash, Due 3/18 | 625,421 | 626,891 | 617,994 |
| Wesco Aircraft Hardware Corp.<br>*Aerospace and Defense* | Senior Secured Loan — Tranche B Term Loan 4.3% Cash, Due 4/17 | 2,590,244 | 2,584,560 | 2,599,154 |
| **Total Investment in Debt Securities (56% of net asset value at fair value)** | | $ 136,034,039 | $134,311,238 | $114,673,506 |

**Equity Portfolio**

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

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment | Percentage Interest/Shares | Cost | Value[2] |
|---|---|---|---|---|
| Plumbing Holdings Corporation[6] *Home and Office Furnishings, Housewares, and Durable Consumer Products* | Common | 7.8% | $ — | $ — |
| Plumbing Holdings Corporation[6] *Home and Office Furnishings, Housewares, and Durable Consumer Products* | Preferred Stock | 1550.0% | 2,716,618 | 2,270,821 |
| Caribe Media Inc. (fka Caribe Information Investments Incorporated)[6] | Common | 1.3% | 359,765 | 538,969 |
| **Total Investment in Equity Securities (3% of net asset value at fair value)** | | | $16,559,610 | $ 6,040,895 |

**CLO Fund Securities**

**CLO Equity Investments**

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

**CLO Rated — Note Investment**

| Portfolio Company | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Katonah 2007-I CLO Ltd.[3], [7], [10] | Class B-2L Notes Par Value of $10,500,000 100.0%, Due 4/22 | 100.0% | $ 1,212,612 | $ 6,675,717 |
| **Total Investment in CLO Rated — Note** | | | $ 1,212,612 | $ 6,675,717 |
| **Total Investment in CLO Fund Securities (24% of net asset value at fair value)** | | | $66,528,482 | $ 48,438,317 |

**Asset Manager Affiliates**

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

See accompanying notes to financial statements.

**Time Deposits and Money Market Account**

| Time Deposits and Money Market Account | Investment | Yield | Par/Cost | Value[2] |
|---|---|---|---|---|
| JP Morgan Asset Account | Time Deposit | 0.0% | $ 229,152 | $ 229,152 |
| JP Morgan Business Money Market Account[9] | 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 |
| **Total Investment in Time Deposit and Money Market Accounts (16% of net asset value at fair value)** | | | $ 31,851,286 | $ 31,851,286 |
| **Total Investments[5] (118% of net asset value at fair value)** | | | $293,588,917 | $241,818,004 |

(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 December 31, 2011.

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

(5) 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.

(6) Non-income producing.

(7) An affiliate CLO Fund managed by an Asset Manager Affiliate.

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

See accompanying notes to financial statements.

**KCAP FINANCIAL, INC.**

**FINANCIAL HIGHLIGHTS**
**(unaudited)**

| | Six Months Ended June 30, | |
|---|---|---|
| | 2012 | 2011 |
| **Per Share Data:** | | |
| Net asset value, at beginning of period | $ 7.85 | $ 8.21 |
| Net income (loss) | | |
| Net investment income[1] | 0.38 | 0.33 |
| Net realized losses[1] | 0.01 | (0.60) |
| Net change in unrealized appreciation/depreciation on investments[1] | (0.43) | 0.70 |
| Net income (loss) | (0.04) | 0.43 |
| Net decrease in net assets resulting from distributions | | |
| From net investment income | (0.18) | (0.17) |
| Net decrease in net assets resulting from distributions | (0.18) | (0.17) |
| 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 | 0.03 |
| Stock based compensation expense | 0.02 | 0.02 |
| Net increase in net assets relating to stock-based transactions | 0.03 | 0.05 |
| Net asset value, end of period | $ 7.66 | $ 8.52 |
| Total net asset value return[2] | (0.2)% | 5.8% |
| **Ratio/Supplemental Data:** | | |
| Per share market value at beginning of period | $ 6.31 | $ 6.97 |
| Per share market value at end of period | $ 7.26 | $ 7.95 |
| Total market return[3] | 17.9% | 16.5% |
| Shares outstanding at end of period | 26,664,132 | 22,841,172 |
| Net assets at end of period | $204,160,309 | $194,591,919 |
| Portfolio turnover rate[4] | 10.9% | 13.0% |
| Average debt outstanding | $ 67,604,396 | $ 47,848,320 |
| Asset coverage ratio | 351% | 424% |
| Ratio of net investment income to average net assets[5] | 9.7% | 7.6% |
| Ratio of total expenses to average net assets[5] | 7.3% | 5.7% |
| Ratio of interest expense to average net assets[5] | 3.1% | 1.7% |
| Ratio of non-interest expenses to average net assets[5] | 4.2% | 4.0% |

(1) Based on weighted average number of common shares outstanding for the period.

(2) 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.

(3) 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.

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

(5) 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 registered investment adviser and 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 June 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.

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
**(unaudited)**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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 recogning 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 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. 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

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**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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 2011 and 2010, 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:

1) 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 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*.
2) If an investment does not have a market quotation on either a broad market exchange or from an independent 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.
4) Illiquid loans, junior and mezzanine securities, equity investments, CLO Fund securities and the investment in the Asset Manager Affiliates may be selected for review by an independent valuation

**KCAP FINANCIAL, INC.**

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**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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.

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

7) The Board of Directors discusses the valuations and determines in good faith that the fair values of each investment 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

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**NOTES TO FINANCIAL STATEMENTS**
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**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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

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**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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 June 30, 2012, four 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.

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
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**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

***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 June 30, 2012, there was an unamortized debt issuance cost of approximately $1.8 million included in other assets in the accompanying balance sheet. Amortization expense for the six months ended June 30, 2012 and 2011 was approximately $236,000 and $162,000, 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 $397,000 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.

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
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**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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.

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## 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 six months ended June 30, 2012 and 2011 (unaudited):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Net increase in net assets from operations | $ 1,617,455 | $ 873,830 | $ 2,194,109 | $10,478,462 |
| Net decrease in net assets allocated to unvested share awards | (19,531) | (12,423) | (27,971) | (151,477) |
| Net increase in net assets available to common stockholders | 1,597,924 | 861,407 | 2,166,138 | 10,326,985 |
| Weighted average number of common shares outstanding for basic shares computation | 26,311,527 | 25,503,115 | 25,127,507 | 22,479,881 |
| Effect of dilutive securities – stock options | — | — | — | 13,787 |
| Weighted average number of common and common stock equivalent shares outstanding for diluted shares computation | 26,311,527 | 25,503,115 | 25,127,507 | 22,493,668 |
| Net increase in net assets per basic common shares: | | | | |
| Net increase in net assets from operations | 0.06 | 0.03 | 0.09 | 0.47 |
| Net decrease in net assets allocated to unvested share awards | (0.00) | (0.00) | (0.00) | (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 40,000 shares were not included in the computation of diluted earnings per share for the period ended June 30, 2012 because the effect was not materially dilutive. Options to purchase 40,000 shares were included in the computation of diluted earnings per share for the period ended June 30, 2011, with a dilutive effect of 13,787 shares. For the periods ended June 30, 2012 and June 30, 2011, options to purchase 20,000 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 and six months ended June 30, 2012, the effect of the convertible debt was anti-dilutive.

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

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**3. EARNINGS PER SHARE – (continued)**

$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. 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 June 30, 2012 and December 31, 2011:

| | June 30, 2012 (unaudited) | | | December 31, 2011 | | |
|---|---|---|---|---|---|---|
| **Security Type** | **Cost** | **Fair Value** | **%[1]** | **Cost** | **Fair Value** | **%[1]** |
| Time Deposits | $ 17,098 | $ 17,098 | — % | $ 229,152 | $ 229,152 | — % |
| Money Market Account | 10,790,686 | 10,790,686 | 5 | 31,622,134 | 31,622,134 | 18 |
| Senior Secured Loan | 79,181,776 | 70,444,927 | 34 | 54,045,184 | 45,259,328 | 25 |
| Junior Secured Loan | 59,984,315 | 43,399,869 | 21 | 58,936,728 | 47,300,172 | 26 |
| Mezzanine Investment | 10,950,636 | 11,588,115 | 6 | 10,931,428 | 11,588,115 | 6 |
| Senior Subordinated Bond | 17,383,292 | 17,435,390 | 9 | 9,997,898 | 10,125,891 | 6 |
| CLO Fund Securities | 79,407,564 | 63,883,515 | 31 | 65,820,840 | 48,438,317 | 27 |
| Equity Securities | 16,559,610 | 7,719,242 | 4 | 16,559,610 | 6,040,895 | 3 |
| Preferred | 400,000 | 395,720 | — | 400,000 | 400,000 | — |
| Asset Manager Affiliates | 83,419,910 | 72,896,000 | 36 | 44,338,301 | 40,814,000 | 23 |
| Total | $358,094,887 | $298,570,562 | 146% | $292,881,275 | $241,818,004 | 134% |

(1) Calculated as a percentage of net asset value.

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

| | June 30, 2012 (unaudited) | | | December 31, 2011 | | |
|---|---|---|---|---|---|---|
| **Industry Classification** | **Cost** | **Fair Value** | **%[1]** | **Cost** | **Fair Value** | **%[1]** |
| Aerospace and Defense | $ 19,716,746 | $ 19,274,720 | 9% | $ 19,683,821 | $ 19,439,230 | 11% |
| Asset Management Companies[2] | 83,419,910 | 72,896,000 | 36 | 44,338,301 | 40,814,000 | 23 |
| Automobile | 4,970,281 | 4,934,202 | 3 | — | — | — |
| Beverage, Food and Tobacco | 18,970,913 | 19,008,315 | 9 | 9,892,275 | 9,796,565 | 5 |
| Broadcasting and Entertainment | 3,970,685 | 3,976,312 | 2 | — | — | — |
| Buildings and Real Estate[3] | 18,591,674 | 519,378 | — | 18,591,674 | 662,443 | — |
| Cargo Transport | — | — | — | 4,374,351 | 4,374,351 | 2 |
| Chemicals, Plastics and Rubber | 4,799,852 | 4,781,126 | 2 | 4,809,459 | 4,614,828 | 3 |
| CLO Fund Securities | 79,407,564 | 63,883,515 | 31 | 65,820,839 | 48,438,317 | 27 |
| Containers, Packaging and Glass | 1,952,878 | 1,923,599 | 1 | — | — | — |
| Diversified/Conglomerate Manufacturing | 6,913,503 | 7,108,500 | 3 | 6,905,447 | 7,000,000 | 4 |

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**4. INVESTMENTS – (continued)**

| | June 30, 2012 (unaudited) | | | December 31, 2011 | | |
|---|---|---|---|---|---|---|
| **Diversified/Conglomerate Service** | **5,525,008** | **3,148,720** | **2** | **2,870,642** | **372,599** | **—** |
| Electronics | 9,138,837 | 9,222,784 | 5 | 8,831,441 | 9,026,186 | 5 |
| Finance | 1,788,204 | 1,840,130 | 1 | — | — | — |
| Healthcare, Education and Childcare | 20,965,362 | 13,542,303 | 7 | 20,956,582 | 19,523,824 | 11 |
| Home and Office Furnishings, Housewares, and Durable Consumer Products | 19,070,930 | 19,677,879 | 10 | 21,683,112 | 20,604,850 | 11 |
| Insurance | 4,934,081 | 4,131,500 | 2 | 4,919,522 | 3,753,000 | 2 |
| Leisure, Amusement, Motion Pictures, Entertainment | 2,387,800 | 2,071,525 | 1 | 2,290,892 | 2,084,012 | 1 |
| Machinery (Non-Agriculture, Non-Construction, Non-Electronic) | 11,405,906 | 12,712,450 | 6 | 3,483,174 | 3,891,900 | 2 |
| Mining, Steel, Iron and Non-Precious Metals | 791,965 | 274,352 | — | 797,091 | 438,913 | — |
| Personal and Non Durable Consumer Products (Mfg. Only) | 5,000,000 | 3,431,250 | 2 | 5,000,000 | 3,250,000 | 2 |
| Personal, Food and Miscellaneous Services | 4,731,557 | 4,700,243 | 2 | 2,872,500 | 2,827,359 | 2 |
| Personal Transportation | 2,025,078 | 1,990,511 | 1 | 2,993,092 | 2,983,648 | 2 |
| Printing and Publishing | 3,017,894 | 3,139,404 | 2 | 1,044,539 | 1,223,743 | 1 |
| Retail Stores | 6,684,451 | 6,664,961 | 3 | 1,885,086 | 1,932,500 | 1 |
| Telecommunications | 2,969,402 | 2,678,707 | 1 | 2,986,151 | 2,776,950 | 2 |
| Time Deposit and Money Market Accounts | 10,807,784 | 10,807,784 | 5 | 31,851,287 | 31,851,286 | 18 |
| Utilities | 4,136,622 | 230,392 | — | 4,000,000 | 137,500 | — |
| Total | $358,094,887 | $298,570,562 | 146% | $292,881,278 | $241,818,004 | 135% |

(1) Calculated as a percentage of net asset value.

(2) Represents the Asset Manager Affiliates.

(3) 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.

**KCAP FINANCIAL, INC.**

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**4. INVESTMENTS – (continued)**

At June 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 June 30, 2012 and December 31, 2011, the Company's ten largest portfolio companies represented approximately 55% and 62%, respectively, of the total fair value of its investments. The Company's largest investment, the Asset Manager Affiliates represented 24% and 17% of the total fair value of the Company's investments at June 30, 2012 and December 31, 2011, respectively. Excluding Asset Manager Affiliates and CLO Fund securities, the Company's ten largest portfolio companies represented approximately 21% and 26% of the total fair value of the Company's investments at June 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 June 30, 2012 and December 31, 2011, the Company had approximately $64 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 June 30, 2012 was approximately $79 million and aggregate unrealized depreciation on the CLO Fund securities totaled approximately $16 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 hierarchal 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").

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
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**4. INVESTMENTS – (continued)**

*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. Substantially all of the Company's investments are classified as Level III. 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.

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
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**4. INVESTMENTS – (continued)**

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

**As of June 30, 2012 (unaudited)**

| | Level I | Level II | Level III | Total |
|---|---|---|---|---|
| Time deposit and money market account | $ — | $10,807,784 | $ — | $ 10,807,784 |
| Debt securities | — | 74,908,187 | 68,355,834 | 143,264,021 |
| CLO Fund securities | — | — | 63,883,515 | 63,883,515 |
| Equity securities | — | — | 7,719,242 | 7,719,242 |
| Asset Manager Affiliates | — | — | 72,896,000 | 72,896,000 |

**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 |

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. For all periods presented, the Asset Manager Affiliates have not earned any incentive fees.

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

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**NOTES TO FINANCIAL STATEMENTS**
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**4. INVESTMENTS – (continued)**

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 2011 and 2010, 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.

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**NOTES TO FINANCIAL STATEMENTS**
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**4. INVESTMENTS – (continued)**

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:

| | Six Months Ended June 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[1] | (4,521,640) | — | — | — | (4,521,640) |
| Transfers into of Level III[1] | 273,352 | — | — | — | 273,352 |
| Net accretion of interest | 83,333 | 2,905,399 | — | — | 2,988,732 |
| Purchases | 6,533,958 | 12,000,000 | — | 13,521,609 | 32,055,567 |
| Issuance of Common Stock | — | — | — | 25,560,000 | — |
| Sales | (10,429,744) | — | | | (10,429,744) |
| Total realized and unrealized gains (losses) included in earnings | (6,678,102) | 2,566,116 | 1,678,347 | (6,999,609) | (9,433,248) |
| Balance, June 30, 2012 | $ 68,355,834 | $ 63,883,515 | $ 7,719,242 | $72,896,000 | $212,854,591 |
| Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date | $ (5,112,878) | $ 2,566,116 | $ 1,678,347 | $ (6,999,609) | $ (7,868,024) |

(1) The transfers to Level II from Level III in the six months ended June 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 six months ended June 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 six months ended June 30, 2012.

| | Six Months Ended June 30, 2011 (unaudited) | | | | |
|---|---|---|---|---|---|
| | Debt Securities | CLO Fund Securities | Equity Securities | Asset Manager Affiliates | Total |
| 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[1] | — | — | — | — | — |
| Net accretion of discount | 53,483 | 39,738 | — | — | 93,221 |
| Purchases | 49,236,831 | — | 2,858,387 | — | 52,095,218 |
| Sales | (28,062,998) | (1,935,000) | (141,769) | (149,213) | (30,288,980) |
| Total realized and unrealized gains (losses) included in earnings | 1,173,299 | 1,225,262 | (684,918) | 857,213 | 2,570,856 |
| Balance, June 30, 2011 | $113,443,543 | $52,361,000 | $ 6,720,532 | $42,201,000 | $214,726,075 |
| Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date | $ 13,718,113 | $ 2,440,262 | $ (684,918) | $ 857,213 | $ 16,330,670 |

(1) For the six months ended June 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 six months ended June 30, 2011.

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
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**4. INVESTMENTS – (continued)**

As of June 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 $85,715,971 as of June 30, 2012.

As of June 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 | $ 58,734,134 | Income Approach | Market yield | 4.8% – 15.5% |
| | $ 9,621,700 | Enterprise value | Average EBITDA multiple | 5.4x – 8.9x |
| | | | Weighted average cost of capital | 10.5% – 11.5% |
| Equity securities | $ 7,719,242 | Enterprise value | Average EBITDA multiple | 4.1x – 7.8x |
| | | | Weighted average cost of capital | 11.1% – 15.7% |
| CLO Fund securities | $ 63,883,595 | Discounted cash flow | Discount rate | 12.5% – 16.0% |
| | | | Probability of default | 1.2% – 4.0% |
| | | | Loss severity | 25% – 45% |
| | | | Recovery rate | 55% – 75% |
| | | | Prepayment rate | 10% – 20% |
| Asset Manager Affiliates | $ 72,896,000 | Discounted cash flow | Discount rate | 1.4% – 13.5% (weighted average 9.54%) |

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

**KCAP FINANCIAL, INC.**

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**4. INVESTMENTS – (continued)**

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 June 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 $73 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 six months ended June 30, 2012, the Asset Manager Affiliates made distributions of $2,025,000 to the Company. For the six months ended June 30, 2011, the Asset Manager Affiliates made distributions of $650,000 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

KCAP FINANCIAL, INC.

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**5. ASSET MANAGER AFFILIATES – (continued)**

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 June 30, 2012 | As of December 31, 2011 |
|---|---|---|
| Investments of CLO Funds, at fair value | $3,294,721,726 | $ 1,768,088,977 |
| Restricted cash of CLO Funds | 118,728,581 | 71,888,141 |
| Total assets | 3,473,641,279 | 1,855,513,431 |
| CLO Fund liabilities, at fair value | 3,035,738,008 | 1,727,560,760 |
| Total liabilities | 3,064,199,810 | 1,753,442,181 |
| Appropriated retained earnings of consolidated VIEs | 366,214,772 | 95,845,268 |

**Asset Manager Affiliates**

Summarized Statements of Operations Information (unaudited)

| | For the three months ended June 30, | | For the six months ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Interest income – CLO Fund investments | $ 31,546,365 | $ 16,408,094 | $ 61,311,055 | $ 32,484,704 |
| Total income | 34,461,811 | 17,403,050 | 66,457,780 | 35,784,667 |
| Interest expense of CLO Fund liabilities | 27,730,344 | 13,619,677 | 58,271,673 | 26,227,097 |
| Total expenses | 32,418,761 | 15,785,020 | 67,005,566 | 31,030,360 |
| Net realized and unrealized gains (losses) | 180,512,853 | 29,111,092 | 174,285,895 | 5,592,512 |
| Net income (loss) attributable to consolidated VIEs | 182,189,641 | 30,311,613 | 173,573,693 | 10,251,467 |

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.

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**5. ASSET MANAGER AFFILIATES – (continued)**

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 $23 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 $3.5 million per year over such period.

At June 30, 2012 there were no intercompany balances with our affiliates. At December 31, 2011 there was an intercompany balance of $391 due from our affiliates.

**6. BORROWINGS**

The Company's debt obligations consist of the following:

| | As of June 30, 2012 | As of December 31, 2011 |
|---|---|---|
| | (unaudited) | |
| Convertible Senior Notes, due March 15, 2016 | 60,000,000 | 60,000,000 |
| Secured credit facility, due December 20, 2014 | 21,500,000 | — |

*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.

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
**(unaudited)**

**6. BORROWINGS – (continued)**

As of June 30, 2012, there was an outstanding balance of $21,500,000 under the Facility and the Company was in compliance with all its debt covenants. As of June 30, 2012, the Company had restricted cash balances of approximately $815,000 which it maintained 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 $397,000 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 an initial conversion rate of 118.5255 shares of common stock per $1,000 principal amount of Convertible Senior Notes, which is equivalent to an initial conversion price of approximately $8.44 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.

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
**(unaudited)**

**6. BORROWINGS – (continued)**

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 $1.7 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 $61.2 million at June 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 six months ended June 30, 2012:

| | Six Months Ended June 30, 2012 |
|---|---|
| | (unaudited) |
| Net increase in net assets resulting from operations | $ 2,194,109 |
| Net change in unrealized (appreciation) depreciation from investments | 7,753,413 |
| Excess capital losses over capital gains | (304,421) |
| Income not on GAAP books currently taxable | 69,944 |
| Income not currently taxable | (36,840) |
| Expenses not currently deductible | 23,452 |
| Taxable income before deductions for distributions | $ 9,699,657 |
| Taxable income before deductions for distributions per weighted average shares for the period | $ 0.36 |

For the quarter ended June 30, 2012, the Company declared a dividend on June 18, 2012 of $0.24 per share for a total of approximately $6.3 million. The record date was July 6, 2012 and the dividend was distributed on July 27, 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

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
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**7. DISTRIBUTABLE TAXABLE INCOME – (continued)**

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 June 30, 2012, the Company had a net capital loss carryforward of approximately $50 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.

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

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
**(unaudited)**

**8. COMMITMENTS AND CONTINGENCIES – (continued)**

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 six months ended June 30, 2012 and the year ended December 31, 2011, the Company issued 43,074 and 141,278 shares, respectively, of common stock under its dividend reinvestment plan. During the six months ended June 30, 2012 the Company issued 3,600,000 shares in connection with the acquisition of Trimaran Advisors. For the six months ended June 30, 2012, 54,626 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 June 30, 2012 and December 31, 2011 was 26,664,132 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.

KCAP FINANCIAL, INC.

NOTES TO FINANCIAL STATEMENTS
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**10. EQUITY INCENTIVE PLAN – (continued)**

*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 June 30, 2012 is as follows:

| | Shares | Weighted Average Exercise Price per Share | Weighted Average Contractual Remaining Term (years) | Aggregate Intrinsic Value[1] |
|---|---|---|---|---|
| Options outstanding at January 1, 2011 | 60,000 | $ 7.24 | | |
| Granted | — | $ 7.24 | | |
| Exercised | — | $ — | | |
| Forfeited | — | $ — | | |
| Options outstanding at December 31, 2011 | 60,000 | $ 7.24 | | |
| Granted | — | $ — | | |
| Exercised | — | $ — | | |
| Forfeited | — | $ — | | |
| Outstanding at June 30, 2012 | 60,000 | $ 7.24 | 7.0 | $ 95,200 |
| Total vested at June 30, 2012 | 60,000 | $ 7.24 | 7.0 | |

(1) Represents the difference between the market value of shares of the Company upon exercise of the options at June 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 six months ended June 30, 2012, the Company recognized no non-cash compensation expense related to stock options. For the six months ended June 30, 2011, the Company recognized non-cash compensation expense related to stock options of approximately $7,000. At June 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

KCAP FINANCIAL, INC.

NOTES TO FINANCIAL STATEMENTS
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**10. EQUITY INCENTIVE PLAN – (continued)**

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 June 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 six months ended June 30, 2012, 54,626 shares of restricted stock had vested. As of June 30, 2012, there were options to purchase 60,000 shares of common stock outstanding and there were 301,560 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 June 30, 2012 is as follows:

| | Unvested Restricted Shares | Weighted Average 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 | $ 8.26 |
| Vested | (54,626) | $ — |
| Forfeited | — | $ — |
| Outstanding at June 30, 2012 | 301,560 | $ 5.52 |
| Total unvested shares at June 30, 2012 | — | $ 5.52 |

For the six months ended June 30, 2012, non-cash compensation expense related to restricted stock was approximately $339,000; of this amount approximately $329,000 was expensed at the Company and approximately $10,000 was a reimbursable expense allocated to the Asset Manager Affiliates. For the six months ended June 30, 2011, non-cash compensation expense related to restricted stock was approximately $451,000; of this amount approximately $371,000 was expensed at the Company and approximately $80,000 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 June 30, 2012, there was approximately $967,000 of total unrecognized compensation cost related to unvested share-based awards. That cost is expected to be recognized over a weighted average period of 2 years.

**KCAP FINANCIAL, INC.**

**NOTES TO FINANCIAL STATEMENTS**
**(unaudited)**

## 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 six months ended June 30, 2012 and 2011, the Company made contributions to the 401K Plan of approximately $34,000 and $13,000, 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 six months ended June 30, 2012, the Company made a contribution of approximately $70,000 to the Pension Plan and a contribution of $69,000 to the Pension Plan for the six months ended June 30, 2011.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders of
**Kohlberg Capital Corporation**

We have audited the accompanying balance sheets, including the schedule of investments, of Kohlberg Capital Corporation and subsidiary (collectively, the "Company") (a Delaware corporation) as of December 31, 2011 and 2010, and the related statements of operations, changes in net assets and cash flows for each of the three years in the period ended December 31, 2011 and financial highlights for each of the five years in the period ended December 31, 2011. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our procedures included confirmation of investments owned as of December 31, 2011 and 2010. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Kohlberg Capital Corporation and subsidiary as of December 31, 2011 and 2010, and the results of their operations, changes in their net assets and their cash flows for each of the three years in the period ended December 31, 2011 and the financial highlights for each of the five years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Kohlberg Capital Corporation and subsidiary's internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), and our report dated March 15, 2012 expressed an unqualified opinion.

/s/ GRANT THORNTON LLP

New York, New York
March 15, 2012

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders of
**Kohlberg Capital Corporation**

We have audited Kohlberg Capital Corporation and subsidiary's (collectively, the "Company") (a Delaware Corporation) internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, Kohlberg Capital Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control — Integrated Framework* issued by COSO.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the accompanying balance sheets of the Company, including the schedule of investments as of December 31, 2011 and 2010, and the related statements of operations, changes in net assets, and cash flows for each of the three years in the period ended December 31, 2010 and financial highlights for each of the five years in the period ended December 31, 2011, and our report dated March 15, 2012 expressed an unqualified opinion.

/s/ GRANT THORNTON LLP

New York, New York
March 15, 2012

## KOHLBERG CAPITAL CORPORATION

## BALANCE SHEETS

| | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| **ASSETS** | | |
| Investments at fair value: | | |
| Time deposits (cost: 2011 – $229,152; 2010 – $720,225) | $ 229,152 | $ 720,225 |
| Money market account (cost: 2011 – $31,622,134; 2010 – $210,311) | 31,622,134 | 210,311 |
| Debt securities (cost: 2011 – $134,311,238; 2010 – $126,545,510) | 114,673,506 | 91,042,928 |
| CLO fund securities managed by non-affiliates (cost: 2011 – $12,544,303; 2010 – $15,690,983) | 2,732,000 | 4,921,000 |
| CLO fund securities managed by affiliate (cost: 2011 – $52,665,506; 2010 – $52,589,217) | 43,680,000 | 48,110,000 |
| Equity securities (cost: 2011 – $16,559,610; 2010 – $13,483,227) | 6,040,895 | 4,688,832 |
| Asset manager affiliates (cost: 2011 – $44,338,301; 2010 – $44,532,329) | 40,814,000 | 41,493,000 |
| Total Investments at fair value | 239,791,687 | 191,186,296 |
| Cash | 2,555,259 | 10,175,488 |
| Restricted cash | — | 67,023,170 |
| Interest and dividends receivable | 2,548,895 | 2,574,115 |
| Receivable for open trades | — | 7,681,536 |
| Accounts Receivable | 859,156 | 851,020 |
| Due from affiliates | 3,517 | — |
| Other assets | 2,375,147 | 331,061 |
| Total assets | $248,133,661 | $ 279,822,686 |
| **LIABILITIES** | | |
| Borrowings | $ — | $ 86,746,582 |
| Convertible Senior Notes | 60,000,000 | — |
| Accounts payable and accrued expenses | 3,527,682 | 2,337,767 |
| Dividend payable | 4,080,037 | 3,812,670 |
| Total liabilities | $ 67,607,719 | $ 92,897,019 |
| **STOCKHOLDERS' EQUITY** | | |
| Common stock, par value $0.01 per share, 100,000,000 common shares authorized; 22,992,211 and 22,767,130 common shares issued and outstanding at December 31, 2011 and December 31, 2010, respectively. | $ 226,648 | $ 224,274 |
| Capital in excess of par value | 284,571,466 | 282,794,025 |
| Accumulated undistributed net investment income | 1,008,783 | 818,664 |
| Accumulated net realized losses | (52,802,400) | (34,325,792) |
| Net unrealized depreciation on investments | (52,478,555) | (62,585,504) |
| Total stockholders' equity | $180,525,942 | $ 186,925,667 |
| Total liabilities and stockholders' equity | $248,133,661 | $ 279,822,686 |
| NET ASSET VALUE PER COMMON SHARE | $ 7.85 | $ 8.21 |

See accompanying notes to financial statements.

## KOHLBERG CAPITAL CORPORATION

## STATEMENTS OF OPERATIONS

| | For the Year Ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| **Investment Income:** | | | |
| Interest from investments in debt securities | $ 9,438,493 | $ 14,409,069 | $ 24,157,213 |
| Interest from cash and time deposits | 21,938 | 21,531 | 17,956 |
| Dividends from investments in CLO fund securities managed by non-affiliates | 1,984,177 | 1,837,024 | 1,296,349 |
| Dividends from investments in CLO fund securities managed by affiliate | 12,565,859 | 8,371,007 | 8,025,695 |
| Dividends from affiliate asset manager | 1,910,000 | 4,500,000 | — |
| Capital structuring service fees | 86,057 | 215,233 | 399,338 |
| Other Income | 2,000,000 | — | — |
| Total investment income | 28,006,524 | 29,353,864 | 33,896,551 |
| **Expenses:** | | | |
| Interest and amortization of debt issuance costs | 4,588,482 | 7,088,202 | 9,276,563 |
| Compensation | 3,907,900 | 3,322,895 | 3,222,604 |
| Professional fees | 2,010,253 | 5,411,499 | 1,691,832 |
| Insurance | 493,305 | 419,942 | 359,062 |
| Administrative and other | 987,381 | 1,214,207 | 990,835 |
| Total expenses | 11,987,321 | 17,456,745 | 15,540,896 |
| **Net Investment Income before Income Tax Expense** | **16,019,203** | **11,897,119** | **18,355,655** |
| Excise taxes | — | — | (25,000) |
| **Net Investment Income** | **16,019,203** | **11,897,119** | **18,330,655** |
| **Realized And Unrealized Gains (Losses) On Investments:** | | | |
| Net realized gain loss from investment transactions | (18,476,608) | (17,862,984) | (15,782,121) |
| Net change in unrealized appreciation (depreciation) on: | | | |
| Debt securities | 15,864,850 | 9,196,912 | 25,300,586 |
| Equity securities | (1,724,319) | (1,142,038) | (7,485,064) |
| CLO fund securities managed by affiliate | (4,506,289) | 3,079,974 | 12,986,453 |
| CLO fund securities managed by non-affiliates | 957,680 | 894,877 | (473,907) |
| Affiliate asset manager investments | (484,973) | (20,352,537) | 1,526,668 |
| Net realized and unrealized appreciation (depreciation) on investments | (8,369,659) | (26,185,796) | 16,072,615 |
| **Net Increase (Decrease) In Stockholders' Equity Resulting From Operations** | **$ 7,649,544** | **$(14,288,677)** | **$ 34,403,270** |
| Net Increase (Decrease) in Stockholders' Equity Resulting from Operations per Common Share: | | | |
| Basic: | $ 0.33 | $ (0.64) | $ 1.56 |
| Diluted: | $ 0.33 | $ (0.64) | $ 1.56 |
| Net Investment Income Per Common Share: | | | |
| Basic: | $ 0.70 | $ 0.53 | $ 0.83 |
| Diluted: | $ 0.70 | $ 0.53 | $ 0.83 |
| Weighted Average Shares of Common Stock Outstanding – Basic | 22,868,648 | 22,283,088 | 22,105,800 |
| Weighted Average Shares of Common Stock Outstanding – Diluted | 22,880,674 | 22,283,088 | 22,105,800 |

See accompanying notes to financial statements.

## KOHLBERG CAPITAL CORPORATION

## STATEMENTS OF CHANGES IN NET ASSETS

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| **Operations:** | | | |
| Net investment income | $ 16,019,203 | $ 11,897,119 | $ 18,330,655 |
| Net realized gain loss from investment transactions | (18,476,608) | (17,862,984) | (15,782,121) |
| Net change in unrealized gain (loss) on investments | 10,106,949 | (8,322,812) | 31,854,736 |
| Net increase (decrease) in net assets resulting from operations | 7,649,544 | (14,288,677) | 34,403,270 |
| **Shareholder distributions:** | | | |
| Dividends from net investment income to common stockholders | (15,802,712) | (11,897,119) | (18,330,654) |
| Dividends from net investment income to restricted stockholders | (26,373) | (55,404) | (125,053) |
| Common Stock Dividends in excess of net investment income | — | (3,269,688) | (1,747,018) |
| Net decrease in net assets resulting from stockholder distributions | (15,829,085) | (15,222,211) | (20,202,725) |
| **Capital share transactions:** | | | |
| Issuance of common stock for: | | | |
| Dividend reinvestment plan | 1,006,205 | 1,621,074 | 2,218,818 |
| Vesting of restricted stock | 961 | 647 | 1,223 |
| Stock based compensation | 772,650 | 919,111 | 909,119 |
| Net increase in net assets resulting from capital share transactions | 1,779,816 | 2,540,832 | 3,129,160 |
| Net assets at beginning of period | 186,925,667 | 213,895,723 | 196,566,018 |
| Net assets at end of period (including accumulated undistributed net investment income of $1,008,783, $818,664, and $1,326,380 in 2011, 2010, and 2009, respectively. | $180,525,942 | $186,925,667 | $ 213,895,723 |
| Net asset value per common share | $ 7.85 | $ 8.21 | $ 9.56 |
| Common shares outstanding at end of period | 22,992,211 | 22,767,130 | 22,363,281 |

See accompanying notes to financial statements.

## KOHLBERG CAPITAL CORPORATION

## STATEMENTS OF CASH FLOWS

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| OPERATING ACTIVITIES: | | | |
| Net increase (decrease) in stockholders' equity resulting from operations | $ 7,649,544 | $ (14,288,677) | $ 34,403,270 |
| Adjustments to reconcile net increase (decrease) in stockholders' equity resulting from operations to net cash provided by operations: | | | |
| Net realized losses on investment transactions | 18,476,608 | 17,862,984 | 15,782,121 |
| Net change in unrealized (appreciation) depreciation on investments | (10,106,949) | 8,322,812 | (31,854,736) |
| Net accretion of discount on securities and loans | (235,789) | (466,826) | (1,706,928) |
| Amortization of debt issuance cost | 22,908 | 595,614 | 824,695 |
| Amortization of convertible notes offering cost | 375,597 | — | — |
| Purchases of investments | (115,976,563) | (12,018,942) | (13,581,354) |
| Capital contribution to (from) affiliate asset manager | 194,027 | (3,780,817) | (3,600,016) |
| Payment-in-kind interest income | (469,329) | (820,262) | (3,801) |
| Proceeds from sale and redemption of investments | 67,194,142 | 204,092,344 | 81,459,787 |
| Stock based compensation expense | 772,650 | 919,112 | 909,121 |
| Changes in operating assets and liabilities: | | | |
| Decrease in interest and dividends receivable | 25,219 | 1,261,916 | 332,567 |
| Increase in accounts receivable | (8,135) | — | — |
| (Increase) Decrease in other assets | (72,137) | (286,473) | 251,550 |
| (Increase) Decrease in due from affiliates | (3,517) | 44,274 | 346,315 |
| Increase (decrease) in accounts payable and accrued expenses | 1,189,915 | (1,570,996) | (6,661) |
| Net cash provided by (used in) operating activities | (30,971,809) | 199,866,063 | 83,555,930 |
| FINANCING ACTIVITIES: | | | |
| Issuance of stock (net of offering costs) | — | 647 | 1,223 |
| Dividends paid in cash | (14,554,554) | (14,200,702) | (19,451,339) |
| Cash paid on repayment of debt | (86,746,582) | (131,303,781) | (43,640,786) |
| Convertible notes offering costs | (2,370,454) | — | — |
| Issuance of Convertible Senior Notes | 60,000,000 | — | — |
| (Increase) Decrease in restricted cash | 67,023,170 | (48,327,147) | (16,576,032) |
| Net cash provided by (used in) financing activities | 23,351,580 | (193,830,983) | (79,666,934) |
| CHANGE IN CASH | (7,620,229) | 6,035,080 | 3,888,996 |
| CASH, BEGINNING OF YEAR | 10,175,488 | 4,140,408 | 251,412 |
| CASH, END OF YEAR | $ 2,555,259 | $ 10,175,488 | $ 4,140,408 |
| Supplemental Information: | | | |
| Interest paid during the year | $ 2,745,968 | $ 7,195,181 | $ 8,297,586 |
| Non-cash dividends paid during the year under the dividend reinvestment plan | $ 1,007,164 | $ 1,621,074 | $ 2,218,818 |

See accompanying notes to financial statements.

## KOHLBERG CAPITAL CORPORATION

## SCHEDULE OF INVESTMENTS
## As of December 31, 2011

### Debt Securities Portfolio

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Advanced Lighting Technologies, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Revolving Loan<br>.5% Cash, Due 6/13 | $ — | $ — | $ — |
| Advanced Lighting Technologies, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Junior Secured Loan — Second Lien Term Loan Note<br>6.3% Cash, Due 6/14 | 5,000,000 | 4,997,622 | 4,965,000 |
| Alaska Communications Systems Holdings, Inc.<br>*Telecommunications* | Senior Secured Loan — Term Loan<br>5.5% Cash, Due 10/16 | 2,970,000 | 2,986,151 | 2,776,950 |
| Avis Budget Car Rental, LLC<br>*Personal Transportation* | Senior Secured Loan — Extended Term Loan<br>5.8% Cash, Due 4/14 | 2,974,338 | 2,993,092 | 2,983,648 |
| Bankruptcy Management Solutions, Inc.<br>*Diversified/Conglomerate Service* | Junior Secured Loan — Loan (Second Lien)<br>1.4% Cash, 7.0% PIK, Due 8/15 | 1,291,447 | 1,217,438 | 39,822 |
| Bankruptcy Management Solutions, Inc.<br>*Diversified/Conglomerate Service* | Senior Secured Loan — Term Loan B<br>6.5% Cash, 1.0% PIK, Due 8/14 | 1,442,478 | 1,434,611 | 331,777 |
| Bicent Power LLC<br>*Utilities* | Junior Secured Loan — Advance (Second Lien)<br>4.6% Cash, Due 12/14 | 4,000,000 | 4,000,000 | 137,500 |
| Burger King Corporation<br>*Personal, Food and Miscellaneous Services* | Senior Secured Loan — Tranche B Term Loan<br>4.5% Cash, Due 10/16 | 2,872,500 | 2,872,500 | 2,827,359 |
| Caribe Media Inc. (fka Caribe Information Investments Incorporated)<br>*Printing and Publishing* | Senior Secured Loan — Loan 10.0% Cash, Due 11/14 | 684,774 | 684,774 | 684,774 |
| CoActive Technologies LLC (fka CoActive Technologies, Inc.)<br>*Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Junior Secured Loan — Term Loan (Second Lien)<br>7.3% Cash, Due 1/15 | 2,000,000 | 1,983,174 | 1,552,200 |
| Del Monte Foods Company<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Initial Term Loan<br>4.5% Cash, Due 3/18 | 2,985,000 | 2,991,687 | 2,843,212 |
| eInstruction Corporation<br>*Healthcare, Education and Childcare* | Junior Secured Loan — Term Loan (Second Lien)<br>11.5% Cash, Due 7/14 | 10,000,000 | 10,000,000 | 9,489,000 |
| Freescale Semiconductor, Inc.<br>*Electronics* | Senior Subordinated Bond —<br>10.125% – 12/2016 – 35687MAP2<br>10.3% Cash, Due 12/16 | 3,000,000 | 3,007,007 | 3,135,000 |
| Ginn LA Conduit Lender, Inc.[8]<br>*Buildings and Real Estate*[4] | Senior Secured Loan — First Lien Tranche A Credit-Linked Deposit<br>7.8% Cash, Due 6/11 | 1,257,143 | 1,224,101 | 91,142 |
| Ginn LA Conduit Lender, Inc.[8]<br>*Buildings and Real Estate*[4] | Senior Secured Loan — First Lien Tranche B Term Loan<br>7.8% Cash, Due 6/11 | 2,694,857 | 2,624,028 | 195,377 |
| Ginn LA Conduit Lender, Inc.[8]<br>*Buildings and Real Estate*[4] | Junior Secured Loan — Loan (Second Lien)<br>11.8% Cash, Due 6/12 | 3,000,000 | 2,715,997 | 15,000 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| HMSC Corporation (aka Swett and Crawford)<br>*Insurance* | Junior Secured Loan — Loan (Second Lien) 5.8% Cash, Due 10/14 | $ 5,000,000 | $ 4,919,522 | $ 3,753,000 |
| Hunter Defense Technologies, Inc.<br>*Aerospace and Defense* | Junior Secured Loan — Term Loan (Second Lien) 7.3% Cash, Due 2/15 | 5,000,000 | 4,916,872 | 5,000,000 |
| Hunter Fan Company<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Junior Secured Loan — Loan (Second Lien) 7.0% Cash, Due 10/14 | 3,000,000 | 3,000,000 | 2,724,300 |
| International Architectural Products, Inc.[8]<br>*Mining, Steel, Iron and Non-Precious Metals* | Senior Secured Loan — Term Loan 12.0% Cash, 3.3% PIK, Due 5/15 | 530,803 | 504,240 | 437,913 |
| Jones Stephens Corp.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Term Loan 7.0% Cash, Due 9/15 | 4,889,912 | 4,889,912 | 4,889,912 |
| Kaseman Holdings and Sallyport Holdings<br>*Aerospace and Defense* | Mezzanine Investment — Mezzanine Notes 14.5% Cash, Due 6/17 | 11,250,597 | 10,931,428 | 11,588,115 |
| KIK Custom Products Inc.<br>*Personal and Non Durable Consumer Products (Mfg. Only)* | 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[8]<br>*Buildings and Real Estate*[4] | Senior Secured Loan — Term Loan (First Lien) 7.5% Cash, Due 1/10 | 3,401,921 | 3,401,921 | 359,923 |
| Legacy Cabinets, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Term Loan 1.0% Cash, 6.3% PIK, Due 5/14 | 492,944 | 463,380 | 253,817 |
| Merisant Company<br>*Beverage, Food and Tobacco* | Senior Secured Loan — Loan 7.5% Cash, Due 1/14 | 5,049,291 | 5,030,584 | 5,043,232 |
| Metropolitan Health Networks, Inc.<br>*Healthcare, Education and Childcare* | 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.)<br>*Beverage, Food and Tobacco* | 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<br>*Retail Stores* | Senior Secured Loan — Term Loan 4.8% Cash, Due 5/18 | 2,000,000 | 1,885,086 | 1,932,500 |
| Pegasus Solutions, Inc.<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Senior Subordinated Bond — Senior Subordinated Second Lien PIK Notes 13.0% Cash, Due 4/14 | 1,490,892 | 1,490,892 | 1,490,892 |
| Perseus Holding Corp.[6]<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Preferred Stock — Preferred Stock 14.0% PIK | 400,000 | 400,000 | 400,000 |
| Potters Holdings, II, L.P.<br>*Diversified/Conglomerate Manufacturing* | Junior Secured Loan — Term B Loan (Second Lien) 10.3% Cash, Due 11/17 | 7,000,000 | 6,905,447 | 7,000,000 |
| Trinseo Materials Operating S.C.A. (fka Styron S.A.R.L)[3]<br>*Chemicals, Plastics and Rubber* | Senior Secured Loan — Term Loan 6.0% Cash, Due 8/17 | 1,989,950 | 1,824,534 | 1,728,779 |
| TriZetto Group, Inc. (TZ Merger Sub, Inc.)<br>*Electronics* | Senior Secured Loan — Term Loan 4.8% Cash, Due 5/18 | 1,979,757 | 1,898,410 | 1,950,554 |
| TUI University, LLC<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term Loan (First Lien) 3.5% Cash, Due 10/14 | 3,040,242 | 2,978,384 | 2,626,161 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Twin-Star International, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Subordinated Bond — Senior Subordinated Note 13.0% Cash, Due 4/14 | $ 5,500,000 | $ 5,500,000 | $ 5,500,000 |
| Univar Inc.<br>*Chemicals, Plastics and Rubber* | Senior Secured Loan — Term B Loan 5.0% Cash, Due 6/17 | 2,984,925 | 2,984,925 | 2,886,049 |
| Vantiv, LLC (fka Fifth Third Processing Solutions, LLC)<br>*Electronics* | Senior Secured Loan — Term B-1 Loan (First Lien) 4.5% Cash, Due 11/16 | 1,989,975 | 1,992,299 | 1,988,482 |
| Vertafore, Inc.<br>*Electronics* | Senior Secured Loan — Term Loan (First Lien) 5.3% Cash, Due 7/16 | 1,989,956 | 1,933,723 | 1,952,147 |
| Walker Group Holdings LLC<br>*Cargo Transport* | Junior Secured Loan — Term Loan B 13.3% Cash, Due 12/13 | 416,737 | 416,737 | 416,737 |
| Walker Group Holdings LLC<br>*Cargo Transport* | Junior Secured Loan — Term Loan B 13.3% Cash, Due 12/13 | 3,957,614 | 3,957,614 | 3,957,614 |
| Warner Chilcott Company, LLC<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-2 Loan 4.3% Cash, Due 3/18 | 454,851 | 455,921 | 449,450 |
| Warner Chilcott Corporation<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-1 Loan 4.3% Cash, Due 3/18 | 909,703 | 911,841 | 898,900 |
| WC Luxco S.A.R.L. (Warner Chilcott)[3]<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term B-3 Loan 4.3% Cash, Due 3/18 | 625,421 | 626,891 | 617,994 |
| Wesco Aircraft Hardware Corp.<br>*Aerospace and Defense* | Senior Secured Loan — Tranche B Term Loan 4.3% Cash, Due 4/17 | 2,590,244 | 2,584,560 | 2,599,154 |
| **Total Investment in Debt Securities (64% of net asset value at fair value)** | | $ 136,034,039 | $134,311,238 | $114,673,506 |

## Equity Portfolio

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

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment | Percentage Interest/Shares | Cost | Value[2] |
|---|---|---|---|---|
| Perseus Holding Corp.[6]<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Common | 0.2% | $ 400,000 | $ 193,120 |
| Plumbing Holdings Corporation[6]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Common | 7.8% | — | — |
| Plumbing Holdings Corporation[6]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Preferred Stock | 9.0% | 2,716,618 | 2,270,821 |
| Caribe Media Inc. (fka Caribe Information Investments Incorporated)[6] | Common | 1.3% | 359,765 | 538,969 |
| **Total Investment in Equity Securities (3% of net asset value at fair value)** | | | $16,559,610 | $ 6,040,895 |

## CLO Fund Securities

### CLO Equity Investments

| Portfolio Company | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Grant Grove CLO, Ltd.[3],[10] | Subordinated Securities | 22.2% | $ 4,724,303 | $ 2,730,000 |
| Katonah III, Ltd.[3],[10] | Preferred Shares | 23.1% | 4,500,000 | 1,000 |
| Katonah V, Ltd.[3],[10],[11] | Preferred Shares | 26.7% | 3,320,000 | 1,000 |
| Katonah VII CLO Ltd.[3],[7],[10] | Subordinated Securities | 16.4% | 4,500,000 | 2,210,000 |
| Katonah VIII CLO Ltd[3],[7],[10] | Subordinated Securities | 10.3% | 3,400,000 | 1,800,000 |
| Katonah IX CLO Ltd[3],[7],[10] | Preferred Shares | 6.9% | 2,000,000 | 1,240,000 |
| Katonah X CLO Ltd[3],[7],[10] | Subordinated Securities | 33.3% | 11,631,226 | 8,320,000 |
| Katonah 2007-I CLO Ltd.[3],[7],[10] | Preferred Shares | 100.0% | 30,027,384 | 23,540,000 |
| **Total Investment in CLO Equity Securities** | | | $64,102,913 | $ 39,842,000 |

### CLO Rated-Note Investment

| Portfolio Company | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Katonah 2007-I CLO Ltd.[3],[7],[10] | Class B-2L Notes<br>Par Value of $10,500,000<br>100.0%, Due 4/22 | 100.0% | $ 1,106,896 | $ 6,570,000 |
| **Total Investment in CLO Rated-Note** | | | $ 1,106,896 | $ 6,570,000 |
| **Total Investment in CLO Fund Securities (26% of net asset value at fair value)** | | | $65,209,809 | $ 46,412,000 |

## Asset Manager Affiliate

| Portfolio Company/Principal Business | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Katonah Debt Advisors | Asset Management Company | 100.0% | $44,338,301 | $ 40,814,000 |
| **Total Investment in Asset Manager Affiliate (23% of net asset value at fair value)** | | | $44,338,301 | $ 40,814,000 |

See accompanying notes to financial statements.

**Time Deposits and Money Market Account**

| Time Deposits and Money Market Account | Investment | Yield | Par/Cost | Value[2] |
|---|---|---|---|---|
| JP Morgan Asset Account | Time Deposit | 0.0% | $ 229,152 | $ 229,152 |
| JP Morgan Business Money Market Account[9] | 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 |
| **Total Investment in Time Deposit and Money Market Accounts (18% of net asset value at fair value)** | | | $ 31,851,286 | $ 31,851,286 |
| **Total Investments[5] (133% of net asset value at fair value)** | | | $292,270,244 | $ 239,791,687 |

(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. For each such loan, the Company has provided the weighted average annual stated interest rate in effect at December 31, 2011.

(2) Reflects the fair market value of all existing investments as of December 31, 2011, as determined by the Company's 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. As of December 31, 2011, the Company had no exposure to mortgage securities (residential mortgage bonds, commercial mortgage backed securities, or related asset backed securities), companies providing mortgage lending or emerging markets investments either directly or through the Company's investments in CLO funds.

(5) The aggregate cost of investments for federal income tax purposes is approximately $292 million. The aggregate gross unrealized appreciation is approximately $8 million, the aggregate gross unrealized depreciation is approximately $60 million, and the net unrealized depreciation is approximately $52 million.

(6) Non-income producing.

(7) An affiliate CLO Fund managed by Katonah Debt Advisors, L.L.C. or its affiliate.

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

(9) Money market account holding restricted cash for employee flexible spending 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 December 31, 2011, this CLO Fund Security was not providing a dividend distribution.

See accompanying notes to financial statements.

## KOHLBERG CAPITAL CORPORATION

## SCHEDULE OF INVESTMENTS
## As of December 31, 2010

### Debt Securities Portfolio

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Advanced Lighting Technologies, Inc.<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Revolving Loan<br>3.7% Cash, Due 6/13 | $ 1,080,000 | $ 1,075,943 | $ 979,452 |
| Advanced Lighting Technologies, Inc.[6]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Junior Secured Loan — Second Lien Term Loan Note<br>6.3% Cash, Due 6/14 | 5,000,000 | 5,000,000 | 5,000,000 |
| Awesome Acquisition Company (CiCi's Pizza)[6]<br>*Personal, Food and Miscellaneous Services* | Junior Secured Loan — Term Loan (Second Lien)<br>5.3% Cash, Due 6/14 | 4,000,000 | 3,985,854 | 3,840,000 |
| Bankruptcy Management Solutions, Inc.[6]<br>*Diversified/Conglomerate Service* | Junior Secured Loan — Second Lien Facility<br>1.3% Cash, 7.0% PIK, Due 8/15 | 1,217,438 | 1,217,438 | 95,368 |
| Bankruptcy Management Solutions, Inc.[6]<br>*Diversified/Conglomerate Service* | Senior Secured Loan — Term Loan B<br>7.5% Cash, Due 8/14 | 1,438,720 | 1,448,006 | 719,360 |
| Bicent Power LLC[6]<br>*Utilities* | Junior Secured Loan — Advance (Second Lien)<br>4.3% Cash, Due 12/14 | 4,000,000 | 4,000,000 | 2,367,600 |
| BP Metals, LLC (fka Constellation Enterprises)[6]<br>*Mining, Steel, Iron and Non-Precious Metals* | Senior Secured Loan — Term Loan<br>12.0% Cash, Due 6/13 | 3,982,143 | 3,982,143 | 4,002,054 |
| Caribe Information Investments Incorporated[6]<br>*Printing and Publishing* | Senior Secured Loan — Term Loan<br>2.5% Cash, Due 3/13 | 1,611,045 | 1,608,021 | 1,273,692 |
| Charlie Acquisition Corp.[9]<br>*Personal, Food and Miscellaneous Services* | Mezzanine Investment — Senior Subordinated Notes<br>17.5% Cash, Due 6/13 | 14,261,996 | 10,744,496 | 250,000 |
| CoActive Technologies LLC (fka CoActive Technologies, Inc.)[6]<br>*Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Junior Secured Loan — Term Loan (Second Lien)<br>7.1% Cash, Due 1/15 | 2,000,000 | 1,977,696 | 1,464,600 |
| eInstruction Corporation[6]<br>*Healthcare, Education and Childcare* | Junior Secured Loan — Term Loan (Second Lien)<br>7.8% Cash, Due 7/14 | 10,000,000 | 10,000,000 | 10,000,000 |
| Freescale Semiconductor, Inc.<br>*Electronics* | Senior Subordinated Bond —<br>10.125% – 12/2016 – 35687MAP2<br>10.1% Cash, Due 12/16 | 3,000,000 | 3,006,137 | 3,176,250 |
| Ginn LA Conduit Lender, Inc.[9]<br>*Buildings and Real Estate*[4] | Senior Secured Loan — First Lien Tranche A Credit-Linked Deposit<br>7.8% Cash, Due 6/11 | 1,257,143 | 1,224,101 | 72,286 |
| Ginn LA Conduit Lender, Inc.[9]<br>*Buildings and Real Estate*[4] | Senior Secured Loan — First Lien Tranche B Term Loan<br>7.8% Cash, Due 6/11 | 2,694,857 | 2,624,028 | 154,954 |
| Ginn LA Conduit Lender, Inc.[9]<br>*Buildings and Real Estate*[4] | Junior Secured Loan — Loan (Second Lien)<br>11.8% Cash, Due 6/12 | 3,000,000 | 2,715,997 | 15,000 |
| HMSC Corporation (aka Swett and Crawford)[6]<br>*Insurance* | Junior Secured Loan — Loan (Second Lien)<br>5.8% Cash, Due 10/14 | 5,000,000 | 4,890,322 | 4,049,000 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Hunter Fan Company[6]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Junior Secured Loan — Loan (Second Lien)<br>7.0% Cash, Due 10/14 | $ 3,000,000 | $ 3,000,000 | $ 2,682,900 |
| International Architectural Products, Inc.[6],[9]<br>*Mining, Steel, Iron and Non-Precious Metals* | Senior Secured Loan — Term Loan<br>8.8% Cash, 3.3% PIK, Due 5/15 | 967,622 | 948,809 | 929,498 |
| Intrapac Corporation/Corona Holdco[6]<br>*Containers, Packaging and Glass* | Junior Secured Loan — Term Loans (Second Lien)<br>7.8% Cash, Due 5/13 | 3,000,000 | 3,009,682 | 3,000,000 |
| Jones Stephens Corp.[6],[9]<br>*Buildings and Real Estate*[4] | Senior Secured Loan — Term Loan (2006)<br>7.8% Cash, Due 9/12 | 9,541,180 | 9,527,522 | 6,364,921 |
| KIK Custom Products Inc.[6]<br>*Personal and Non Durable Consumer Products (Mfg. Only)* | Junior Secured Loan — Loan (Second Lien)<br>5.3% Cash, Due 12/14 | 5,000,000 | 5,000,000 | 3,435,000 |
| LBREP/L-Suncal Master I LLC[9]<br>*Buildings and Real Estate*[4] | Junior Secured Loan — Term Loan (Third Lien)<br>15.0% Cash, Due 2/12 | 2,332,868 | 2,332,868 | 933 |
| LBREP/L-Suncal Master I LLC[6],[9]<br>*Buildings and Real Estate*[4] | Senior Secured Loan — Term Loan (First Lien)<br>7.5% Cash, Due 1/10 | 3,875,156 | 3,875,156 | 58,127 |
| LBREP/L-Suncal Master I LLC[6],[9]<br>*Buildings and Real Estate*[4] | Junior Secured Loan — Term Loan (Second Lien)<br>9.5% Cash, Due 1/11 | 2,000,000 | 1,920,211 | 7,600 |
| Legacy Cabinets, Inc.[6]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Senior Secured Loan — Term Loan<br>7.3% Cash, Due 5/14 | 463,380 | 463,380 | 92,676 |
| MCCI Group Holdings, LLC[6]<br>*Healthcare, Education and Childcare* | Junior Secured Loan — Term Loan (Second Lien)<br>7.5% Cash, Due 6/13 | 1,000,000 | 1,000,000 | 1,000,000 |
| Pegasus Solutions, Inc.[12]<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Senior Subordinated Bond — Senior Subordinated Second Lien PIK Notes<br>13.0% Cash, Due 4/14 | 1,314,459 | 1,314,459 | 1,314,459 |
| Perseus Holding Corp.[7]<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Preferred Stock — Preferred Stock<br>14.0% Cash | 400,000 | 400,000 | 356,960 |
| QA Direct Holdings, LLC[6]<br>*Printing and Publishing* | Senior Secured Loan — Term Loan<br>8.3% Cash, Due 8/14 | 4,396,024 | 4,372,508 | 4,396,024 |
| Resco Products, Inc.<br>*Mining, Steel, Iron and Non-Precious Metals* | Junior Secured Loan — Term Loan (Second Lien)<br>12.0% Cash, 8.0% PIK, Due 6/14 | 2,078,079 | 2,078,079 | 2,078,079 |
| Resco Products, Inc.[6]<br>*Mining, Steel, Iron and Non-Precious Metals* | Junior Secured Loan — Term Loan (Second Lien)<br>12.0% Cash, 8.0% PIK, Due 6/14 | 7,193,458 | 7,079,981 | 7,193,458 |
| Specialized Technology Resources, Inc.[6]<br>*Diversified/Conglomerate Service* | Junior Secured Loan — Loan (Second Lien)<br>7.3% Cash, Due 12/14 | 7,500,000 | 7,500,000 | 7,500,000 |
| TUI University, LLC[6]<br>*Healthcare, Education and Childcare* | Senior Secured Loan — Term Loan (First Lien)<br>3.3% Cash, Due 10/14 | 3,119,818 | 3,033,934 | 2,958,212 |
| Walker Group Holdings LLC<br>*Cargo Transport* | Junior Secured Loan — Term Loan B<br>13.3% Cash, Due 12/13 | 470,643 | 470,643 | 470,643 |
| Walker Group Holdings LLC[6]<br>*Cargo Transport* | Junior Secured Loan — Term Loan B<br>13.3% Cash, Due 12/13 | 4,469,539 | 4,469,539 | 4,469,539 |

See accompanying notes to financial statements.

| Portfolio Company/Principal Business | Investment Interest Rate[1]/Maturity | Principal | Cost | Value[2] |
|---|---|---|---|---|
| Wesco Aircraft Hardware Corp.<br>*Aerospace and Defense* | Junior Secured Loan — Loan (Second Lien) 6.0% Cash, Due 3/14 | $ 1,720,000 | $ 1,679,298 | $ 1,720,000 |
| Wesco Aircraft Hardware Corp.[6]<br>*Aerospace and Defense* | Junior Secured Loan — Loan (Second Lien) 6.0% Cash, Due 3/14 | 3,554,283 | 3,569,258 | 3,554,283 |
| **Total Investment in Debt Securities (49% of net asset value at fair value)** | | $ 130,939,851 | $126,545,510 | $ 91,042,928 |

## Equity Portfolio

| Portfolio Company/Principal Business | Investment | Percentage Interest/Shares | Cost | Value[2] |
|---|---|---|---|---|
| Aerostructures Holdings L.P.[7]<br>*Aerospace and Defense* | Partnership Interests | 1.2% | $ 1,000,000 | $ 88,600 |
| Aerostructures Holdings L.P.[7]<br>*Aerospace and Defense* | Series A Preferred Interests | 1.2% | 250,961 | 250,961 |
| Bankruptcy Management Solutions, Inc.[6],[7]<br>*Diversified/Conglomerate Service* | Warrants | 0.1% | — | — |
| Coastal Concrete Holding II, LLC[7]<br>*Buildings and Real Estate*[4] | Class A Units | 10.8% | 8,625,626 | 250,143 |
| eInstruction Acquisition, LLC[7]<br>*Healthcare, Education and Childcare* | Membership Units | 1.1% | 1,079,617 | 1,079,724 |
| FP WRCA Coinvestment Fund VII, Ltd.[3],[7]<br>*Machinery (Non-Agriculture, Non-Construction, Non-Electronic)* | Class A Shares | 1,500 | 1,500,000 | 2,400,000 |
| International Architectural Products, Inc.[6],[7]<br>*Mining, Steel, Iron and Non-Precious Metals* | Common | 2.5% | 292,851 | 227,223 |
| Legacy Cabinets, Inc.[6],[7]<br>*Home and Office Furnishings, Housewares, and Durable Consumer Products* | Equity | 4.0% | 115,580 | 49,422 |
| Perseus Holding Corp.[7]<br>*Leisure, Amusement, Motion Pictures, Entertainment* | Common | 0.2% | 400,000 | 312,200 |
| Bankruptcy Management Solutions, Inc.[6],[7]<br>*Diversified/Conglomerate Service* | Common Stock | 1.2% | 218,592 | 30,559 |
| **Total Investment in Equity Securities (3% of net asset value at fair value)** | | | $13,483,227 | $ 4,688,832 |

## CLO Fund Securities

### CLO Equity Investments

| Portfolio Company | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Grant Grove CLO, Ltd.[3],[12] | Subordinated Securities | 22.2% | $ 4,720,982 | $ 3,150,000 |
| Katonah III, Ltd.[3],[12] | Preferred Shares | 23.1% | 4,500,000 | 470,000 |
| Katonah IV, Ltd.[3],[12] | Preferred Shares | 17.1% | 3,150,000 | 1,300,000 |
| Katonah V, Ltd.[3],[12],[13] | Preferred Shares | 26.7% | 3,320,000 | 1,000 |
| Katonah VII CLO Ltd.[3],[8],[12] | Subordinated Securities | 16.4% | 4,500,000 | 2,090,000 |
| Katonah VIII CLO Ltd[3],[8],[12] | Subordinated Securities | 10.3% | 3,400,000 | 1,690,000 |
| Katonah IX CLO Ltd[3],[8],[12] | Preferred Shares | 6.9% | 2,000,000 | 1,300,000 |
| Katonah X CLO Ltd [3],[8],[12] | Subordinated Securities | 33.3% | 11,612,677 | 8,820,000 |
| Katonah 2007-I CLO Ltd.[3],[8],[12] | Preferred Shares | 100.0% | 29,987,959 | 26,200,000 |
| **Total Investment in CLO Equity Securities** | | | $67,191,618 | $ 45,021,000 |

See accompanying notes to financial statements.

**CLO Rated-Note Investment**

| Portfolio Company | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Katonah 2007-I CLO Ltd.[3],[8],[12] | Class B-2L Notes Par Value of $44,674 5.2%, Due 1/00 | 100.0% | $ 1,088,582 | $ 8,010,000 |
| **Total Investment in CLO Rated-Note** | | | $ 1,088,582 | $ 8,010,000 |
| **Total Investment in CLO Fund Securities (28% of net asset value at fair value)** | | | $68,280,200 | $ 53,031,000 |

**Asset Manager Affiliate**

| Portfolio Company / Principal Business | Investment | Percentage Interest | Cost | Value[2] |
|---|---|---|---|---|
| Katonah Debt Advisors | Asset Management Company | 100.0% | $44,532,329 | $ 41,493,000 |
| **Total Investment in Asset Manager Affiliate (22% of net asset value at fair value)** | | | $44,532,329 | $ 41,493,000 |

**Time Deposits and Money Market Account**

| Time Deposits and Money Market Account | Investment | Yield | Par / Cost | Value[2] |
|---|---|---|---|---|
| JP Morgan Asset Account | Time Deposit | 0.03% | $ 720,225 | $ 720,225 |
| JP Morgan Business Money Market Account[11] | Money Market Account | 0.2% | 210,311 | 210,311 |
| **Total Investment in Time Deposit and Money Market Accounts (0% of net asset value at fair value)** | | | $ 930,536 | $ 930,536 |
| **Total Investments[5] (102% of net asset value at fair value)** | | | $253,771,802 | $ 191,186,296 |

(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. For each such loan, the Company has provided the weighted average annual stated interest rate in effect at December 31, 2010.

(2) Reflects the fair market value of all existing investments as of December 31, 2010, as determined by the Company's 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. As of December 31, 2010, the Company had no exposure to mortgage securities (residential mortgage bonds, commercial mortgage backed securities, or related asset backed securities), companies providing mortgage lending or emerging markets investments either directly or through the Company's investments in CLO funds.

(5) The aggregate cost of investments for federal income tax purposes is approximately $254 million. The aggregate gross unrealized appreciation is approximately $8 million, the aggregate gross unrealized depreciation is approximately $71 million, and the net unrealized depreciation is approximately $63 million.

(6) Pledged as collateral for the secured revolving credit facility (see Note 6 to the financial statements).

(7) Non-income producing.

(8) An affiliate CLO Fund managed by Katonah Debt Advisors L.L.C. or its affiliate.

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

(10) Time deposit investment partially restricted under terms of the secured credit facility (see Note 6 to financial statements).

See accompanying notes to financial statements.

(11) Money market account holding restricted cash for employee flexible spending accounts.

(12) 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.

(13) As of December 31, 2010, this CLO Fund securities were not providing a dividend distribution.

See accompanying notes to financial statements.

## KOHLBERG CAPITAL CORPORATION

## FINANCIAL HIGHLIGHTS
### ($ per share)

| | For the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| **Per Share Data:** | | | | | |
| Net asset value, at beginning of year | $ 8.21 | $ 9.56 | $ 9.03 | $ 14.38 | $ 14.29 |
| Net investment income[1] | 0.70 | 0.53 | 0.83 | 1.50 | 1.27 |
| Net realized losses[1] | (0.81) | (0.79) | (0.71) | (0.03) | 0.01 |
| Net change in unrealized appreciation/depreciation on investments[1] | 0.37 | (0.54) | 1.19 | (6.80) | 0.12 |
| Net income | 0.26 | (0.80) | 1.31 | (5.33) | 1.40 |
| Net decrease in net assets resulting from distributions | | | | | |
| From net investment income | (0.69) | (0.52) | (0.84) | (1.43) | (1.36) |
| In excess of net investment income | — | (0.14) | (0.08) | (0.01) | (0.04) |
| Net decrease in net assets resulting from distributions | (0.69) | (0.66) | (0.92) | (1.44) | (1.40) |
| Net increase in net assets relating to stock-based transactions | | | | | |
| Issuance of common stock (not including DRIP) | — | — | — | 1.26 | — |
| Issuance of common stock under dividend reinvestment plan | 0.04 | 0.07 | 0.10 | 0.12 | 0.06 |
| Stock based compensation expense | 0.03 | 0.04 | 0.04 | 0.04 | 0.03 |
| Net increase in net assets relating to stock-based transactions | 0.07 | 0.11 | 0.14 | 1.42 | 0.09 |
| Net asset value, end of year | $ 7.85 | $ 8.21 | $ 9.56 | $ 9.03 | $ 14.38 |
| Total net asset value return[2] | 4.0% | (7.1)% | 16.0% | (27.2)% | 10.4% |
| **Ratio/Supplemental Data:** | | | | | |
| Per share market value at beginning of year | $ 6.97 | $ 4.56 | $ 3.64 | $ 12.00 | $ 17.30 |
| Per share market value at end of year | $ 6.31 | $ 6.97 | $ 4.56 | $ 3.64 | $ 12.00 |
| Total market return[3] | 0.4% | 67.6% | 50.5% | (57.7)% | (22.5)% |
| Shares outstanding at end of year | 22,992,211 | 22,767,130 | 22,363,281 | 21,771,186 | 18,017,699 |
| Net assets at end of year | $180,525,942 | $186,925,667 | $213,895,724 | $196,566,018 | $259,068,164 |
| Portfolio turnover rate | 24.5% | 3.4% | 3.2% | 14.4% | 24.7% |
| Average debt outstanding | $ 53,974,098 | $154,952,070 | $236,184,703 | $248,300,441 | $105,616,438 |
| Average debt outstanding per share | $ 2.35 | $ 6.81 | $ 10.56 | $ 11.41 | $ 5.86 |
| Asset coverage ratio | 401% | 315% | 198% | 175% | 202% |
| Ratio of net investment income to average net assets | 8.1% | 5.8% | 8.7% | 12.0% | 8.6% |
| Ratio of total expenses to average net assets | 6.0% | 8.5% | 7.4% | 7.2% | 5.9% |
| Ratio of interest expense to average net assets | 2.3% | 3.4% | 4.4% | 4.3% | 2.7% |
| Ratio of non-interest expenses to average net assets | 3.7% | 5.0% | 3.0% | 3.0% | 3.2% |

(1) Based on weighted average number of common shares outstanding for the period.

(2) 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.

(3) Total market return equals the change in the ending market price over the beginning of period price per share plus dividends, divided by the beginning price.

See accompanying notes to financial statements.

## KOHLBERG CAPITAL CORPORATION

## NOTES TO FINANCIAL STATEMENTS

### 1. ORGANIZATION

Kohlberg Capital Corporation ("Kohlberg Capital" 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 was formed as a Delaware limited liability company on August 8, 2006 and, prior to the issuance of shares of the Company's common stock in its initial public offering, converted to a corporation incorporated in Delaware on December 11, 2006. Prior to its initial public offering ("IPO"), the Company did not have material operations. The Company's IPO of 14,462,000 shares of common stock raised net proceeds of approximately $200 million. Prior to the IPO, the Company issued 3,484,333 shares to affiliates of Kohlberg & Co., L.L.C. ("Kohlberg & Co."), a leading middle market private equity firm, in exchange for the contribution of their ownership interests in Katonah Debt Advisors, L.L.C., and related affiliates controlled by the Company (collectively, "Katonah Debt Advisors") and in securities issued by collateralized loan obligation funds ("CLO Funds") managed by Katonah Debt Advisors and two other asset managers to the Company. As of December 31, 2011, Katonah Debt Advisors had approximately $1.9 billion of assets under management.

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. The Company also expects to continue to receive distributions of recurring fee income and to generate capital appreciation from its investment in the asset management business of Katonah Debt Advisors. Katonah Debt Advisors manages CLO Funds which invest in broadly syndicated loans, high-yield bonds and other credit instruments.

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. 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 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").

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 including the fair value of investments that do not have a readily available market value. Actual results could differ from those estimates, and the differences

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 (Katonah Debt Advisors, including related affiliates, is currently the only company in which the Company has a controlling interest). Effective January 1, 2010, Katonah Debt Advisors adopted guidance encompassed in Accounting Standards Codification Topic 810, "Consolidation." Although the Company cannot consolidate portfolio company investments, the adoption of this new guidance had an impact on the required disclosures relating to Katonah Debt Advisors, as it requires Katonah Debt Advisors to consolidate its managed CLO Funds that were not previously consolidated. As a result of the consolidation of these CLO Funds into

**KOHLBERG CAPITAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

Katonah Debt Advisors, Katonah Debt Advisors qualifies as a "significant subsidiary" and, as a result, the Company is required to include additional disclosure regarding Katonah Debt Advisors in its filings. The additional disclosures regarding Katonah Debt Advisors do not directly impact the financial operations or results of the Company.

*Accounting Standards Codification.* In June 2009, the Financial Accounting Standards Board ("FASB") issued a pronouncement establishing the FASB Accounting Standards Codification ("ASC") as the source of authoritative accounting principles recognized by the FASB to be applied in the preparation of financial statements in conformity with GAAP. The ASC reorganized existing U.S. accounting and reporting standards issued by the FASB and other related private sector standard setters into a single source of authoritative accounting principles arranged by topic. The standard explicitly recognizes rules and interpretive releases of the Commission under federal securities laws as authoritative GAAP for SEC registrants. The ASC supersedes all existing U.S. accounting standards; all other accounting literature not included in the ASC (other than SEC guidance for publicly-traded companies) is considered non-authoritative. The ASC was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. The adoption of the ASC changed the Company's references to U.S. GAAP accounting standards but did not impact its results of operations, financial position or liquidity.

**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 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. 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 January 2010, the FASB issued guidance that clarifies and requires new disclosures about fair value measurements. The clarifications and requirement to disclose the amounts and reasons for significant transfers between Level 1 and Level 2, as well as significant transfers in and out of Level 3 of the fair value hierarchy, were adopted by the Company in the first quarter of 2010. Note 4 below reflects the amended disclosure requirements. The new guidance also requires that purchases, sales, issuances and settlements be presented gross in the Level III reconciliation and that requirement is effective for fiscal years beginning after December 15, 2010 and for interim periods within those years. The Company is evaluating the increased disclosure requirements for implementation by the effective date. Since this new guidance only amends the disclosures requirements, it did not impact our statements of financial position, statements of operations, or cash flow statements.

*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.

**KOHLBERG CAPITAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

In 2011 and 2010, the Company 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 1 or Level 2 trading activity or observable market inputs. The independent valuation firm concluded that the Company's 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. Third party valuations were performed on approximately 8% of investments at fair value as of December 31, 2011. 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.

The Board of Directors may consider other methods of valuation than those set forth above to determine the fair value of Level III investments as appropriate in conformity with GAAP. 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:

1) 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 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.
2) If an investment does not have a market quotation on either a broad market exchange or from an independent 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.
4) Illiquid loans, junior and mezzanine securities, equity investments, CLO Fund securities and Katonah Debt Advisors 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.
6) Upon approval of the investment valuations by the Valuation Committee of the Board of Directors, the Audit Committee of the Board of Directors reviews the results for inclusion in the Company's quarterly and annual financial statements, as applicable.

**KOHLBERG CAPITAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

7) The Board of Directors discusses the valuations and determines in good faith that the fair values of each investment 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, most 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

**KOHLBERG CAPITAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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 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.

*Affiliate Asset Manager.* The Company's investment in its wholly-owned asset management company, Katonah Debt Advisors, 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. Katonah Debt Advisors 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.

*CLO Fund Securities.* The Company typically makes a minority investment in the most junior class of securities of CLO Funds raised and managed by Katonah Debt Advisors and may selectively invest in securities issued by funds managed by other asset management companies (collectively "CLO Fund securities"). The Company's CLO Fund securities relate exclusively to credit instruments issued by corporations and do not include any asset-backed securities secured by commercial mortgages, residential mortgages, or consumer borrowings.

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 for more recent CLO Funds 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 NAVs 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 an individual security-by-security basis.

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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 bond rated 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 at December 31, 2010 consisted mostly of cash held in an operating account pursuant to the Company's secured credit facility agreement with its lender. As the Company paid off its secured credit facility as of January 31, 2011, no such restricted cash balances were needed.

***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 December 31, 2011, three issuers representing less than 1% of total investments at fair value were considered in default.

***Dividends from Affiliate Asset Manager.*** The Company records dividend income from its affiliate asset manager 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 Katonah Debt Advisors and selective investments in securities issued by funds managed by other asset management companies. The Company's CLO Fund junior class securities are subordinated to senior bond holders who typically receive a fixed rate of return on their investment. The CLO Funds are leveraged funds and any excess cash flow or "excess spread" (interest earned by the

**KOHLBERG CAPITAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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 Company makes estimated interim accruals of such dividend income based on recent historical distributions and CLO Fund performance and adjusts such accruals on a quarterly basis to reflect actual distributions.

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, recognizes 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 December 31, 2011, there was an unamortized debt issuance cost of approximately $2.0 million included in other assets in the accompanying balance sheet. Amortization expense for the year ended December 31, 2011 and 2010 was approximately $353,000 and $596,000, respectively.

***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 its asset manager affiliates share office space and certain other operating expenses. The Company has entered into an Overhead Allocation Agreement with its 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

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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 "— Portfolio 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 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.

**3. EARNINGS (LOSSES) PER SHARE**

The following information sets forth the computation of basic and diluted net increase (decrease) in stockholders' equity per share for the years ended December 31, 2011, 2010, and 2009:

| | For the Years ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Net increase (decrease) in net assets from operations | $ 7,649,544 | $(14,288,677) | $ 34,403,270 |
| Net increase (decrease) in net assets available to common stockholders | 7,649,544 | (14,288,677) | 34,403,270 |
| Weighted average number of common shares outstanding for basic shares computation | 22,868,647 | 22,598,185 | 22,105,800 |
| Effect of dilutive securities – stock options | — | — | — |
| Weighted average number of common and common stock equivalent shares outstanding for diluted shares computation | 22,868,647 | 22,598,185 | 22,105,800 |
| Net increase (decrease) in net assets per basic common shares: | | | |
| Net increase (decrease) in Net assets from operations[(1)] | 0.33 | (0.63) | 1.56 |

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. Included in the weighted average shares outstanding for the year ended December 31, 2011 are 305,221 shares of unvested restricted stock, which were deemed to be participating securities.

Options to purchase 20,000 shares were included in the computation of diluted earnings per share for the year ended December 31, 2011. For the year ended December 31, 2010, options to purchase 40,000 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

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**3. EARNINGS (LOSSES) PER SHARE – (continued)**

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 year ended December 31, 2011, the convertible debt is anti-dilutive.

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 have a conversion price of $8.44 per share which was above the Company's net asset value per share at the time of issuance. Upon conversion, the Company would issue the full amount of common stock upon conversion and retire the full amount of debt outstanding.

On February 29, 2012, the Company completed the acquisition of Trimaran Advisors, L.L.C. ("Trimaran") through a newly-formed, wholly-owned subsidiary of the Company. The aggregate consideration paid for all of the outstanding equity interests in Trimaran consisted of $13.0 million in cash and 3,600,000 shares of common stock, par value $0.01 per share, of the Company. The change in the number of common shares outstanding at December 31, 2011 as if this acquisition had closed prior to year end would be an increase of 3,600,000 common shares to a total outstanding share amount of 26,367,130.

**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. The Company generally targets companies that generate positive cash flows because the Company looks to cash flows as the primary source for servicing debt. However, the Company may invest in other industries if it is presented with attractive opportunities.

The following table shows the Company's portfolio by security type at December 31, 2011 and December 31, 2010:

| | December 31, 2011 | | | December 31, 2010 | | |
|---|---|---|---|---|---|---|
| **Security Type** | **Cost** | **Fair Value** | **%** | **Cost** | **Fair Value** | **%** |
| Time Deposits | $ 229,152 | $ 229,152 | —% | $ 720,225 | $ 720,225 | —% |
| Money Market Account | 31,622,134 | 31,622,134 | 18 | 210,311 | 210,311 | — |
| Senior Secured Loan | 54,045,184 | 45,259,328 | 25 | 34,183,551 | 22,001,256 | 12 |
| Junior Secured Loan | 58,936,728 | 47,300,172 | 26 | 76,896,867 | 63,944,003 | 34 |
| Mezzanine Investment | 10,931,428 | 11,588,115 | 6 | 10,744,496 | 250,000 | — |
| Senior Subordinated Bond | 9,997,898 | 10,125,891 | 6 | 4,320,596 | 4,490,709 | 3 |
| CLO Fund Securities | 65,209,809 | 46,412,000 | 26 | 68,280,200 | 53,031,000 | 28 |
| Equity Securities | 16,559,610 | 6,040,895 | 3 | 13,232,266 | 4,437,871 | 3 |
| Preferred | 400,000 | 400,000 | — | 650,961 | 607,921 | — |
| Affiliate Asset Managers | 44,338,301 | 40,814,000 | 23 | 44,532,329 | 41,493,000 | 22 |
| Total | $292,270,244 | $239,791,687 | 133% | $253,771,802 | $191,186,296 | 102% |

(1) Calculated as a percentage of net asset value

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**4. INVESTMENTS – (continued)**

The industry concentrations, based on the fair value of the Company's investment portfolio as of December 31, 2011 and December 31, 2010, were as follows:

| | December 31, 2011 | | | December 31, 2010 | | |
|---|---|---|---|---|---|---|
| **Industry Classification** | **Cost** | **Fair Value** | **%[1]** | **Cost** | **Fair Value** | **%[1]** |
| Aerospace and Defense | $ 19,683,821 | $ 19,439,230 | 10% | $ 6,499,518 | $ 5,613,844 | 3% |
| Asset Management Company[2] | 44,338,301 | 40,814,000 | 23 | 44,532,329 | 41,493,000 | 22 |
| Beverage, Food and Tobacco | 9,892,274 | 9,796,565 | 5 | — | — | — |
| Broadcasting and Entertainment[3] | — | — | — | — | — | — |
| Buildings and Real Estate | 18,591,674 | 662,443 | — | 32,845,509 | 6,923,964 | 4 |
| Cargo Transport | 4,374,350 | 4,374,351 | 2 | 4,940,182 | 4,940,182 | 3 |
| Chemicals, Plastics and Rubber | 4,809,459 | 4,614,828 | 3 | — | — | — |
| CLO Fund Securities | 65,209,809 | 46,412,000 | 26 | 68,280,200 | 53,031,000 | 28 |
| Containers, Packaging and Glass | — | — | — | 3,009,682 | 3,000,000 | 2 |
| Diversified/Conglomerate Manufacturing | 6,905,447 | 7,000,000 | 4 | — | — | — |
| Diversified/Conglomerate Service | 2,870,642 | 372,599 | — | 10,384,036 | 8,345,287 | 4 |
| Electronics | 8,831,440 | 9,026,186 | 5 | 3,006,137 | 3,176,250 | 2 |
| Healthcare, Education and Childcare | 20,956,582 | 19,523,824 | 11 | 15,113,551 | 15,037,936 | 8 |
| Home and Office Furnishings, Housewares, and Durable Consumer Products | 21,683,112 | 20,604,850 | 11 | 9,654,903 | 8,804,450 | 5 |
| Insurance | 4,919,522 | 3,753,000 | 2 | 4,890,322 | 4,049,000 | 2 |
| Leisure, Amusement, Motion Pictures, Entertainment | 2,290,892 | 2,084,012 | 1 | 2,114,458 | 1,983,619 | 1 |
| Machinery (Non-Agriculture, Non-Construction, Non-Electronic) | 3,483,174 | 3,891,900 | 2 | 3,477,696 | 3,864,600 | 2 |
| Mining, Steel, Iron and Non-Precious Metals | 797,091 | 438,913 | — | 14,381,863 | 14,430,312 | 8 |
| Personal and Non Durable Consumer Products (Mfg. Only) | 5,000,000 | 3,250,000 | 2 | 5,000,000 | 3,435,000 | 2 |
| Personal, Food and Miscellaneous Services | 2,872,500 | 2,827,359 | 2 | 14,730,350 | 4,090,000 | 2 |
| Personal Transportation | 2,993,092 | 2,983,648 | 2 | — | — | — |
| Printing and Publishing | 1,044,539 | 1,223,743 | 1 | 5,980,529 | 5,669,716 | 3 |
| Retail Stores | 1,885,086 | 1,932,500 | 1 | — | — | — |
| Telecommunications | 2,986,151 | 2,776,950 | 2 | — | — | — |
| Time Deposit and Money Market Accounts | 31,851,286 | 31,851,286 | 18 | 930,537 | 930,536 | — |
| Utilities | 4,000,000 | 137,500 | — | 4,000,000 | 2,367,600 | 1 |
| Total | $ 292,270,244 | $ 239,791,687 | 133% | $ 253,771,802 | $ 191,186,296 | 102% |

(1) Calculated as a percentage of net asset value.

(2) Represents Katonah Debt Advisors and related asset manager affiliates.

(3) Buildings and real estate relate to real estate ownership, builders, managers and developers and excludes

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**4. INVESTMENTS – (continued)**

mortgage debt investments and mortgage lenders or originators. As of December 31, 2011 and December 31, 2010, the Company had no exposure to mortgage securities (residential mortgage bonds, commercial mortgage backed securities, or related asset backed securities) or companies providing mortgage lending.

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, which 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. The Company is generally prohibited from buying or selling any security from or to any portfolio company of a private equity fund managed by Kohlberg & Co. without the prior approval of the SEC. In addition, the Company may co-invest on a concurrent basis with Kohlberg & Co. or any of its affiliates, subject to compliance with existing regulatory guidance, applicable regulations and its allocation procedures. Certain types of negotiated co-investments may be made only if the Company receives an order from the SEC permitting it to do so. There can be no assurance that any such order will be applied for or, if applied for, obtained.

At December 31, 2011 and December 31, 2010, approximately 21% and 29% of the Company's investments were foreign assets (including the Company's investments in CLO Funds, which are typically domiciled outside the U.S. and represented approximately 19% and 28% of its portfolio on such dates), respectively. At December 31, 2011, no foreign assets were in U.S. dollar denominated over-night time Eurodollar deposits which revert to cash each business morning.

At December 31, 2011 and December 31, 2010, the Company's ten largest portfolio companies represented approximately 62% and 65%, respectively, of the total fair value of its investments. The Company's largest investment, Katonah Debt Advisors which is its wholly-owned asset manager affiliate, represented 17% and 22% of the total fair value of the Company's investments at December 31, 2011 and December 31, 2010, respectively. Excluding Katonah Debt Advisors and CLO Fund securities, the Company's ten largest portfolio companies represented approximately 26% and 30% of the total fair value of the Company's investments at December 31, 2011 and December 31, 2010, 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 Katonah Debt Advisors and may selectively invest in securities issued by funds managed by other asset management companies. Preferred shares or subordinated securities issued by CLO Funds are entitled to recurring dividend distributions which generally equal the net remaining cash flow of the payments made by the underlying CLO Fund's securities less contractual payments to senior bond holders and CLO Fund expenses. CLO Funds managed by Katonah Debt Advisors ("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 and exclude mortgage pools or mortgage securities (residential mortgage bonds, commercial mortgage backed securities, or related asset-backed securities), debt to companies providing mortgage lending and emerging markets investments. 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, fund expenses and management fees) is paid to the holders of the CLO Fund's subordinated securities or preferred shares.

The subordinated securities and preferred share securities are considered equity positions in the CLO Funds and, as of December 31, 2011 and December 31, 2010, the Company had approximately $40 million and $45 million, respectively, of such CLO equity investments at fair value. The cost basis of the

**KOHLBERG CAPITAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**4. INVESTMENTS – (continued)**

Company's investment in CLO Fund equity securities as of December 31, 2011 was approximately $64 million and aggregate unrealized depreciation on CLO Fund securities totaled approximately $24 million. The cost basis of the Company's investment in CLO Fund equity securities as of December 31, 2010, was approximately $67 million and aggregate unrealized depreciation on CLO Fund securities totaled approximately $22 million.

In May, 2009 the Company purchased the class B-2L notes of the Katonah 2007-1 CLO investment managed by Katonah Debt Advisors ("Katonah 2007-1 B-2L"). The Company purchased the 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 December 31, 2011 were approximately $7 million, $1 million, and $6 million, respectively, and at December 31, 2010, the fair value, cost basis, and aggregate unrealized appreciation of the Katonah 2007-1 B-2L investment were $8 million, $1 million, and $7 million, respectively. Both the B-2L notes and preferred shares of Katonah 2007-1 are owned 100% by the Company and are making their required quarterly distributions.

All CLO Funds managed by Katonah Debt Advisors are currently making quarterly dividend distributions to the Company and are paying all senior and subordinate management fees to Katonah Debt Advisors. With the exception of the Katonah V, Ltd. CLO Fund, 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 matters, requires enhanced disclosures about investments that are measured and reported at fair value. This standard defines fair value and establishes a hierarchal 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

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**4. INVESTMENTS – (continued)**

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. 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. Substantially all of the Company's investments are classified as Level III. 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. Ongoing reviews by the Company's investment analysts, Chief Investment Officer, Valuation Committee and independent valuation firms (if engaged) are based on an assessment of each underlying investment, its current and prospective operating and financial performance, 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 December 31, 2011 and December 31, 2010, respectively:

| | 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 affiliate | — | — | 40,814,000 | 40,814,000 |

| | As of December, 31 2010 | | | |
|---|---|---|---|---|
| | Level I | Level II | Level III | Total |
| Time deposit and money market account | $ — | $ 930,536 | $ — | $ 930,536 |
| Debt securities | — | — | 91,042,928 | 91,042,928 |
| CLO fund securities | — | — | 53,031,000 | 53,031,000 |
| Equity securities | — | — | 4,688,832 | 4,688,832 |
| Asset manager affiliate | — | — | 41,493,000 | 41,493,000 |

As a BDC, it is required that the Company invest primarily in the debt and equity of non-public companies for which there is little, if any, market-observable information. As a result, most, if not all, of the Company's investments at any given time will most likely be deemed Level III investments. The Company believes that investments classified as Level III for *Fair Value Measurements and Disclosures* have a further

**KOHLBERG CAPITAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**4. INVESTMENTS – (continued)**

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 hierarchy of such methodologies are presented in the above table and discussed below in descending rank.

Investment values derived by a third party pricing service are deemed Level III values since such values are not traded on an active public exchange and may represent a traded or broker quote on an asset that is infrequently traded.

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 2011 and 2010, the Company 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 1 or Level 2 trading activity or observable market inputs. The independent valuation firm concluded that the Company's 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. Third party valuations were performed on approximately 8% of investments at fair value as of December 31, 2011. 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.

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

**KOHLBERG CAPITAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**4. INVESTMENTS – (continued)**

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 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 affiliate. The Company recognizes that comparable asset managers may not be fully comparable to its 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.

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**4. INVESTMENTS – (continued)**

The changes in investments measured at fair value for which the Company has used unobservable inputs to determine fair value are as follows:

| | Year Ended December 31, 2011 | | | | |
|---|---|---|---|---|---|
| | Debt Securities | CLO Fund Securities | Equity Securities | Asset Manager Affiliates | Total |
| Balance, December 31, 2010 | $ 91,042,928 | $53,031,000 | $ 4,688,832 | $41,493,000 | $190,255,760 |
| Transfers out of Level III [1] | — | — | — | — | — |
| Net accretion of discount | 156,180 | 79,609 | — | — | 235,789 |
| Purchases | 81,815,921 | — | 3,218,151 | (194,027) | 84,840,045 |
| Sales | (56,944,765) | (1,935,000) | (141,769) | — | (59,021,534) |
| Total loss realized and unrealized included in earnings | (1,396,758) | (4,763,609) | (1,724,319) | (484,973) | (8,369,659) |
| Balance, December 31, 2011 | $114,673,506 | $46,412,000 | $ 6,040,895 | $40,814,000 | $207,940,401 |
| Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date | $ (2,344,027) | (4,198,609) | (1,724,321) | (1,703,973) | (9,970,930) |

| | Year Ended December 31, 2010 | | | | |
|---|---|---|---|---|---|
| | Debt Securities | CLO Fund Securities | Equity Securities | Asset Manager Affiliates | Total |
| Balance, December 31, 2009 | $ 297,356,529 | $ 48,971,000 | $ 4,713,246 | $ 58,064,720 | $ 409,105,495 |
| Transfers out of Level III[1] | — | — | — | — | — |
| Net accretion of discount | 381,677 | 85,149 | — | — | 466,826 |
| Purchases | 9,981,426 | — | 1,927,366 | 3,780,817 | 15,689,609 |
| Sales | (208,820,374) | — | — | — | (208,820,374) |
| Total gain (loss) realized and unrealized included in earnings | (7,856,330) | 3,974,851 | (1,951,780) | (20,352,537) | (26,185,796) |
| Balance, December 31, 2010 | $ 91,042,928 | $ 53,031,000 | $ 4,688,832 | $ 41,493,000 | $ 190,255,760 |
| Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date | $ (5,623,079) | $ 3,974,851 | $ (1,142,038) | $(20,352,537) | $ (23,142,803) |

(1) Transfers out of Level III represent a transfer of $0 relating to debt securities for which pricing inputs, other than their quoted prices in active markets were observable as of Dec 31, 2011

**5. AFFILIATE ASSET MANAGERS**

*Wholly-Owned Asset Manager*

Katonah Debt Advisors is a wholly-owned portfolio company. Katonah Debt Advisors manages CLO Funds primarily for third party investors that invest in broadly syndicated loans, high yield bonds and other credit instruments issued by corporations. These CLO Funds do not invest in asset-backed securities secured by commercial mortgages, residential mortgages or other consumer borrowings. At December 31, 2011,

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**5. AFFILIATE ASSET MANAGERS – (continued)**

Katonah Debt Advisors had approximately $1.9 billion of par value of assets under management, and the Company's 100% equity interest in Katonah Debt Advisors was valued at approximately $41 million.

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

During 2009, certain CLO funds managed by Katonah Debt Advisors were restricted from currently paying their subordinated management fees as a result of the failure by those CLO Funds to satisfy certain restrictive covenants contained in their indenture agreements. At such time, those subordinated management fees continued to be accrued by the applicable CLO Fund to become payable to Katonah Debt Advisors when such CLO Fund becomes compliant with the applicable covenants. During the year ended December 31, 2010, all those CLO Funds which deferred payment of their subordinated management fees regained compliance with all applicable covenants in order to pay current subordinated management fees as well as a portion of previously accrued subordinated management fees. During the year ended December 31, 2010, approximately $5 million of deferred subordinated management fees had been paid.

In future years, Katonah Debt Advisors may receive accrued incentive fees upon the liquidation of CLO Funds it manages, provided such CLO Funds have achieved a minimum investment return to holders of their subordinated securities or preferred shares.

On January 2, 2008, the Katonah Debt Advisors platform acquired substantially all of the assets of Scott's Cove Capital Management LLC ("Scott's Cove"), an asset manager focused on an event-driven credit long short investment strategy. On February 4, 2011, Katonah Debt Advisors entered to an Asset Purchase Agreement with a third-party buyer controlled by a former Katonah Debt Advisors employee to sell substantially all of the Scott's Cove assets for a purchase price of $25,000. The transaction closed on February 28, 2011. At closing, Katonah Debt Advisors and the buyer entered into a Services Agreement, pursuant to which the buyer paid to Katonah Debt Advisors $225,000 for certain transitional services to be provided by Katonah Debt Advisors (including access to office space, secretarial services and information technology support) and agreed to pay an additional amount of $75,000 on each of the first and second anniversaries of the closing date (subject to, in the case of the first payment, deferment for up to one year under certain circumstances). Katonah Debt Advisors' obligation to provide transitional services under the Services Agreement continued through June 30, 2011. At closing, Katonah Debt Advisors and the employees that formerly managed the Scott's Cove assets also entered into employee termination agreements, whereby they agreed to terminate their employment with Katonah Debt Advisors and to relinquish all claims against Katonah Debt Advisors or its affiliates.

The revenue that Katonah Debt Advisors generates through the fees it receives for managing CLO Funds and after paying the expenses associated with its operations, including compensation of its employees, may be distributed to the Company. Any distributions of Katonah Debt Advisors' net income are recorded as dividends from affiliate asset manager are recorded as declared (where declaration date represents ex-dividend date) by Katonah Debt Advisors as income on our statement of operations. For the year ended December 31, 2011, Katonah Debt Advisors made distributions of $1.9 million to the Company. Dividends are recorded as declared (where declaration date represents ex-dividend date) by Katonah Debt Advisors as income on our statement of operations. The declared fourth quarter dividend of $750,000 by Katonah Debt Advisors was recorded as a dividend receivable as of December 31, 2011.

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**5. AFFILIATE ASSET MANAGERS – (continued)**

As with all other investments, Katonah Debt Advisors' fair value is periodically determined. The valuation is primarily based on an analysis of both a percentage of its assets under management and Katonah Debt Advisors' 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. For the year ended December 31, 2011 Katonah Debt Advisors had a decrease in fair value of approximately $679,000.

As a separately regarded entity for tax purposes, Katonah Debt Advisors is taxed at normal corporate rates. For tax purposes, any distributions of taxable net income earned by Katonah Debt Advisors to the Company would generally need to be distributed to the Company's shareholders. Generally, such distributions of Katonah Debt Advisors' income to the Company's shareholders will be considered as qualified dividends for tax purposes. Katonah Debt Advisors' 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 IPO in exchange for shares of the Company's stock valued at $33 million. Although this transaction was a stock transaction rather than an asset purchase and thus no goodwill was recognized for GAAP purposes, such exchange was considered an asset purchase under Section 351(a) of the Code. At the time of the transfer, Katonah Debt Advisors had equity of approximately $1 million resulting in tax goodwill of approximately $32 million which will be 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.

At December 31, 2011 and December 31, 2010 there were no intercompany balances with our affiliates.

**6. BORROWINGS**

The Company's debt obligations consist of the following:

| | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| Convertible Senior Notes, due March 15, 2016 | $ 60,000,000 | $ — |
| Secured credit facility, due February 28, 2011[(1)] | $ — | $ 86,746,582 |

(1) February 28, 2011 was the maturity date as established by a Forbearance and Settlement Agreement dated September 20, 2010.

*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.

*Convertible Senior Notes*

On March 16, 2011, the Company issued $55 million in aggregate principal amount of unsecured 8.75% convertible senior notes due 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 for the Convertible Senior Notes, following

**KOHLBERG CAPITAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**6. BORROWINGS – (continued)**

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 118.5255 shares of common stock per $1,000 principal amount of Convertible Senior Notes, which is equivalent to an initial conversion price of approximately $8.44 per share of common stock. The conversion rate will be subject to adjustment upon certain events.

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 $2.0 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.

For the period from March 11, 2011 (the date of issuance of the notes) to December 31, 2011, the Company recorded approximately $4.5 million of interest costs and amortization of financing costs as interest expense.

*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 $55.2 million at December 31, 2011. The fair value was determined based on the average of indicative bid and offer pricing for the Convertible Senior Notes.

KOHLBERG CAPITAL CORPORATION

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## 7. DISTRIBUTABLE TAX 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 2011). 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 2011.

The following reconciles net decrease in shareholders' equity resulting from operations to taxable income for the year ended December 31, 2011:

| | Year Ended December 31, | |
|---|---|---|
| | 2011 | 2010 |
| Net increase (decrease) in stockholders' equity resulting from operations | $ 7,649,544 | $ (14,288,677) |
| Net change in unrealized (appreciation) depreciation from investments | (10,106,949) | 8,322,812 |
| Excess capital losses over capital gains | 18,476,608 | 17,862,984 |
| Income not on GAAP books currently taxable | 85,608 | 241,110 |
| Income not currently taxable | (89,793) | (76,990) |
| Expenses not currently deductible | (120,240) | 347,883 |
| Expenses not on GAAP books currently deductible | (3,978) | (3,978) |
| Taxable income before deductions for distributions | $ 15,890,800 | $ 12,405,144 |
| Taxable income before deductions for distributions per weighted average shares for the period | $ 0.69 | $ 0.55 |

Taxable income differs from net increase (decrease) in stockholders' equity 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.

Distributions which exceed tax distributable income (tax net investment income and realized gains, if any) are reported as distributions of paid-in capital ( i.e. , return of capital). The tax character of distributions paid during the years ended December 31, 2011, 2010, and 2009 was as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| *Distributions paid from:* | | | |
| Ordinary income | $ 15,890,800 | $ 12,405,144 | $ 19,869,708 |
| | 15,890,800 | 12,405,144 | 19,869,708 |
| (Under distribution) Return of Capital | (114,461) | 2,817,067 | 333,017 |
| | $ 15,776,339 | $ 15,222,211 | $ 20,202,725 |

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**7. DISTRIBUTABLE TAX INCOME – (continued)**

As of December 31, 2011 and 2010, the components of accumulated earnings on a tax basis were as follows:

| | Year Ended December 31, | |
|---|---|---|
| | 2011 | 2010 |
| Distributable ordinary income | $ 947,068 | $ 818,664 |
| Capital loss carryforward | (50,501,419) | (32,024,811) |
| Net unrealized depreciation | (52,478,555) | (62,585,504) |

At December 31, 2011, the Company had a net capital loss carryforward of $51 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 both December 31, 2011 and December 31, 2010, the Company had committed to make a total of approximately $2 million of investments in various revolving senior secured loans, of which approximately $0 had been funded as of December 31, 2011 and $1 million had been funded as of December 31, 2010. As of December 31, 2011 and December 31, 2010, the Company had committed to make no investments in delayed draw senior secured loans.

The Company and certain directors and officers were named as defendants in three putative class actions pending in the Southern District of New York brought by stockholders of the Company and filed in December 2009 and January 2010. The complaints in these three actions alleged violations of Sections 10 and 20 of the Exchange Act based on the Company's disclosures of its year-end 2008 and first- and second-quarter 2009 financial statements. The federal court consolidated the three lawsuits and appointed a lead plaintiff under the Private Securities Litigation Reform Act on March 21, 2011, and lead plaintiff filed a consolidated amended complaint on May 11, 2011. The Company moved to dismiss the consolidated amended complaint. On July 28, 2011, the Court granted that motion and dismissed the consolidated amended complaint, giving

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**8. COMMITMENTS AND CONTINGENCIES – (continued)**

the plaintiff until August 22, 2011 to file any further amended complaint. Lead plaintiff filed a second amended consolidated class action complaint on August 22, 2011, which defendants moved to dismiss. The Court dismissed that complaint with prejudice on October 7, 2011. The time for that Lead plaintiff to appeal the dismissal has now passed.

In addition, the Company and certain directors and officers were also named as defendants in a derivative action filed on March 2, 2010 in the Supreme Court of New York, County of New York. The complaint in this action purported to state causes of action for breaches of fiduciary duties, unjust enrichment, abuse of control, gross mismanagement, and corporate waste. On October 20, 2010, the court dismissed the complaint, and found, among other things, that the plaintiff had not alleged that any of the Company's directors "knowingly' misrepresented or permitted others to misrepresent KCAP's financial condition," or that the directors were confronted with "red flags" sufficient to put them on notice of potential problems with KCAP's investment valuations so as to excuse plaintiff's requirement under Delaware law to make a demand on KCAP's board before filing suit. On January 12, 2011, the court entered the final judgment dismissing the complaint. While plaintiff filed a timely notice of appeal, the time to perfect that appeal expired in November.

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. The Company cannot predict the outcome of, or the time frame for, the conclusion of this investigation.

**9. STOCKHOLDERS' EQUITY**

On April 28, 2008 the Company completed a rights offering which resulted in the issuance of 3.1 million common shares and net proceeds of approximately $27 million. During the year ended December 31, 2011 and December 31, 2010, the Company issued 141,278 and 301,663 shares, respectively, of common stock under its dividend reinvestment plan. 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 were converted to common stock during the year due to vesting. The total number of shares issued and outstanding as of December 31, 2011 was and 22,992,211, respectively and shares issued and outstanding as of December 31, 2010 was 22,767,130.

**10. EQUITY INCENTIVE PLAN**

During 2006 and as amended in 2008, the Company established an equity incentive plan (the "Plan") and reserved 2,000,000 shares of common stock 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.

***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

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**10. EQUITY INCENTIVE PLAN – (continued)**

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, 2010 through December 31, 2011 is as follows:

| | Shares | Weighted Average Exercise Price per Share | Weighted Average Contractual Remaining Term (years) | Aggregate Intrinsic Value[(1)] |
|---|---|---|---|---|
| Options outstanding at January 1, 2010 | 40,000 | $ 8.45 | | |
| Granted | 20,000 | $ 4.83 | | |
| Exercised | — | $ — | | |
| Forfeited | — | $ — | | |
| Options outstanding at December 31, 2010 | 60,000 | $ 7.24 | | |
| Granted | — | $ — | | |
| Exercised | — | $ — | | |
| Forfeited | — | $ — | | |
| Outstanding at December 31, 2011 | 60,000 | $ 7.24 | 7.5 | $ 57,200 |
| Total vested at December 31, 2011 | 60,000 | $ 7.24 | 7.5 | |

(1) Represents the difference between the market value of shares of the Company upon exercise of the options at December 31, 2011 and the cost for the option holders to exercise the options.

For the year ended December 31, 2011, 20,000 options with a weighted average grant date fair value of $4.88 vested during the period and 50,000 options issued at a weighted average grant date fair value of $7.73 remained unvested. For the year ended December 31, 2010, 10,000 options with a weighted average grant date fair value of $4.83 vested during the period and 60,000 options issued at a grant date fair value of $7.24 weighted average remained unvested.

The Company uses a Binary Option Pricing Model (American, call option) to establish the expected value of all stock option grants. For the year ended December 31, 2011, the Company recognized non-cash compensation expense related to stock options of approximately $8,000. For the year ended December 31, 2010, the Company recognized non-cash compensation expense related to stock options of approximately $25,000. For the year ended December 31, 2009, the Company recognized non-cash compensation expense related to stock options of approximately $21,000. At December 31, 2011, the Company had no remaining compensation cost related to unvested stock-based awards.

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**10. EQUITY INCENTIVE PLAN – (continued)**

***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 October 7, 2011 and July 22, 2010, the Board of Directors approved the grant of an additional 86,805 and 103,519 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 December 31, 2011, 233,998 of such shares were vested and converted to common shares. 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 year ended December 31, 2011, 96,122 shares of restricted stock were vested and converted to common shares. As of December 31, 2011, after giving effect to these option cancellations and restricted stock awards, there were options to purchase 60,000 shares of common stock outstanding and there were 327,339 shares of restricted stock outstanding. Information with respect to restricted stock granted, exercised and forfeited under the Plan for the period January 1, 2009 through December 31, 2011 is as follows:

| | Non-Vested Restricted Shares | Weighted Average Exercise Price per Share |
|---|---|---|
| Non-vested shares outstanding at December 31, 2009 | 302,139 | $ 9.63 |
| Granted | 103,519 | $ 4.83 |
| Vested | (64,667) | $ 10.39 |
| Forfeited | (4,667) | $ 9.82 |
| Non-vested shares outstanding at December 31, 2010 | 336,324 | $ 8.01 |
| Granted | 90,805 | $ 8.11 |
| Vested | (96,122) | $ 11.16 |
| Forfeited | (3,668) | $ 9.67 |
| Outstanding at December 31, 2011 | 327,339 | $ 6.46 |
| Total non-vested shares at December 31, 2011 | 327,339 | $ 6.46 |

For the year ended December 31, 2011, non-cash compensation expense related to restricted stock was approximately $766,000; of this amount approximately $677,000 was expensed at the Company and approximately $89,000 was a reimbursable expense allocated to Katonah Debt Advisors. For the year ended December 31, 2010, non-cash compensation expense related to restricted stock was approximately $894,000; of this amount approximately $654,000 was expensed at the Company and approximately $240,000 was a reimbursable expense allocated to Katonah Debt Advisors. For the year ended December 31, 2009 non-cash

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**10. EQUITY INCENTIVE PLAN – (continued)**

compensation expense related to restricted stock was approximately $890,000; of this amount approximately $609,000 was expensed at the Company and approximately $281,000 was a reimbursable expense allocated to Katonah Debt Advisors.

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. At December 31, 2011, the Company had approximately $1 million of total unrecognized compensation cost related to nonvested share-based awards. That cost is expected to be recognized over a weighted average period of 2.3 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 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 years ended December 31, 2011 and 2010, the Company made contributions to the 401K Plan of approximately $23,000 and $29,000, respectively.

The Company has also adopted a deferred compensation plan ("Profit-Sharing Plan") effective January 1, 2007. Employees are eligible for the Profit-Sharing Plan provided that they are employed and working with the Company for 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 Profit-Sharing Plan. On behalf of the employee, the Company may contribute to the Profit-Sharing 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 Profit-Sharing Plan after five years of service. For the year ended December 31, 2011, the Company made contributions of approximately $139,000 to the Profit-Sharing Plan.

**12. IMPACT OF NEW ACCOUNTING STANDARDS**

In May 2011, the FASB issued Accounting Standards Update 2011-04, "Fair Value Measurements: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements" (ASU 2011-04). ASU 2011-04 amends Topic 820 to clarify existing fair value measurement disclosures to (1) specifically provide quantitative information about the significant unobservable inputs used for all level 3 measurements and (2) disclose any transfers between levels 1 and 2 of the fair value hierarchy, not just significant transfers. ASU 2011-04 also requires a number of additional disclosures regarding fair value measurements. Specifically, ASU 2011-04 requires entities to disclose: (1) a qualitative discussion about the sensitivity of recurring level 3 measurements to changes in the unobservable inputs disclosed, including the interrelationship between inputs; (2) a description of the Company's valuation processes surrounding level 3 measurements; (3) information about when the current use of a non-financial asset measured at fair value differs from its highest and best use; and (4) the hierarchy classification for items whose fair value is not recorded on the balance sheet but is disclosed in the notes. ASU 2011-04 amends Topic 820 to change the fair value measurement of financial instruments and the application of premiums and discounts in a fair value measurement. ASU 2011-04 also clarifies existing fair value measurement regarding the concepts of valuation premise, the application of the highest and best use, and the fair value measurement of an instrument classified in an entity's shareholders' equity. The adoption of ASU 2011-04 is not expected to have an effect on the Company's current fair value measurements but is expected to have a significant impact on the Company's disclosures related to the assets and liabilities of its consolidated investment products that are classified as level 3 assets within the fair value hierarchy. The amendments to Topic 820 made by ASU 2011-04 are effective for interim and annual periods beginning on or after December 15, 2011. As such, these disclosure changes will be required in the Company's Form 10-Q for the three months ended March 31, 2012.

KOHLBERG CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

**13. SELECTED QUARTERLY DATA (Unaudited)**

| | Q1 2011 | Q2 2011 | Q3 2011 | Q4 2011 |
|---|---|---|---|---|
| Total interest and related portfolio income | $7,346,660 | $6,293,311 | $ 7,260,030 | $ 7,106,522 |
| Net investment income | $5,007,602 | $2,900,004 | $ 4,047,546 | $ 4,064,052 |
| Net increase (decrease) in net assets resulting from operations | $9,604,633 | $ 873,829 | $(1,485,255) | $(1,343,663) |
| Net increase (decrease) in net assets resulting from operations per share – basic | $ 0.43 | $ 0.04 | $ (0.07) | $ (0.06) |
| Net increase (decrease) in net assets resulting from operations per share – diluted | $ 0.43 | $ 0.04 | $ (0.07) | $ (0.06) |
| Net investment income per share – basic | $ 0.22 | $ 0.13 | $ 0.18 | $ 0.18 |
| Net investment income per share – diluted | $ 0.22 | $ 0.13 | $ 0.18 | $ 0.18 |

| | Q1 2010 | Q2 2010 | Q3 2010 | Q4 2010 |
|---|---|---|---|---|
| Total interest and related portfolio income | $6,963,826 | $ 7,382,805 | $ 8,091,217 | $ 6,916,015 |
| Net investment income | $2,578,494 | $ 297,198 | $ 3,831,270 | $ 5,190,156 |
| Net increase (decrease) in net assets resulting from operations | $1,594,909 | $(5,690,916) | $(3,319,312) | $(6,873,359) |
| Net increase (decrease) in net assets resulting from operations per share – basic and diluted | $ 0.07 | $ (0.26) | $ (0.15) | $ (0.31) |
| Net increase (decrease) in net assets resulting from operations per share – diluted | $ 0.07 | $ (0.26) | $ (0.15) | $ (0.31) |
| Net investment income per share – basic | $ 0.12 | $ 0.01 | $ 0.17 | $ 0.23 |
| Net investment income per share – diluted | $ 0.12 | $ 0.01 | $ 0.17 | $ 0.23 |

**14. SUBSEQUENT EVENTS**

On February 24, 2012, the Company entered into a Note Purchase Agreement (the "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 ("BNYM"), and KCAP Funding, a special-purpose bankruptcy remote wholly-owned subsidiary of the Company ("KCAP Funding"), whereby KCAP Funding purchased a portfolio of senior secured term loans (the "Collateral Debt Obligations"), the purchase of which was financed by the issuance of (a) a senior note in an aggregate principal amount of $30.0 million, issued to CS in exchange for $30.0 million in cash and (b) a junior note in an aggregate principal amount of $12.5 million, issued to the Company in exchange for the sale by the Company to KCAP Funding of the Collateral Debt Obligations. Pursuant to the Note Purchase Agreement, the Company has agreed to act as Portfolio Manager on behalf of KCAP Funding and CS of the Collateral Debt Obligations, and has granted a security interest to KCAP Funding in all of the Company's right to receive certain management fees, and KCAP Funding granted to CS a security interest in, among other things, the Collateral Debt Obligations and its rights to receive the management fees pledged to it by the Company. In its capacity as Portfolio Manager, the Company also entered into a Collateral Administration Agreement, dated as of February 24, 2012, with KCAP Funding, CS and BNYM, as collateral administrator and collateral agent, whereby BNYM will, among other things, hold the collateral on behalf of CS, as secured party, administer the Collateral Debt Obligations and perform certain other administrative obligations.

On February 29, 2012, the Company completed the acquisition of Trimaran Advisors, L.L.C. ("Trimaran") through a newly-formed, wholly-owned subsidiary of the Company. The aggregate consideration paid for all of the outstanding equity interests in Trimaran consisted of $13.0 million in cash and 3,600,000 shares of common stock, par value $0.01 per share, of the Company. Trimaran manages four CLO Funds with aggregate assets under management of approximately $1.5 billion. Contemporaneously with the acquisition, the Company also acquired the subordinated or preferred share interests in certain CLO Funds managed by Trimaran for an aggregate cash purchase price of $12.0 million.

## OTHER FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Member of
**Katonah Debt Advisors**

Katonah Debt Advisors, L.L.C.

We have audited the accompanying combined balance sheets of Katonah Debt Advisors, L.L.C., and affiliates, Katonah Management Holding, LLC, Katonah X Management LLC, Katonah 2007-I Management LLC, Katonah Scott's Cove Capital Management LLC, Katonah VII CLO Ltd., Katonah VIII CLO Ltd., Katonah IX CLO Ltd., Katonah X CLO Ltd., and Katonah 2007-I CLO, Ltd., (a Delaware corporation) (collectively, the "Company") as of December 31, 2011 and 2010, and the related combined statements of operations, changes in member's equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of Katonah Debt Advisors, L.L.C. and affiliates as of December 31, 2011 and 2010, and the results of their operations, changes in member's equity and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

New York, New York
March 15, 2012

## KATONAH DEBT ADVISORS, L.L.C.

## COMBINED BALANCE SHEETS

| | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| **ASSETS** | | |
| Investments of CLO Funds at fair value | $ 1,768,088,977 | $ 1,741,497,876 |
| Cash | 6,364,939 | 4,497,282 |
| Restricted cash of CLO Funds | 71,888,141 | 137,546,770 |
| Accrued management fees receivable | — | 198,521 |
| Accrued interest receivable | 8,065,586 | 7,968,701 |
| Deferred tax asset | 383,348 | — |
| Other assets | 722,440 | 2,874,698 |
| Total assets | $ 1,855,513,431 | $ 1,894,583,848 |
| **LIABILITIES** | | |
| CLO Fund liabilities at fair value | $ 1,727,560,760 | $ 1,717,378,071 |
| Accrued interest expense | 7,676,896 | 6,231,024 |
| Payable for open trades | 15,454,626 | 32,235,824 |
| Accounts payable and accrued expenses | 2,749,899 | 2,481,610 |
| Deferred tax liability | — | 182,585 |
| Total liabilities | $ 1,753,442,181 | $ 1,758,509,114 |
| **MEMBER'S EQUITY** | | |
| Member's contributions | $ 12,933,258 | $ 12,112,655 |
| Accumulated earnings (deficit) | (6,707,276) | (5,548,487) |
| Total Katonah Debt Advisors L.L.C. equity | 6,225,982 | 6,564,168 |
| Appropriated retained earnings of Consolidated Variable Interest Entities | 95,845,268 | 129,510,566 |
| Total member's equity | 102,071,250 | 136,074,734 |
| Total liabilities and member's equity | $ 1,855,513,431 | $ 1,894,583,848 |

See accompanying notes to combined financial statements.

## KATONAH DEBT ADVISORS, L.L.C.

## COMBINED STATEMENTS OF OPERATIONS

| | For the Year Ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| | | | (unaudited) |
| **Income** | | | |
| Interest income – investments of CLO Funds | $ 68,772,354 | $ 63,504,932 | $ — |
| Interest income – cash and time deposits | 72,372 | 81,297 | 17,617 |
| Management and incentive fees | 448,790 | 1,376,108 | 10,158,056 |
| Fee income – investments of CLO Funds | 3,769,889 | 2,318,083 | — |
| Other income | 7,231 | 24,244 | 6,897 |
| **Total income** | 73,070,636 | 67,304,664 | 10,182,570 |
| **Expenses** | | | |
| Interest expense of CLO Fund liabilities | 55,650,280 | 36,043,196 | — |
| Compensation | 5,399,450 | 6,557,730 | 6,497,776 |
| Insurance | 469,089 | 403,171 | 372,531 |
| Professional fees | 990,307 | 2,262,786 | 382,506 |
| Administrative and other | 1,429,837 | 1,609,358 | 1,110,023 |
| Trustee fees | 540,683 | 545,326 | — |
| **Total expenses** | 64,479,646 | 47,421,567 | 8,362,836 |
| Net realized and unrealized gain (loss) | (41,726,392) | (29,488,314) | — |
| **Net income (loss) before tax** | (33,135,402) | (9,605,217) | 1,819,734 |
| Income tax expense (benefit) | (221,315) | 873,901 | 1,228,518 |
| **Net income (loss)** | (32,914,087) | (10,479,118) | 591,216 |
| Net income (loss) attributable to noncontrolling interests in consolidated Variable Interest Entities | (33,665,298) | (11,002,220) | — |
| Net income (loss) attributable to Katonah Debt Advisors, L.L.C. | $ 751,211 | $ 523,102 | $ 591,216 |

See accompanying notes to combined financial statements.

## KATONAH DEBT ADVISORS, L.L.C.

## COMBINED STATEMENTS OF CHANGES IN MEMBER'S EQUITY

| | Member's Contributions | Accumulated Earnings (Deficit) | Appropriated Retained Earnings of Variable Interest Entities | Total Member's Equity |
|---|---|---|---|---|
| **Total at January 1, 2009 (unaudited)** | **$ 4,748,421** | **$ (2,162,805)** | **$ —** | **$ 2,585,616** |
| Net income (loss) (unaudited) | — | 591,216 | — | 591,216 |
| Contributions (unaudited) | 3,600,016 | — | — | 3,600,016 |
| **Total at December 31, 2009 (unaudited)** | **8,348,437** | **(1,571,589)** | **—** | **6,776,848** |
| Adoption of guidance now encompassed in ASC Topic 810 | — | — | 140,512,786 | 140,512,786 |
| January 1, 2010, as adjusted | 8,348,437 | (1,571,589) | 140,512,786 | 147,289,634 |
| Net income (loss) | — | 523,102 | — | 523,102 |
| Contributions | 3,764,218 | — | — | 3,764,218 |
| Distributions | — | (4,500,000) | — | (4,500,000) |
| Net income (loss) classified as appropriated retained earnings | — | — | (11,002,220) | (11,002,220) |
| Total at December 31, 2010 | **12,112,655** | **(5,548,487)** | **129,510,566** | **136,074,734** |
| Net income (loss) | — | 751,211 | — | 751,211 |
| Distributions | (34,640) | (1,910,000) | — | (1,944,640) |
| Contributions | 855,243 | — | — | 855,243 |
| Net income (loss) classified as appropriated retained earnings | — | — | (33,665,298) | (33,665,298) |
| **Total at December 31, 2011** | **$ 12,933,258** | **$ (6,707,276)** | **$ 95,845,268** | **$102,071,250** |

See accompanying notes to combined financial statements.

## KATONAH DEBT ADVISORS, L.L.C.

## COMBINED STATEMENTS OF CASH FLOWS

| | Year Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2011 | | 2010 | | 2009 (unaudited) | |
| | Katonah Debt Advisors, L.L.C. cash | Katonah Debt Advisors CLO Restricted Cash | Katonah Debt Advisors, L.L.C. cash | Katonah Debt Advisors CLO Restricted Cash | Katonah Debt Advisors, L.L.C. cash | Katonah Debt Advisors CLO Restricted Cash |
| OPERATING ACTIVITIES: | | | | | | |
| Net income (loss) attributable to Katonah Debt Advisors | $ 751,211 | — | $ 523,102 | — | $ 591,216 | — |
| Net income (loss) attributable to Variable Interest Entities | — | $ (33,665,298) | — | $ (11,002,220) | — | — |
| **Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:** | | | | | | |
| Net change in deferred tax assets | (565,933) | — | 620,648 | — | (63,285) | — |
| Net realized and unrealized loss | 1,808,520 | 39,917,872 | — | 29,488,314 | — | — |
| **Changes in operating assets and liabilities:** | | | | | | |
| Decrease (increase) in accrued management fees receivable | 190,826 | 7,694 | 3,849,962 | (3,878,142) | (2,265,122) | — |
| Decrease (increase) in accrued interest receivable | (13) | (96,872) | 3 | (2,348,135) | 243 | — |
| Decrease receivable for open trades | — | — | — | 1,855,000 | — | — |
| Decrease (increase) in other assets | 78,190 | (131,130) | 283,247 | 9,039 | 510,312 | — |
| Increase (decrease) in accounts payable and accrued expenses | 444,253 | (29,284) | (369,846) | (31,487) | (4,639,838) | — |
| Increase (decrease) in payable for open trades | — | (16,781,198) | — | 13,508,283 | — | — |
| Increase (decrease) in accrued interest expense | — | 1,445,871 | — | 2,503,203 | — | — |
| Net cash provided by (used in) operating activities | 2,707,054 | (9,332,345) | 4,907,116 | 30,103,855 | (5,866,474) | — |
| **Investing activities:** | | | | | | |
| Change in Investments: | | | | | | |
| Purchase of investments | — | (836,925,087) | — | (646,646,273) | — | — |
| Sale of investments | — | 77,790,466 | — | 117,530,020 | — | — |
| Proceeds from sale and redemption of investments | 250,000 | 704,008,337 | — | 532,448,082 | — | — |
| Net cash provided by (used in) investing activities | 250,000 | (55,126,284) | — | 3,331,829 | — | — |
| **Financing Activities:** | | | | | | |
| Member’s contributions | 855,243 | — | 3,764,218 | — | 3,600,016 | — |
| Member’s distributions | (34,640) | — | — | — | — | — |
| Dividends paid in cash | (1,910,000) | — | (4,500,000) | — | — | — |
| Repayments of Debt | — | (1,200,000) | — | (9,821,734) | — | — |
| Net cash provided by (used in) financing activities | (1,089,397) | (1,200,000) | (735,782) | (9,821,734) | 3,600,016 | — |
| CHANGE IN CASH | 1,867,657 | (65,658,629) | 4,171,334 | 23,613,950 | (2,266,458) | — |
| CASH, BEGINNING OF YEAR | 4,497,282 | 137,546,770 | 325,948 | 113,932,820 | 2,592,406 | — |
| CASH, END OF YEAR | $ 6,364,939 | $ 71,888,141 | $ 4,497,282 | $ 137,546,770 | $ 325,948 | — |
| Supplemental Information: | | | | | | |
| Cash paid for interest | — | $ 54,204,409 | — | $ 33,539,993 | — | |
| Cash paid for taxes | $ 40,500 | — | $ 477,904 | — | $ 579,944 | |

See accompanying notes to combined financial statements.

## KATONAH DEBT ADVISORS, L.L.C.

## NOTES TO COMBINED FINANCIAL STATEMENTS

### 1. ORGANIZATION

Katonah Debt Advisors, L.L.C., and affiliates, Katonah Management Holding, LLC, Katonah X Management LLC, Katonah 2007-I Management LLC, Katonah Scott's Cove Capital Management LLC, Katonah VII CLO Ltd., Katonah VIII CLO Ltd., Katonah IX CLO Ltd., Katonah X CLO Ltd., and Katonah 2007-I CLO, Ltd. (collectively with its affiliates, "Katonah Debt Advisors") manages collateralized loan obligation funds ("CLO Funds") which invest in broadly syndicated loans, high-yield bonds and other credit instruments. Katonah Debt Advisors is wholly owned by Kohlberg Capital Corporation ("Kohlberg Capital") which is an internally managed, non-diversified closed-end publically traded investment company that is regulated as a business development company ("BDC") under the Investment Company Act of 1940. Katonah Debt Advisors does not have any investment interests in the CLO Funds it manages; however, Kohlberg Capital holds investments in a portion of the bonds issued by the CLO Funds managed by Katonah Debt Advisors.

Katonah Debt Advisors provides investment management services to CLO Funds, making day-to-day investment decisions concerning the assets of the CLO Funds. As of December 31, 2011, Katonah Debt Advisors had approximately $1.9 billion of assets under management in five CLO Funds.

The five CLO funds managed by Katonah Debt Advisors are considered to be variable interest entities ("VIEs") for which Katonah Debt Advisors is the primary beneficiary are consolidated into the financial statements of Katonah Debt Advisors as discussed in Note 3 — CLO Funds.

On January 2, 2008, the Katonah Debt Advisors platform acquired substantially all of the assets of Scott's Cove Capital Management LLC ("Scott's Cove"), an asset manager focused on an event-driven credit long short investment strategy. On February 28, 2011, Katonah Debt Advisors sold its interest in Scotts Cove to a third-party buyer controlled by a former Katonah Debt Advisors employee for a purchase price of $25,000 and the buyer entered into a Services Agreement, pursuant to which the buyer paid to Katonah Debt Advisors $225,000 for certain transitional services to be provided by Katonah Debt Advisors and agreed to pay an additional amount of $75,000 on each of the first and second anniversaries of the closing date (subject to, in the case of the first payment, deferment for up to one year under certain circumstances). During the year ended December 31, 2011, Katonah Debt Advisors recognized a loss of $1.8 million on the sale of Scott's Cove which is included in net realized and unrealized gain (loss) on the combined statements of operations.

### 2. SIGNIFICANT ACCOUNTING POLICIES

**Basis of Accounting and Combination**

In the opinion of management, the combined financial statements reflect all adjustments, consisting of normal recurring accruals, which are necessary for the fair presentation of the financial condition and results of operations for the periods presented. All significant intercompany transactions, balances, revenues and expenses are eliminated upon combination.

*Use of Estimates*

The preparation of the financial statements requires management to make significant estimates and assumptions that affect reported revenues, expenses, assets and liabilities and disclosure of contingent liabilities, including the fair value of CLO fund investments and CLO fund liabilities that do not have a readily available market value. Actual results could differ from those estimates, and the differences could be material.

The combined financial statements have been prepared in accordance with U.S. GAAP and include the financial statements of Katonah Debt Advisors and any VIEs required to be consolidated. A VIE is an entity that does not have sufficient equity to finance its operations without additional subordinated financial support, or an entity for which the risks and rewards of ownership are not directly linked to voting interests. Control is deemed to be present when the Parent holds a majority voting interest or otherwise has the power to govern the financial and operating policies of the subsidiary or VIE so as to obtain the benefits from its activities.

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

Katonah Debt Advisors provides investment management services to CLO Funds, making day-to-day investment decisions concerning the assets of the CLO Funds. All of the CLO Funds are considered to be VIEs as discussed in Note 3 — CLO Funds.

Although Katonah Debt Advisors has no ownership interests in the CLO Funds it manages, Katonah Debt Advisors follows the provisions of Accounting Standards Codification (ASC) Topic 810, "Consolidation," when accounting for VIEs further detailed below.

For CLO Funds, if Katonah Debt Advisors is deemed to have the power to direct the activities of the CLO that most significantly impact the CLO's economic performance, and the obligation to absorb losses/right to receive benefits (management fees and potential incentive fees) from the CLO that could potentially be significant to the CLO, then Katonah Debt Advisors is deemed to be the CLO's primary beneficiary and is required to consolidate the CLO.

All of the investments held and notes issued by CLO Funds considered to be VIEs are presented at fair value in Katonah Debt Advisors' Combined Balance Sheet and interest income and expense of consolidated CLO Funds are presented in Katonah Debt Advisors' Combined Statement of Operations. The surplus of consolidated CLO assets over CLO liabilities is reflected in Katonah Debt Advisor's Combined Balance Sheets as retained earnings appropriated for investors in consolidated variable interest entities. Current period gains (losses) attributable to investors in consolidated CLOs are included in gains (losses) attributable to non-controlling interests in consolidated variable interest entities in the Combined Statement of Operations and in appropriated retained earnings of consolidated variable interest entities in the Consolidated Balance Sheets, as they are considered non-controlling interests of Katonah Debt Advisors.

*Accounting Standards Codification*. In June 2009, the Financial Accounting Standards Board ("FASB") issued a pronouncement establishing the FASB Accounting Standards Codification ("ASC") as the source of authoritative accounting principles recognized by the FASB to be applied in the preparation of financial statements in conformity with GAAP. The ASC reorganized existing U.S. accounting and reporting standards issued by the FASB and other related private sector standard setters into a single source of authoritative accounting principles arranged by topic. The standard explicitly recognizes rules and interpretive releases of the Commission under federal securities laws as authoritative GAAP for SEC registrants. The ASC supersedes all existing U.S. accounting standards; all other accounting literature not included in the ASC (other than SEC guidance for publicly-traded companies) is considered non-authoritative. The ASC was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. The adoption of the ASC changed the references to U.S. GAAP accounting standards but did not impact its results of operations, financial position or liquidity.

***Investments of CLO Funds at Fair Value***. Investment transactions are recorded on the applicable trade date. Realized gains or losses are determined using the specific identification method. Investments held by the CLO Funds are stated at fair value. ASC 820-10, Fair Value Measurements and Disclosures ("ASC 820-10"), requires among other things, disclosures about assets and liabilities that are measured and reported at fair value.

*Hierarchy of Fair Value Inputs*. The provisions of ASC 820-10 establish a hierarchy that prioritizes inputs to valuation techniques used to measure fair value and require companies to disclose the fair value of their financial instruments according to the fair value hierarchy (i.e., Level 1, 2 and 3 inputs, as defined). The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. Additionally, companies are required to provide additional disclosure regarding instruments in the Level 3 category (which have inputs to the valuation techniques that are unobservable and require significant management judgment), including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities.

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

Assets and liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

Level 1 Inputs:

Quoted prices (unadjusted) in active markets for identical assets or liabilities at the reporting date.

- Level 1 assets may include listed mutual funds (including those accounted for under the equity method of accounting as these mutual funds are investment companies, that have publicly available NAVs which in accordance with GAAP are calculated under fair value measures and are equal to the earnings of such funds), ETFs, equities and certain derivatives.

Level 2 Inputs:

Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities that are not active; quotes from pricing services or brokers, for which Katonah Debt Advisors can determine that orderly transactions took place at the quoted price or that the inputs used to arrive at the price were observable; and inputs other than quoted prices that are observable, such as models or other valuation methodologies.

- Level 2 assets in this category may include debt securities, bank loans, short-term floating rate notes and asset-backed securities, restricted public securities valued at a discount, as well as over the counter derivatives, including interest and inflation rate swaps and foreign currency exchange contracts that have inputs to the valuations that generally can be corroborated by observable market data.

Level 3 Inputs:

Unobservable inputs for the valuation of the asset or liability, which may include non-binding broker quotes. Level 3 assets include investments for which there is little, if any, market activity. These inputs require significant management judgment or estimation.

- Level 3 assets in this category may include general and limited partnership interests in private equity funds, funds of private equity funds, real estate funds, hedge funds, and funds of hedge funds, direct private equity investments held within consolidated funds, bank loans, bonds issued by CLO Funds and certain held for sale real estate disposal assets.
- Level 3 liabilities included in this category include borrowings of consolidated collateralized loan obligations valued based upon non-binding broker quotes or discounted cash flow model based on a discount margin calculation.

Significance of Inputs:

Katonah Debt Advisors' assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument.

*Valuation of Portfolio Investments*. 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 based on detailed analyses prepared by management, and, in certain circumstances, may utilize third parties with valuation expertise. Katonah Debt Advisors follows the provisions of ASC 820-10. 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 ASC 820-10, the FASB has issued various staff positions clarifying the initial standard as noted below.

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

In January 2010, the FASB issued guidance that clarifies and requires new disclosures about fair value measurements. The clarifications and requirement to disclose the amounts and reasons for significant transfers between Level 1 and Level 2, as well as significant transfers in and out of Level 3 of the fair value hierarchy, were adopted by Katonah Debt Advisors in 2010.

*Fair Value Measurements and Disclosures* requires the disclosure 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.

Katonah Debt Advisors' valuation methodology and procedures for investments held by the CLO Funds are generally as follows:

1. For any asset which is also held by Kohlberg Capital on the applicable date, the Kohlberg Capital fair value mark as of such applicable date is used.
2. 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 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 ASC 820-10.
3. If an investment does not have a market quotation on either a broad market exchange or from an independent pricing service, the investment is initially valued by Katonah Debt Advisors' investment professionals responsible for the portfolio investment in conjunction with the portfolio management team. Generally, such fair values 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. 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.
4. Preliminary valuation conclusions are discussed and documented by management.
5. Illiquid loans, junior and mezzanine securities and investments in other CLO bonds are fair valued using models developed by management with applicable market assumptions.
6. Management discusses the valuations and determines in good faith that the fair values of each investment in the portfolio is reasonable based upon any applicable independent pricing service, input of management, and estimates from independent valuation firms (if any).

*Debt Securities*. Most of the CLO Funds' investment portfolio is composed of broadly syndicated debt securities for which an independent pricing service quote is available. To the extent that the 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.

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

***CLO Fund Securities***. The CLO Funds managed by Katonah Debt Advisors may selectively invest in securities issued by funds managed by other asset management companies. For bond rated tranches of CLO Funds (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***. Katonah Debt Advisors' defines cash as demand deposits. Katonah Debt Advisors' 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 of CLO Funds***. Restricted cash consist of cash held for reinvestment, quarterly interest and principal distributions (if any) to holders of CLO Fund liabilities, and payment of CLO Fund expenses.

***CLO Fund Liabilities at Fair Value***. Katonah Debt Advisors has no debt; however the CLO Funds it manages and that are consolidated herein, have issued rated and unrated bonds to finance their operations. Debt is presented at fair value.

***Interest Income***. Interest income is recorded on the accrual basis on interest-bearing assets. The CLO Funds 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 Katonah Debt Advisors otherwise does not expect the debtor to be able to service its debt obligations. Non-accrual loans represented 0.23% and 0.63% of Investments of CLO Funds at fair value as of December 31, 2011 and December 31, 2010, respectively. The aggregate unpaid principal value of loans past due as of December 31, 2011 was approximately $28.0 million and the difference between fair value and the unpaid principal balance was approximately $24.1 million. The aggregate unpaid principal value of loans past due as of December 31, 2010 was approximately $47.9 million and the difference between fair value and the unpaid principal balance was approximately $36.9 million.

***Management and Incentive Fees***. As a manager of CLO Funds and the Scotts Cove Funds, Katonah Debt Advisors receives management fees and incentive fees, which are contractual interests that Katonah Debt Advisors earns based on assets under management, and a percentage of net profits (Scotts Cove Funds) and residual cash flows, subject to a specified relative and/or absolute investment (CLO Funds), respectively. Incentive fees may be earned by Katonah Debt Advisors upon exceeding specified relative and/or absolute investment 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. At December 31, 2011, and December 31, 2010, Katonah Debt Advisors has not earned any incentive fees from the CLO Funds.

For the year ended December 31, 2009, Kohlberg Debt Advisors earned management fees of $10.2 million. For the years ended December 31, 2011 and 2010, Katonah Debt Advisors earned management fees and incentive fees from the Scotts Cove Funds of $500 thousand and $1.4 million respectively. The management fees Katonah Debt Advisors receives from the CLO Funds, which have two components — a senior management fee and a subordinated management fee — have been eliminated in consolidation for the years ended December 31, 2011 and 2010.

***Fee Income***. Fee income is earned upon the completion of transactions involving collateral assets in our CLO Funds and include, but are not limited to, restructuring fees, delayed closing fees, commitment fees and consent fees, which are recorded in the combined Financial Statements on the date the transactions are legally closed.

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

***Dividends to Member***. Dividends payable to Katonah Debt Advisors' sole member are recognized on the declaration date. Generally, dividends are declared and paid on a quarterly basis.

***Expenses***. Katonah Debt Advisors 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, monitoring and servicing the CLO Fund investments managed Katonah Debt Advisors and related overhead charges and expenses, including rental expense. Katonah Debt Advisors' and its asset manager affiliates share office space and certain other operating expenses. Katonah Debt Advisors has entered into an Overhead Allocation Agreement with its sole member, Kohlberg Capital, 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 settled quarterly. Katonah Debt Advisors accounts for its operating leases, which may include escalations, in accordance with ASC 840-10, Leases, and expenses the lease payments associated with operating leases evenly during the lease term (including rent-free periods), beginning on the commencement of the lease term.

***Interest Expenses***. Katonah Debt Advisors has no debt; however the CLO Funds it manages and that are consolidated herein, have issued rated and unrated bonds to finance their operations. Interest on CLO Fund liabilities is calculated by the third party trustee of the CLO Funds. Interest is accrued and generally paid quarterly.

***Trustee Fees***. Each CLO Fund has a third party trustee that is the custodian for all investments of the CLO Funds and receives and disburses all cash in accordance to the trustee and custodial agreements. Trustee fees are accrued and paid quarterly by the CLO Funds.

***Income Taxes***. Katonah Debt Advisors accounts for income taxes under the asset and liability method prescribed by ASC 740-10, Income Taxes ("ASC 740-10"). Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases using currently enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on deferred income tax assets and liabilities is recognized in income in the period that includes the enactment date.

Management periodically assesses the recoverability of its deferred income tax assets based upon expected future earnings, taxable income in prior carryback years, future deductibility of the asset, changes in applicable tax laws and other factors. If management determines that it is not more likely than not that the deferred tax asset will be fully recoverable in the future, a valuation allowance will be established for the difference between the asset balance and the amount expected to be recoverable in the future. This allowance will result in a charge to income tax expense on the combined statements of income. Katonah Debt Advisors records its income taxes receivable and payable based upon its estimated income tax liability.

ASC 740-10 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements by prescribing a threshold for measurement and recognition in the financial statements of an asset or liability resulting from a tax position taken or expected to be taken in an income tax return. ASC 740-10 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

***Accounting Policies Adopted in the Year Ended December 31, 2010***

*New Consolidation Guidance for Variable Interest Entities*

In June 2009, the Financial Accounting Standards Board ("FASB") issued ASU 2009-17, which amended the consolidation guidance for VIEs. The amendments include: (1) the elimination of the exemption from consolidation for qualifying special purpose entities, (2) a new approach for determining the primary beneficiary of a VIE, which requires that the primary beneficiary have both (i) the power to control the most

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

significant activities of the VIE and (ii) either the obligation to absorb losses or the right to receive benefits that potentially could be significant to the VIE, and (3) the requirement to continually reassess the primary beneficiary of a VIE.

On January 1, 2010, upon the adoption of the forgoing guidance now encompassed in ASC 810, Katonah Debt Advisors determined it was the primary beneficiary of all five of the CLO Funds it manages as it has the power to direct the activities of the CLO Funds that most significantly impact the CLO Funds' economic performance, and the obligation to absorb losses/right to receive benefits (in the form of senior and subordinate management fees as well as the potential to earn an incentive fee) from the CLO Funds that could potentially be significant to the CLO Funds. As a result, these CLO Funds are consolidated into the combined financial statements of Katonah Debt Advisors.

*Fair Value Option*

Upon consolidation of the CLO Funds, the assets and liabilities of the consolidated CLOs were measured at fair value, as the determination of carrying amounts was not practicable. Katonah Debt Advisors has elected the fair value option under ASC Topic 825-10-25 to measure the assets and liabilities of all consolidated CLOs at fair value subsequent to the date of initial adoption of this additional guidance to mitigate accounting mismatches between the carrying value of the assets and liabilities and to achieve operational simplifications.

The cumulative effect adjustment upon adoption at January 1, 2010 resulted in an appropriation of retained earnings of $140.5 million.

*Improved Disclosures Regarding Fair Value Measurements.*

In January 2010, the FASB issued Accounting Standards Update 2010-06, "Improving Disclosures about Fair Value Measurements" (ASU 2010-06). ASU 2010-06 amends Topic 820 to require a number of additional disclosures regarding fair value measurements. Specifically, ASU 2010-06 requires entities to disclose: (1) the amount of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for these transfers; (2) the reasons for any transfers in or out of Level 3; and (3) information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements on a gross basis. ASU 2010-06 also clarifies existing fair value disclosures about the appropriate level of disaggregation and about inputs and valuation techniques for both recurring and nonrecurring fair value measurements that fall in either Level 2 or Level 3. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The additional disclosure requirements with respect to rollforward activity did not have a significant impact on the Company's disclosures.

In May 2011, the FASB issued Accounting Standards Update 2011-04, "Fair Value Measurements: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements" (ASU 2011-04). ASU 2011-04 amends Topic 820 to clarify existing fair value measurement disclosures to (1) specifically provide quantitative information about the significant unobservable inputs used for all level 3 measurements and (2) disclose any transfers between levels 1 and 2 of the fair value hierarchy, not just significant transfers. ASU 2011-04 also requires a number of additional disclosures regarding fair value measurements. Specifically, ASU 2011-04 requires entities to disclose: (1) a qualitative discussion about the sensitivity of recurring level 3 measurements to changes in the unobservable inputs disclosed, including the interrelationship between inputs; (2) a description of the Company's valuation processes surrounding level 3 measurements; (3) information about when the current use of a non-financial asset measured at fair value differs from its highest and best use; and (4) the hierarchy classification for items whose fair value is not recorded on the balance sheet but is disclosed in the notes. ASU 2011-04 amends Topic 820 to change the fair value measurement of financial instruments and the application of premiums and discounts in a fair value measurement. ASU 2011-04 also clarifies existing fair value measurement regarding the concepts of valuation premise, the application of the

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

highest and best use, and the fair value measurement of an instrument classified in an entity's shareholders' equity. The adoption of ASU 2011-04 is not expected to have an effect on the Company's current fair value measurements but is expected to have a significant impact on the Company's disclosures related to the assets and liabilities of its consolidated investment products that are classified as level 3 assets within the fair value hierarchy. The amendments to Topic 820 made by ASU 2011-04 are effective for interim and annual periods beginning on or after December 15, 2011.

**3. CLO FUNDS**

A CLO Fund generally refers to a special purpose vehicle that owns a portfolio of investments and issues various tranches of debt and subordinated note securities to finance the purchase of those investments. Investments purchased by the CLO Funds are governed by extensive investment guidelines, including limits on exposure to any single industry or issuer and limits on the ratings of the CLO Fund's assets. The CLO Funds managed by Katonah Debt Advisors have a defined investment period during which they are allowed to make investments or reinvest capital as it becomes available.

Katonah Debt Advisors manages five CLO Funds primarily for third party investors that invest in broadly syndicated loans, high yield bonds and other credit instruments issued by corporations. These CLO Funds do not invest in asset-backed securities secured by commercial mortgages, residential mortgages or other consumer borrowings. At December 31, 2011 and 2010, Katonah Debt Advisors had approximately $1.9 billion of par value of assets under management in these CLO Funds.

CLO Funds typically issue multiple tranches of debt and subordinated note securities with varying ratings and levels of subordination to finance the purchase their underlying investments. Interest and principal payments (net of designated CLO Fund expenses) from the CLO Fund are paid to each issued security in accordance with an agreed upon priority of payments, commonly referred to as the "waterfall." The most senior notes, generally rated AAA/Aaa, commonly represent the majority of the total liabilities of the CLO Fund. AAA/Aaa notes are issued at a specified spread over LIBOR and normally have the first claim on the earnings on the CLO Fund's investments after payment of certain fees and expenses. Lower subordinated "mezzanine" tranches of rated notes generally have ratings ranging from AA/Aa to BB/Ba and are usually issued at a specified spread over LIBOR with higher spreads paid on the tranches with lower ratings. Each tranche is typically only entitled to a share of the earnings on the CLO Fund's investments if the required interest and principal payments have been made on the more senior tranches in the waterfall. The most junior tranche can take the form of either subordinated notes or preferred shares. The subordinated notes or preferred shares generally do not have a stated coupon but are entitled to residual cash flows from the CLO Fund's investments after all of the other tranches of notes and certain other fees and expenses are paid.

The CLO Funds are primarily financed via capital contributed by equity and debt holders. Katonah Debt Advisors' risk with respect to each investment in the CLO Funds it manages is limited to any uncollected management fees (as Katonah Debt Advisors has no investment in the CLO Funds and it has no exposure or benefits in the ownership of the CLO Funds bonds). Therefore, the gains or losses of the CLO Funds have not had a significant impact on Katonah Debt Advisors' financial position, results of operations or cash flows. Katonah Debt Advisors has no right to the benefits from, nor does it bear the risks associated with, these investments, beyond the management fees generated from the CLO Funds. If Katonah Debt Advisors were to liquidate, these investments would not be available to any general creditors of Katonah Debt Advisors. Additionally, the collateral assets of consolidated CLO Funds are held solely to satisfy the obligations of the CLO Funds, and the investors in the consolidated CLO Funds have no recourse to the general credit of Katonah Debt Advisors for the notes issued by the CLO Funds.

CLO Funds are investment vehicles created for the sole purpose of issuing collateralized loan instruments that offer investors the opportunity for returns that vary with the risk level of their investment. The notes issued by the CLO Funds are backed by diversified collateral asset portfolios consisting primarily of loans or

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**3. CLO FUNDS – (continued)**

structured debt. For managing the collateral for the CLO Fund entities, Katonah Debt Advisors earns investment management fees, including subordinated management fees, as well as contingent incentive fees. Katonah Debt Advisors has no investment in the CLO Funds it manages. However, its sole shareholder, Kohlberg Capital, has invested in certain of the CLO Funds, generally taking a portion of the unrated, junior subordinated position (generally subordinated to other interests in the entities and entitle Kohlberg Capital and other subordinated tranche investors to receive the residual cash flows, if any, from the entities).

Upon adoption of guidance encompassed in ASC Topic 810, Katonah Debt Advisors determined that it was the primary beneficiary of these CLO Funds, as it has the power to direct the activities of the CLO Funds that most significantly impact the CLO Funds' economic performance, and the obligation to absorb losses/right to receive benefits (in the form of senior and subordinate management fees as well as the potential to earn an incentive fee) from the CLO Funds that could potentially be significant to the CLO Funds. The primary beneficiary assessment includes an analysis of the rights of Katonah Debt Advisors in its capacity as investment manager. In certain CLOs, Katonah Debt Advisors' role as investment manager provides that Katonah Debt Advisors contractually has the power, as defined in ASC Topic 810, to direct the activities of the CLO Funds that most significantly impact the CLO Funds' economic performance, such as managing the collateral portfolio and its credit risk. Additionally, the primary beneficiary assessment includes an analysis of Katonah Debt Advisors' rights to receive benefits and obligations to absorb losses associated with its management/incentive fees.

As a manager of the CLO Funds, Katonah Debt Advisors receives contractual and recurring management fees and may receive a one-time structuring fee from the CLO Funds for its management and advisory services. The annual fees which Katonah Debt Advisors receives are generally based on a fixed percentage of assets under management (at par value and not subject to changes in market value), and Katonah Debt Advisors generates annual operating income equal to the amount by which its fee income exceeds it operating expenses. The annual management fees Katonah Debt Advisors receives have two components — a senior management fee and a subordinated management fee. At December 31, 2011, Katonah Debt Advisors continued to receive all senior and subordinated management fees payable by the CLO Funds managed by it.

During 2009, certain CLO funds managed by Katonah Debt Advisors were restricted from currently paying their subordinated management fees as a result of the failure by those CLO Funds to satisfy certain restrictive covenants contained in their indenture agreements. At such time, those subordinated management fees continued to be accrued by the applicable CLO Fund to become payable to Katonah Debt Advisors if and when such CLO Fund becomes compliant with the applicable covenants. During the year ended December 31, 2010, all those CLO Funds which deferred payment of their subordinated management fees regained compliance with all applicable covenants in order to pay current subordinated management fees as well as a portion of previously accrued subordinated management fees. Currently, all CLO Funds managed by Katonah Debt Advisors are paying both their senior and subordinated management fees on a current basis.

In future years, Katonah Debt Advisors may receive accrued incentive fees upon the liquidation of CLO Funds it manages, provided such CLO Funds have achieved a minimum investment return to holders of their subordinated securities or preferred shares.

Fair value of consolidated CLO Funds

The investments held by consolidated CLO Funds are primarily invested in senior secured bank loans (typically syndicated by banks), bonds, equity securities, and other CLOs and structured finance securities. Bank loan investments, which comprise the majority of consolidated CLO Fund portfolio collateral, are senior secured corporate loans from a variety of industries, including but not limited to the aerospace and defense, broadcasting, technology, utilities, household products, healthcare, oil and gas, and finance industries. Bank loan investments mature at various dates between 2012 and 2019, pay interest at Libor plus a spread of up to 8.5%, and typically range in credit rating categories from BBB down to unrated. At December 31, 2011, the unpaid par principal balance exceeded the fair value of the senior secured bank loans and bonds by

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**3. CLO FUNDS – (continued)**

approximately $211 million. At December 31, 2010, the unpaid par principal balance exceeded the fair value of the senior secured bank loans and bonds by approximately $239 million. Less than 0.23% and 0.63% of the collateral assets at fair value are in default as of December 31, 2011 and December 31, 2010, respectively. Substantially all the CLO Fund investments are valued based on price quotations provided by an independent third-party pricing source which are indicative of traded prices and/or dealer price quotations. In the event that a third-party pricing source is unable to price an investment, other relevant factors, data and information are considered, including: i) information relating to the market for the investment, including price quotations for and trading in the investment and interest in similar investments and the market environment and investor attitudes towards the investment and interests in similar investments; ii) the characteristics of and fundamental analytical data relating to the investment, including the cost, size, current interest rate, period until next interest rate reset, maturity and base lending rate, the terms and conditions of the loan and any related agreements, and the position of the loan in the issuer's debt structure; iii) the nature, adequacy and value of the senior secured corporate loan's collateral, including the CLO's rights, remedies and interests with respect to the collateral; iv) the creditworthiness of the borrower, based on an evaluation of its financial condition, financial statements and information about the business, cash flows, capital structure and future prospects; v) the reputation and financial condition of the agent and any intermediate participants in the senior secured corporate loan; and vi) general economic and market conditions affecting the fair value of the senior secured corporate loan.

CLO Fund liabilities issued by consolidated CLO Funds have a legal maturity at various dates between 2013 and 2022 and have a weighted average maturity of 7.6 years. The CLO Fund liabilities are issued in various tranches with different risk profiles and ratings. The interest rates are generally variable rates based on Libor plus a pre-defined spread, which varies from 0.225% for the more senior tranches to 5.00% for the more subordinated tranches. At December 31, 2011 and 2010, the outstanding balance on the CLO Fund liabilities issued by consolidated CLO Funds exceeds their fair value by approximately $252 million and $263 million, respectively. The investors in the CLO Fund liabilities have no recourse to the general credit of Katonah Debt Advisors. CLO Fund liabilities are recorded at fair value using an income approach, driven by cash flows expected to be received from the portfolio collateral assets. Fair value is determined using current information, notably market yields and projected cash flows of collateral assets based on forecasted default and recovery rates that a market participant would use in determining the current fair value of the liabilities, taking into account the overall credit quality of the issuers and Katonah Debt Advisors' past experience in managing similar securities. Market yields, default rates and recovery rates used in Katonah Debt Advisors' estimate of fair value vary based on the nature of the investments in the underlying collateral pools. In periods of rising market yields, default rates and lower debt recovery rates, the fair value, and therefore the carrying value, of the liabilities may be adversely affected. Once the undiscounted cash flows of the collateral assets have been determined, Katonah Debt Advisors applies appropriate discount rates that a market participant would use, to determine the discounted cash flow valuation of the liabilities.

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**3. CLO FUNDS – (continued)**

The following table presents the fair value hierarchy levels of the CLO investments held and CLO Fund liabilities issued by the CLO Funds, which are measured at fair value as of December 31, 2011 and December 31, 2010:

| | December 31, 2011 | | | |
|---|---|---|---|---|
| **($ in millions)** | **Fair Value** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Assets: | | | | |
| Investments of CLO Funds | 1,768.1 | — | 1,562.7 | 205.4 |
| Liabilities: | | | | |
| CLO Fund Liabilities | 1,727.6 | — | — | 1,727.6 |

| | December 31, 2010 | | | |
|---|---|---|---|---|
| **($ in millions)** | **Fair Value** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Assets: | | | | |
| Investments of CLO Funds | 1,741.5 | — | 1,625.0 | 116.5 |
| Liabilities: | | | | |
| CLO Fund Liabilities | 1,717.4 | — | — | 1,717.4 |

The following table shows a reconciliation of the beginning and ending fair value measurements for Level 3 assets using significant unobservable inputs:

| | For the year ended December 31, | |
|---|---|---|
| **($ in millions)** | **2011** | **2010** |
| Beginning balance | 116.5 | 235.1 |
| Transfers to Level 3 | 13.0 | 5.0 |
| Transfers from Level 3 | (7.0) | (115.6) |
| Purchase of investments | 104.9 | 30.4 |
| Sale of investments | (5.0) | (6.3) |
| Proceeds from paydown and redemption of investments | (7.8) | (40.0) |
| Realized and unrealized gains / (losses), net | (9.2) | 8.0 |
| Ending balance | 205.4 | 116.6 |
| Changes in unrealized appreciation (depreciation) included in net realized and unrealized loss related to investments still held at the reporting date | 4.0 | (10.8) |

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**3. CLO FUNDS – (continued)**

The following table shows a reconciliation of the beginning and ending fair value measurements for Level 3 liabilities using significant unobservable inputs:

| | For the year ended December 31, | |
|---|---|---|
| **($ in millions)** | **2011** | **2010** |
| Beginning balance | 1,717.4 | 1,618.0 |
| Repayment of debt | (1.2) | (9.8) |
| Unrealized appreciation/(depreciation) | 11.4 | 109.2 |
| Ending balance | 1,727.6 | 1,717.4 |
| Changes in unrealized appreciation (depreciation) included in net realized and unrealized loss related to liabilities still held at the reporting date | 11.4 | 109.2 |

All transfers into and out of Level 3 represent transfers between Level 3 and Level 2. There were no transfers in or out of Level 1 for the periods presented. All Level 1, 2, and 3 transfers are recognized at the beginning of each accounting period, the actual date of the event, or change in circumstance that caused the transfer, or at the end of the accounting period.

**4. UNCONSOLIDATED VIEs**

Katonah Debt Advisors deems the funds managed by Scotts Cove (“Scott’s Cove Funds”) to be VIEs for which Katonah Debt Advisors is not the primary beneficiary and thus the Scotts Cove Funds are not consolidated into the financial statements of Katonah Debt Advisors. A primary beneficiary is one that absorbs a majority of the entity’s expected losses, receives a majority of the entity’s residual returns or both. Katonah Debt Advisors has no obligation to absorb any of the entity’s expected losses. In addition, Katonah Debt Advisors does not receive the majority of the entity’s expected residual returns. As a result, Katonah Debt Advisors does not consolidate the Scott’s Cove Funds. Katonah Debt Advisors’ maximum exposure to loss as a result of it involvement in the Scott’s Cove Funds is limited to any uncollected management fees due from the funds it manages. At December 31, 2010 Katonah Debt Advisors had a $67,000 investment interest in the Scott’s Cove Funds and no investment interest in the Scott’s Cove Funds at December 31, 2011 due to the sale of Scotts Cove on February 28, 2011, as discussed in Note 1.

**5. INCOME TAXES**

As a separately regarded entity for tax purposes, Katonah Debt Advisors is taxed at normal corporate rates. The CLO Funds are not taxed.

For tax purposes, Katonah Debt Advisors’ 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 and tax goodwill amortization.

Goodwill amortization for tax purposes was created upon the purchase of 100% of the equity interests in Katonah Debt Advisors by its sole member, Kohlberg Capital, in exchange for shares of the Kohlberg Capital’s stock valued at $33 million. Although this transaction was a stock transaction rather than an asset purchase and thus no goodwill was recognized for GAAP purposes, such exchange was considered an asset purchase under Section 351(a) of the Code. At the time of the transfer, Katonah Debt Advisors had equity of approximately $1 million resulting in tax goodwill of approximately $32 million which will be 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.

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**5. INCOME TAXES – (continued)**

Any distributions of taxable net income earned by Katonah Debt Advisors to Kohlberg Capital would generally need to be distributed to the Kohlberg Capital's shareholders. Generally, such distributions of Katonah Debt Advisors' income to the Kohlberg Capital's shareholders will be considered as qualified dividends for tax purposes.

The components of income tax expense (benefit) for the years ended December 31, 2011, 2010 and 2009 are as follows:

| | For the year ended December 31, | | |
|---|---|---|---|
| **($ in millions)** | **2011** | **2010** | **2009** |
| Current income tax expense: | | | |
| Federal | 84,821 | 290,622 | 191,846 |
| State & local | 259,797 | (39,719) | (24,115) |
| Total current income tax expense | 344,618 | 250,903 | 167,731 |
| Deferred income tax expense (benefit): | | | |
| Federal | (350,459) | (39,639) | 1,205,433 |
| State & local | (215,474) | 662,637 | (144,646) |
| Total deferred income tax expense (benefit) | (565,933) | 622,998 | 1,060,787 |
| Total income tax expense | (221,315) | 873,901 | 1,228,518 |

The Company's effective income tax rate and pre-tax book income was 0.7%, -9.1% and 67.5% for tax years 2011, 2010 and 2009, respectively. The difference between the Company's reported provision for income taxes and the U.S. federal statutory rate of 35% is primarily due to tax goodwill amortization and the CLO funds having no tax consequences.

Deferred income taxes are provided for the effects of temporary differences between the tax basis of an asset or liability and its reported amount in the consolidated financial statements. These temporary differences result in taxable or deductible amounts in future years.

The components of deferred income tax assets and liabilities are shown below:

| | For the year ended December 31, | |
|---|---|---|
| **($ in millions)** | **2011** | **2010** |
| Deferred income tax assets: | | |
| Net operating loss and tax credit carryforward | 3,912,080 | 3,671,698 |
| Restricted stock | 327,886 | 242,533 |
| Other | 21,490 | 231,359 |
| Less: Valuation allowance | (3,878,108) | (3,623,183) |
| Total deferred tax assets | 383,348 | (522,407) |
| Deferred income tax liabilities: | | |
| Fixed asset and intangible depreciation/amortization | — | (704,992) |
| Total deferred tax liabilities | 383,348 | (182,585) |
| Net deferred tax assets | 383,348 | (887,577) |

The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income during the periods in which the temporary differences become deductible. If it is not more likely than not that some portion or all of the gross deferred income tax assets will be realized in future years, a valuation allowance is recorded.

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**5. INCOME TAXES – (continued)**

At December 31, 2011 the Company had federal and state net loss carryovers of $8.7 million and $8.3 million available to offset future taxable income. At December 31, 2010, federal and state net loss carryovers were $7.7 million and $8.1 million, respectively. The net loss carryovers expire in the years 2022 to 2029. At December 31, 2011, the federal and state net operating loss carryovers made up $3.0 million and $0.9 million of the deferred tax asset, respectively. At the present time, the Company believes it is more likely than not that the deferred tax assets related to net operating loss carryovers will not be recognized. Accordingly, the Company has provided a full valuation allowance against such carryovers.

Katonah Debt Advisors adopted Financial Accounting Standards Board ASC Topic 740 Accounting for Uncertainty in Income Taxes ("ASC 740") as of January 1, 2009. 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 tax returns to determine whether the tax positions are "more-likely-than-not" of being sustained by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. Adoption of ASC 740 was applied to all open taxable years (the last three fiscal years) as of the effective date. 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. With a few exceptions, the Company is no longer subject to U.S. federal, state and local tax examinations by tax authorities for years prior to 2008.

**6. COMMITMENTS AND CONTINGENCIES**

Katonah Debt Advisors has no direct commitments and contingencies; however, the CLO Funds have purchase commitments to fund approximately $326,000 and $6 million of investments as of December 31, 2011 and December 2010, respectively. Rent expense was approximately $295,459, $341,441 and $322,256 for the years ended December 31, 2011, 2010 and 2009, respectively.

The following table summarizes our future minimum lease payments as of December 31, 2011:

| Contractual Obligations | 2012 | 2013 | 2014 | 2015 | 2016 | More than 5 years |
|---|---|---|---|---|---|---|
| Operating lease obligations | $ 335,445 | $ 342,611 | $ 361,177 | $ 369,432 | $ 369,432 | $ 2,893,884 |

**7. MEMBER'S EQUITY**

The member interest of Katonah Debt Advisors is held solely by Kohlberg Capital. Kohlberg Capital owns 100 common units (no par or stated value) of Katonah Debt Advisors.

**8. OTHER EMPLOYEE COMPENSATION**

Katonah Debt Advisors adopted a 401(k) plan ("401K Plan") effective January 1, 2007 that it shares with its sole shareholder, Kohlberg Capital. The 401K Plan is open to all full time employees. The 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. Katonah Debt Advisors 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 years ended December 31, 2011 and 2010, Katonah Debt Advisors made contributions to the 401K Plan of approximately $41,000 and $66,000, respectively.

Certain employees of Katonah Debt Advisors may receive restricted stock grants in the stock of Katonah Debt Advisors' sole member, Kohlberg Capital. On October 7, 2011 and July 22, 2010, the Board of Directors

**KATONAH DEBT ADVISORS, L.L.C.**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**8. OTHER EMPLOYEE COMPENSATION – (continued)**

approved the grant of an additional 86,805 and 103,519 shares of restricted stock, respectively, to a certain executive officer of the Katonah Debt Advisors. 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.

For the years ended December 31, 2011, December 31, 2010, and December 31, 2009, non-cash compensation expense of $89,000, $240,000, $281,000 respectively, was expensed at Katonah Debt Advisors related to an allocated reimbursable expense for a grant of restricted stock of Kohlberg Capital.

**9. SUBSEQUENT EVENTS**

Katonah Debt Advisors has evaluated events or transactions that have occurred since December 31, 2011 through March 15, 2012 the date the financial statements were available for issuance. KDA has determined that there are no material events that would require the disclosure in the financial statements.

## REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Members of

**Trimaran Advisors, L.L.C.**

We have audited the accompanying consolidated balance sheets of Trimaran Advisors, L.L.C. and affiliates, Trimaran CLO IV, Ltd., Trimaran CLO V, Ltd., Trimaran CLO VI, Ltd., Trimaran CLO VII, Ltd. (collectively, the "Company") as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in member's equity and cash flows for the three years ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Trimaran Advisors, L.L.C. and affiliates as of December 31, 2011 and 2010, and the results of their operations, changes in member's equity and their cash flows for the three years ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

New York, New York
May 14, 2012

**TRIMARAN ADVISORS, L.L.C.**
**Consolidated Balance Sheets**
**December 31, 2011 and 2010**

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| **ASSETS** | | |
| Investments of CLO Funds at fair value | $1,349,008,739 | $1,369,322,251 |
| Cash | 7,906,591 | 6,190,629 |
| Restricted cash of CLO Funds | 48,858,526 | 34,122,491 |
| Accrued interest receivable | 3,344,306 | 3,519,128 |
| Receivable for open trades | — | 18,229,161 |
| Property and equipment, net | 256,587 | 321,820 |
| Other assets | 1,058,049 | 656,400 |
| Total assets | $1,410,432,798 | $1,432,361,880 |
| **LIABILITIES** | | |
| CLO Fund liabilities at fair value | $1,260,095,487 | $1,264,019,037 |
| Accrued interest expense | 1,114,238 | 895,884 |
| Payable for open trades | 24,116,579 | 21,279,162 |
| Term loan payable at fair value | 1,893,850 | 2,256,975 |
| Accounts payable and accrued expenses | 3,018,427 | 3,631,429 |
| Unfunded commitment | 910,000 | — |
| Total liabilities | 1,291,148,581 | 1,292,082,487 |
| **MEMBERS' EQUITY** | | |
| Beginning Trimaran Advisors, L.L.C. equity | 450,129 | 8,883,114 |
| Net income (loss) | 5,695,316 | (4,632,985) |
| Distributions to members | (3,000,000) | (3,800,000) |
| Ending Trimaran Advisors, L.L.C. equity | 3,145,445 | 450,129 |
| Appropriated retained earnings of consolidated variable interest entities | 116,138,772 | 139,829,264 |
| Total members' equity | 119,284,217 | 140,279,393 |
| Total liabilities and members' equity | $1,410,432,798 | $1,432,361,880 |

*The accompanying notes are an integral part of these statements.*

**TRIMARAN ADVISORS, L.L.C.**
**Consolidated Statements of Operations**
**Years ended December 31, 2011, 2010 and 2009**

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| INCOME | | | |
| Interest income – investments of CLO Funds | $ 55,878,933 | $ 50,382,485 | $ — |
| Interest income – cash and time deposits | 8,599 | 13,464 | 3,648,304 |
| Management fees | — | — | 7,205,344 |
| Total income | 55,887,532 | 50,395,949 | 10,853,648 |
| EXPENSES | | | |
| Interest expense of CLO Fund liabilities | 36,424,253 | 33,009,949 | — |
| Compensation | 4,706,111 | 5,534,512 | 7,957,812 |
| Trustee fees | 399,599 | 466,191 | — |
| Professional fees | 638,005 | 284,567 | 360,583 |
| Depreciation and amortization expense | 68,893 | 71,258 | 87,906 |
| Other admin fees | 727,352 | 631,339 | — |
| Rent and rent related expenses | 466,011 | 450,212 | 334,491 |
| Research | 312,996 | 308,063 | 253,363 |
| Interest expense of term loan | 66,777 | 85,059 | 112,815 |
| General and administrative expenses | 239,416 | 279,573 | 238,917 |
| Total expenses | 44,049,413 | 41,120,723 | 9,345,887 |
| Net realized and unrealized gain (loss) | (29,789,751) | (34,576,019) | 3,904,621 |
| Net income (loss) before tax | (17,951,632) | (25,300,793) | 5,412,382 |
| Income tax expense | 43,544 | 3,561 | 37,621 |
| Net income (loss) | (17,995,176) | (25,304,354) | 5,374,761 |
| Net (loss) attributable to non-controlling interests in consolidated variable interest entities | (23,690,492) | (20,671,369) | — |
| Net income (loss) attributable to Trimaran Advisors, L.L.C. | $ 5,695,316 | $ (4,632,985) | $ 5,374,761 |

*The accompanying notes are an integral part of these statements.*

**TRIMARAN ADVISORS, L.L.C.**
**Consolidated Statements of Cash Flows**
**Years ended December 31, 2011, 2010 and 2009**

| | 2011 | | 2010 | | 2009 |
|---|---|---|---|---|---|
| | Trimaran Advisors, L.L.C. | Trimaran CLO Restricted Cash | Trimaran Advisors, L.L.C. | Trimaran CLO Restricted Cash | Trimaran Advisors, L.L.C. |
| OPERATING ACTIVITIES | | | | | |
| Net income (loss) attributable to Trimaran Advisors, L.L.C. | $ 5,695,316 | $ — | $ (4,632,985) | $ — | $ 5,374,761 |
| Net (loss) attributable to Variable Interest Entities | — | (23,690,492) | — | (20,671,369) | — |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities | | | | | |
| Depreciation and amortization | 68,893 | | 71,258 | | 87,906 |
| Net realized and unrealized (gain) loss | 182,953 | 29,606,798 | 378,712 | 34,197,307 | (3,904,621) |
| Changes in operating assets and liabilities: | | | | | |
| Decrease (increase) in accrued interest receivable | — | 174,822 | — | (1,188,365) | — |
| Decrease (increase) in receivable for open trades | — | 18,229,161 | — | (11,111,189) | — |
| Decrease (increase) in other assets | (401,649) | — | (508,096) | — | (78,781) |
| Decrease in accrued management fees receivable | — | — | — | — | 46,351 |
| Increase in accrued interest expense | — | 218,354 | — | 30,829 | — |
| Increase (decrease) in payable for open trades | — | 2,837,417 | — | (1,012,008) | — |
| Increase (decrease) in accounts payable and accrued expenses | (619,604) | 6,602 | 2,921,043 | 43,967 | (501,175) |
| Net cash provided by (used in) operating activities | 4,925,909 | 27,382,662 | (1,770,068) | 289,172 | 1,024,441 |
| INVESTING ACTIVITIES | | | | | |
| Change in investments | | | | | |
| Purchase of investments | — | (693,224,359) | — | (891,861,130) | — |
| Sale of investments | — | 684,635,683 | — | 894,972,554 | — |
| Unfunded commitments | — | 910,000 | — | — | — |
| Proceeds from CLO Investments | 12,751,215 | — | 11,288,465 | — | — |
| Net income from CLOs related to Trimaran Advisors, L.L.C. | (12,411,423) | — | (2,749,068) | — | — |
| Cash paid for purchases of property and equipment | (3,661) | — | (15,537) | — | (13,770) |
| Return of capital from CLO investments | — | — | — | — | 548,529 |
| Payments under capital lease | — | — | — | — | (11,729) |
| Net cash used in investing activities | 336,131 | (7,678,676) | 8,523,860 | 3,111,424 | 523,030 |
| CASH FLOW FROM FINANCING ACTIVITIES | | | | | |
| Member's contributions | — | — | — | — | 10,973 |
| Member's distributions | (3,000,000) | — | (3,800,000) | — | — |
| Trimaran Income from CLOs in excess of distributions | — | (339,792) | — | (8,539,397) | — |
| Repayments of debt | (546,078) | (4,628,159) | (400,100) | (2,787,017) | (1,217,730) |
| Net cash provided by (used in) financing activities | (3,546,078) | (4,967,951) | (4,200,100) | (11,326,414) | (1,206,757) |
| Change in cash | 1,715,962 | 14,736,035 | 2,553,692 | (7,925,818) | 340,714 |
| Cash, beginning of year | 6,190,629 | 34,122,491 | 3,636,937 | 42,048,309 | 3,296,223 |
| Cash, end of year | $ 7,906,591 | $ 48,858,526 | $ 6,190,629 | $ 34,122,491 | $ 3,636,937 |
| Supplemental disclosures | | | | | |
| Cash payments for interest on Term Loans | $ 67,805 | $ — | $ 86,143 | $ — | $ 137,629 |
| Cash payments for interest on CLO Fund liabilities | $ — | $ 36,205,900 | $ — | $ 32,979,119 | $ — |

*The accompanying notes are an integral part of these statements.*

**TRIMARAN ADVISORS, L.L.C.**
**Consolidated Statements of Members' Equity**
**Years ended December 31, 2011, 2010 and 2009**

| | Trimaran Advisors, L.L.C.Stand Alone | CLOs Trimaran Advisors, L.L.C. | Appropriated Retained Earnings of VIEs | Total Members' Equity |
|---|---|---|---|---|
| Adoption of guidance now encompassed in ASC Topic 810 | | | $160,500,633 | $ 160,500,633 |
| **January 1, 2010, as adjusted** | $ 1,325,871 | $ 7,557,243 | 160,500,633 | 169,383,747 |
| Net income (loss) | (7,382,053) | 2,749,068 | — | (4,632,985) |
| Management fee/income notes distribution | 11,288,465 | (11,288,465) | — | — |
| Distributions to members | (3,800,000) | — | | (3,800,000) |
| Net loss classified as appropriated retained earnings | — | — | (20,671,369) | (20,671,369) |
| **Total at December 31, 2010** | 1,432,283 | (982,154) | 139,829,264 | 140,279,393 |
| Net income | (6,716,107) | 12,411,423 | — | 5,695,316 |
| Management fee/income notes distribution | 12,751,215 | (12,751,215) | — | — |
| Distributions to members | (3,000,000) | — | — | (3,000,000) |
| Net loss classified as appropriated retained earnings | — | — | (23,690,492) | (23,690,492) |
| **Total at December 31, 2011** | $ 4,467,391 | $ (1,321,946) | $116,138,772 | $ 119,284,217 |

*The accompanying notes are an integral part of these statements.*

**TRIMARAN ADVISORS, L.L.C.**

**Notes to Consolidated Financial Statements**

## 1. ORGANIZATION

Trimaran Advisors, L.L.C. ("Trimaran" or the "Company"), a Delaware limited liability company, was formed and commenced operations on June 29, 1998 as Caravelle Advisors, L.L.C. Caravelle Advisors, L.L.C. changed its name to Trimaran Advisors, L.L.C. on March 29, 2001.

Trimaran provides investment management services to a number of collateralized loan obligation ("CLO Funds") entities. These entities are investment vehicles created for the sole purpose of issuing collateralized loan instruments that offer investors the opportunity for returns that vary with the risk level of their investment. The notes issued by CLO Funds are backed by diversified portfolios consisting primarily of broadly syndicated loans, high-yield bonds or other credit instruments. For managing the collateral for the CLO entities, the Company earns investment management fees, including certain management fees that are subordinated to other fund expenses, as well as contingent incentive fees.

As of December 31, 2011, Trimaran had approximately $1.4 billion par value of assets under management in four CLOs.

The Company has invested in certain of these entities, generally taking a relatively small ownership interest in the unrated, junior subordinated tranche of the CLO. At December 31, 2011, Trimaran held a combined $18 million face value of the unrated, subordinated tranches of these CLOs, which represents the maximum risk of loss to the Company. Trimaran's investments in these CLOs are subordinated to other interests in the entities and entitle the Company to receive its ratable interest in the residual cash flows, if any, from the entities. Investors in CLOs have no recourse against the Company for any losses sustained in the CLO structure. The Company's positions in the unrated, subordinated tranches of these CLOs are eliminated upon the adoption of Accounting Standards Codification (ASC) Topic 810 as described further below in Note 4 — CLO Funds.

## 2. SIGNIFICANT ACCOUNTING POLICIES

### Basis of Accounting and Consolidation

In the opinion of management, the consolidated financial statements reflect all adjustments, consisting of normal recurring accruals, which are necessary for the fair presentation of the financial condition and results of operations for the periods presented. All significant intercompany transactions, balances, revenues and expenses are eliminated upon consolidation.

Trimaran follows the provisions of Accounting Standards Codification (ASC) Topic 810, "Consolidation," when accounting for variable interest entities ("VIEs") as further detailed below. Pursuant to ASC 810-10, VIEs, or entities in which the risks and rewards of ownership are not directly linked to voting interests, for which Trimaran is the primary beneficiary are consolidated.

For CLO Funds, if Trimaran is deemed to have the power to direct the activities of the CLO that most significantly impact the CLO's economic performance, and the obligation to absorb losses/right to receive benefits (management fees and potential incentive fees) from the CLO that could potentially be significant to the CLO, then Trimaran is deemed to be the CLO's primary beneficiary and is required to consolidate the CLO.

All of the investments held and notes issued by CLO Funds that are considered to be VIEs are presented at fair value in Trimaran's Consolidated Balance Sheets as of December 31, 2011 and December 31, 2010, respectively and interest income and expense of consolidated CLO Funds are presented in Trimaran's Consolidated Statements of Operations for the years ended December 31, 2011 and December 31, 2010, respectively. Trimaran reviews factors, including the rights of the equity holders and obligations of equity holders to absorb losses, or receive expected residual returns, to determine if the investment product is a VIE. Trimaran is required to consolidate a VIE when it is deemed to be the primary beneficiary, which is evaluated continuously as facts and circumstances change.

**TRIMARAN ADVISORS, L.L.C.**

**Notes to Consolidated Financial Statements**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

At the date of adoption of ASC Topic 810, the portion of the surplus of consolidated CLO assets over consolidated CLO liabilities attributable to third-party ownership interests in the CLOs is reflected in the Company's Consolidated Balance Sheets as retained earnings appropriated for investors in consolidated CLO Funds. Current period gains/(losses) attributable to third-party investors in consolidated CLO Funds are included in (gains)/losses attributable to non-controlling interests in consolidated entities in the Consolidated Statements of Operations and in the retained earnings appropriated for investors in CLO Funds in the Consolidated Balance Sheets, as they are considered non-controlling interests of the Company. Please refer to Note 4 — CLO Funds below for additional details.

Upon consolidation of the CLO Funds, the assets and liabilities of the consolidated CLOs were measured at fair value, as the determination of carrying amounts was not practicable. Trimaran has elected the fair value option under ASC Topic 825-10-25 to measure the assets and liabilities of all consolidated CLOs at fair value subsequent to the date of initial adoption of this additional guidance to mitigate accounting mismatches between the carrying value of the assets and liabilities and to achieve operational simplifications.

The cumulative effect adjustment upon adoption at January 1, 2010 resulted in an appropriation of retained earnings of $160.5 million.

As discussed further in Note 1, the Company holds a relatively small ownership interest in the unrated, junior subordinated tranches of the CLO Funds managed by it. The Company's investments in CLOs are generally subordinated to other interests in the entities and entitle the investors to receive the residual cash flows, if any, from the entities. Investors in CLOs have no recourse against the Company for any losses sustained in the CLO structure. The Company's ownership interests were quantitatively assessed based on the provisions of FIN 46 R to determine if the company is the primary beneficiary of these entities for Trimaran's Consolidated Statements of Operations for the year ended December 31, 2009. Trimaran determined that it did not absorb the majority of the expected gains or losses from the CLOs and therefore is not their primary beneficiary.

**Use of Estimates**

The preparation of the financial statements requires management to make significant estimates and assumptions that affect reported revenues, expenses, assets and liabilities and disclosure of contingent liabilities, including the fair value of CLO fund investments and CLO fund liabilities that do not have a readily available market value. Actual results could differ from those estimates, and the differences could be material.

**Cash**

Cash consists of cash and money market investments which are primarily held at one major financial institution in the United States of America.

**Restricted Cash of CLO Funds**

Restricted Cash consists of cash held for reinvestment, quarterly interest and principal distributions (if any) to holders of CLO Fund liabilities and payment of CLO Fund expenses. Cash and cash equivalents of CLO Funds are not available for general use by the Company.

**Investments of CLO Funds**

Investment transactions are recorded on the applicable trade date. Realized gains or losses are determined using the specific identification method. Investments held by the CLO Funds are stated at fair value. ASC 820-10, Fair Value Measurements and Disclosures ("ASC 820-10"), requires among other things, disclosures about assets and liabilities that are measured and reported at fair value.

**TRIMARAN ADVISORS, L.L.C.**

**Notes to Consolidated Financial Statements**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

**Hierarchy of Fair Value Inputs**

The provisions of ASC 820-10 establish a hierarchy that prioritizes inputs to valuation techniques used to measure fair value and require companies to disclose the fair value of their financial instruments according to the fair value hierarchy (i.e., Level 1, 2 and 3 inputs, as defined). The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. Additionally, companies are required to provide additional disclosure regarding instruments in the Level 3 category (which have inputs to the valuation techniques that are unobservable and require significant management judgment), including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities.

Assets and liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

Level 1 — Inputs: Quoted prices (unadjusted) in active markets for identical assets or liabilities at the reporting date.

- Level 1 assets may include listed mutual funds (including those accounted for under the equity method of accounting as these mutual funds are investment companies, that have publicly available NAVs which in accordance with GAAP are calculated under fair value measures and are equal to the earnings of such funds), ETFs, equities and certain derivatives.

Level 2 — Inputs: Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities that are not active; quotes from pricing services or brokers, for which Trimaran can determine that orderly transactions took place at the quoted price or that the inputs used to arrive at the price were observable; and inputs other than quoted prices that are observable, such as models or other valuation methodologies.

- Level 2 assets in this category may include debt securities, bank loans, short-term floating rate notes and asset-backed securities, restricted public securities valued at a discount, as well as over the counter derivatives, including interest and inflation rate swaps and foreign currency exchange contracts that have inputs to the valuations that generally can be corroborated by observable market data.

Level 3 — Inputs: Unobservable inputs for the valuation of the asset or liability, which may include non-binding broker quotes. Level 3 assets include investments for which there is little, if any, market activity. These inputs require significant management judgment or estimation.

- Level 3 assets in this category may include general and limited partnership interests in private equity funds, funds of private equity funds, real estate funds, hedge funds, and funds of hedge funds, direct private equity investments held within consolidated funds, bank loans and bonds issued by CLO funds.
- Level 3 liabilities included in this category include borrowings of consolidated collateralized loan obligations and debt of Trimaran valued based upon non-binding broker quotes or discounted cash flow model based on a discount margin calculation.

**Significance of Inputs**

Trimaran's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument.

**Valuation of Investments of CLO Funds**

Trimaran follows the provisions of ASC 820 Fair Value Measurements and Disclosures ("Fair Value Measurements and Disclosures"). This standard defines fair value, establishes a framework for measuring fair

**TRIMARAN ADVISORS, L.L.C.**

**Notes to Consolidated Financial Statements**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

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 January 2010, the FASB issued guidance that clarifies and requires new disclosures about fair value measurements. The clarifications and requirement to disclose the amounts and reasons for significant transfers between Level 1 and Level 2, as well as significant transfers in and out of Level 3 of the fair value hierarchy, were adopted by Trimaran in the first quarter of 2010. The new guidance also requires that purchases, sales, issuances and settlements be presented gross in the Level 3 reconciliation and that requirement is effective for fiscal years beginning after December 15, 2010 and for interim periods within those years, which was adopted by Trimaran in the first quarter of 2011.

ASC 820-10 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.

Trimaran's valuation methodology and procedures for investments held by the CLO Funds are generally as follows:

1. 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 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 ASC 820-10.
2. If an investment does not have a market quotation on either a broad market exchange or from an independent pricing service, the investment is initially valued by Trimaran'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.
4. Management discusses the valuations and determines in good faith that the fair values of each investment in the portfolio is reasonable based upon any applicable independent pricing service, input of management and estimates from independent valuation firms (if any).

Most of the CLO Funds' investment portfolio is composed of broadly syndicated debt securities for which an independent pricing service quote is available. To the extent that the 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 are generally 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.

**Property, Equipment and Depreciation**

Property and equipment includes owned property, leasehold improvements, computer hardware/software and other equipment and is stated at cost less accumulated depreciation or amortization. Expenditures for major additions and improvements are capitalized; minor replacements, maintenance and repairs are charged to expense as incurred. Depreciation/amortization is calculated to write off the cost, less estimated residual value, of each asset on a straight-line basis over its expected useful life up to five years and over the shorter of the life or the term of the lease for leashold improvements.

**TRIMARAN ADVISORS, L.L.C.**

**Notes to Consolidated Financial Statements**

**2. SIGNIFICANT ACCOUNTING POLICIES – (continued)**

**Interest Income**

Interest income is recorded on the accrual basis on interest-bearing assets. The CLO Funds generally place a loan or security on non-accrual status and cease recognizing cash interest income on such loan or security when a loan or security becomes 90 days or more past due or if Trimaran otherwise does not expect the debtor to be able to service its debt obligations.

**Investment Management Fees**

As a manager of CLO Funds, Trimaran receives contractual and recurring management fees and may receive a one-time structuring fee from the CLO Funds for its management and advisory services. The annual fees which Trimaran receives are generally based on a fixed percentage of assets under management (at par value and not subject to changes in market value). The annual management fees Trimaran receives from its CLOs have two components — a senior management fee and a subordinated management fee. At December 31, 2011, Trimaran continued to receive all senior and subordinated management fees payable by the CLO Funds managed by it. The investment management fees are eliminated upon the adoption of Accounting Standards Codification (ASC) Topic 810.

**Incentive Fees**

As a manager of CLO Funds, Trimaran may receive an incentive fee upon exceeding specified relative and/or absolute investment 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. Incentive fees are eliminated upon the adoption of Accounting Standards Codification (ASC) Topic 810. For all periods presented, Trimaran has not earned any incentive management fees.

**Trustee Fees**

Each CLO Fund has a third party trustee that is the custodian for all investments of the CLO Funds and receives and disburses all cash in accordance to the trustee and custodial agreements. Trustee fees are accrued and paid quarterly by the CLO Funds.

**Income Taxes**

Trimaran is not subject to federal, state or local income taxes. Such taxes are the responsibility of the individual members. However, certain aspects of the Company’s business are subject to New York City unincorporated business tax.

Trimaran conducts its business activities on a global basis and derives its income from these activities. Trimaran believes that the conduct of these activities does not subject it to tax from other jurisdictions outside the United States and, accordingly, no provision for foreign taxes has been recorded in the accompanying consolidated financial statements.

**3. ADOPTION OF NEW ACCOUNTING PROUNCEMENTS**

*Accounting Standards Codification*

In June 2009, the Financial Accounting Standards Board (“FASB”) issued a pronouncement establishing the FASB Accounting Standards Codification (“ASC”) as the source of authoritative accounting principles recognized by the FASB to be applied in the preparation of financial statements in conformity with GAAP. The ASC recognized existing U.S. accounting and reporting standards issued by the FASB and other related private sector standard setters into a single source of authoritative accounting principles arranged by topic. The standard explicitly recognizes rules and interpretive releases of the Commission under federal securities laws as authoritative GAAP for SEC registrants. The ASC supersedes all existing U.S. accounting standards;

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**Notes to Consolidated Financial Statements**

**3. ADOPTION OF NEW ACCOUNTING PROUNCEMENTS – (continued)**

all other accounting literature not included in the ASC (other than SEC guidance for publicly-traded companies) is considered non-authoritative. The ASC was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. The adoption of ASC changed the Company's references to U.S. GAAP accounting standards but did not impact its results of operations, financial position or liquidity.

*New Consolidation Guidance for Variable Interest Entities*

In June 2009, the FASB issued ASU 2009-17, which amended the consolidation guidance for VIEs. The amendments include: (1) the elimination of the exemption from consolidation for qualifying special purpose entities, (2) a new approach for determining the primary beneficiary of a VIE, which requires that the primary beneficiary have both (i) the power to control the most significant activities of the VIE and (ii) either the obligation to absorb losses or the right to receive benefits that potentially could be significant to the VIE, and (3) the requirement to continually reassess the primary beneficiary of a VIE.

In February 2010, the FASB issued ASU 2010-10. This ASU defers the application of SFAS No. 167 for a reporting enterprise's interest in an entity if *all* of the following conditions are met:

1. the entity either has all of the attributes of an investment company, as specified in ASC 946-10, Financial Services-Investment Companies ("ASC 946-10") or it is industry practice to apply measurement principles for financial reporting that are consistent with those in ASC 946-10;
2. the entity is not a securitization entity, an asset-backed financing entity, or an entity formerly considered a qualifying special-purpose entity, and
3. the reporting enterprise does not have an explicit or implicit obligation to fund losses of the entity that could potentially be significant to the entity.

In addition, the deferral applies to a reporting entity's interest in an entity that is required to comply or operate in accordance with the requirements of Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

The amendments in ASU 2010-10 clarify that for entities that do not qualify for the deferral, related parties should be considered when evaluating each of the criteria for determining whether a decision maker or service provider fee represents a variable interest.

An entity that qualifies for the deferral will continue to be assessed for consolidation under the overall guidance on variable interest entities in ASC 810, (before its amendment by SFAS No. 167) or other applicable consolidation guidance, including guidance for the consolidation of partnerships in ASC 810. The amendment does not defer the disclosure requirements of ASU 2009-17.

*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 1 and 2, and activity in Level 3 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 3 disclosures, which are effective for fiscal years beginning after December 15, 2010 and interim periods within those years, the new guidance became effective for Trimaran in the first quarter of 2010. The adoption of this disclosure-only guidance is included in the Investments section above and did not have a material impact on Trimaran's financial results.

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**Notes to Consolidated Financial Statements**

**3. ADOPTION OF NEW ACCOUNTING PROUNCEMENTS – (continued)**

In May 2011, the FASB issued Accounting Standards Update 2011-04, "Fair Value Measurements: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements" (ASU 2011-04). ASU 2011-04 amends Topic 820 to clarify existing fair value measurement disclosures to (1) specifically provide quantitative information about the significant unobservable inputs used for all Level 3 measurements and (2) disclose any transfers between Levels 1 and 2 of the fair value hierarchy, not just significant transfers. ASU 2011-04 also requires a number of additional disclosures regarding fair value measurements. Specifically, ASU 2011-04 requires entities to disclose: (1) a qualitative discussion about the sensitivity of recurring Level 3 measurements to changes in the unobservable inputs disclosed, including the interrelationship between inputs; (2) a description of the Company's valuation processes surrounding Level 3 measurements; (3) information about when the current use of a non-financial asset measured at fair value differs from its highest and best use; and (4) the hierarchy classification for items whose fair value is not recorded on the balance sheet but is disclosed in the notes. ASU 2011-04 amends Topic 820 to change the fair value measurement of financial instruments and the application of premiums and discounts in a fair value measurement. ASU 2011-04 also clarifies existing fair value measurement regarding the concepts of valuation premise, the application of the highest and best use, and the fair value measurement of an instrument classified in an entity's shareholders' equity. The adoption of ASU 2011-04 is not expected to have an effect on the Company's current fair value measurements but is expected to have a significant impact on the Company's disclosures related to the assets and liabilities that are classified as Level 3 assets within the fair value hierarchy. The amendments to Topic 820 made by ASU 2011-04 are effective for interim and annual periods beginning on or after December 15, 2011.

*Amended Guidance for Accounting for Uncertainty in Income Taxes*

In September 2009, the FASB issued amended accounting principles to ASC 740 as Accounting Standards Update ("ASU") No. 2009-096, "Implementation Guidance on accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities." These amended principles provide guidance in implementation of accounting for uncertainty in income taxes. These amended principles are effective for financial statements issued for periods ending after September 15, 2009. Management has reviewed the tax positions for the open tax years 2009 through 2011 and had determined that the adoption of these amended principles had no impact on the Company's financial statements or require additional disclosure.

**4. CLO FUNDS**

A CLO Fund, or entity, generally refers to a special purpose vehicle that owns a portfolio of investments and issues various tranches of debt and subordinated note securities to finance the purchase of those investments. Investments purchased by CLO Funds are governed by extensive investment guidelines, which may include limits on exposure to any single industry or issuer and limits on the ratings of the CLO Fund's assets. The CLO Funds managed by Trimaran have a defined investment period during which they are allowed to make investments or reinvest capital as it becomes available.

Trimaran manages four CLO Funds primarily for third party investors that invest in broadly syndicated loans, high yield bonds and other credit instruments issued by corporations. These CLO Funds do not invest in asset-backed securities secured by commercial mortgages, residential mortgages or other consumer borrowings. At December 31, 2011 and 2010, Trimaran had approximately $1.4 billion par value of assets under management in four CLO Funds.

CLO Funds typically issue multiple tranches of debt and subordinated note securities with varying ratings and levels of subordination to finance the purchase their underlying investments. Interest and principal payments (net of designated CLO Fund expenses) from the CLOs are paid to each issued security in accordance with an agreed upon priority of payments, commonly referred to as the "waterfall." The most senior notes, generally rated AAA/Aaa, commonly represent the majority of the total liabilities of the CLO Fund. AAA/Aaa notes are issued at a specified spread over LIBOR and normally have the first claim on the

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**Notes to Consolidated Financial Statements**

**4. CLO FUNDS – (continued)**

earnings on the CLO Fund's investments after payment of certain fees and expenses. Lower subordinated "mezzanine" tranches of rated notes generally have initial ratings ranging from AA/Aa to BB/Ba and are usually issued at a specified spread over LIBOR with higher spreads paid on the tranches with lower ratings. Each tranche is typically only entitled to a share of the earnings on the CLO Fund's investments if the required interest and principal payments have been made on the more senior tranches in the waterfall. The most junior tranche (sometimes referred to as the "equity" tranche) can take the form of unrated subordinated notes, income notes or preferred shares. The subordinated notes, income notes or preferred shares generally do not have a stated coupon but are entitled to residual cash flows from the CLO's investments after all of the other tranches of notes and certain other fees and expenses are paid.

The CLOs are primarily financed via capital contributed by equity and debt holders. Trimaran's risk with respect to each investment in the CLO Funds managed by it is limited to its investment in the equity tranche of each CLO Fund, as well as any uncollected management fees. The collateral assets of consolidated CLO Funds are held solely to satisfy the obligations of the CLOs, and the investors in the consolidated CLO Funds have no recourse to the general credit of Trimaran for the notes issued by the CLOs.

Upon adoption of guidance encompassed in ASC Topic 810, Trimaran determined that it was the primary beneficiary of these CLO Funds, as it has the power to direct the activities of the CLO Funds that most significantly impact the CLO Funds' economic performance, and the obligation to absorb losses/right to receive benefits (in the form of senior and subordinate management fees as well as the potential to earn an incentive fee) from the CLO Funds that could potentially be significant to the CLO Funds. The primary beneficiary assessment includes an analysis of the rights of Trimaran in its capacity as investment manager. In certain CLOs, Trimaran's role as collateral manager provides that the Company contractually has the power, as defined in ASC Topic 810, to direct the activities of the CLO Funds that most significantly impact the CLO Funds' economic performance, such as managing the portfolio collateral and its credit risk. Additionally, the primary beneficiary assessment includes an analysis of Trimaran's rights to receive benefits and obligations to absorb losses associated with its management/incentive fees as well as its investment in the equity tranches of the CLOs.

**Fair Value of Consolidated CLO Funds**

The investments held by consolidated CLO Funds are primarily invested in senior secured bank loans (typically syndicated by banks), bonds and equity securities. Bank loan investments, which comprise the majority of consolidated CLO Fund portfolio collateral, are senior secured corporate loans from a variety of industries, including but not limited to the aerospace and defense, broadcasting, technology, utilities, household products, healthcare, oil and gas, and finance industries. Bank loan investments mature at various dates between 2012 and 2019, pay interest at Libor plus a spread of up to 7.75%, and typically range in credit rating categories from BBB down to unrated. At December 31, 2011, the unpaid par principal balance exceeded the fair value of the senior secured bank loans and bonds by approximately $60.8 million. At December 31, 2010, the unpaid par principal balance exceeded the fair value of the senior secured bank loans and bonds by approximately $33.0 million. Approximately 0.34% and 0.54% of the collateral assets at fair value were in default and placed on non-accrual status as of December 31, 2011 and December 31, 2010, respectively. At December 31, 2011 and 2010, all the CLO Fund investments are valued based on price quotations provided by an independent third-party pricing service which are indicative of traded prices and/or dealer price quotations.

CLO Fund liabilities issued by consolidated CLO Funds have a legal maturity at various dates between 2017 and 2021 and have a weighted average maturity of 7.3 years. The CLO Fund liabilities are issued in various tranches with different risk profiles and ratings. The interest rates are generally variable rates based on Libor plus a pre-defined spread, which varies from 0.25% for the more senior tranches to 5.15% for the more subordinated tranches. At December 31, 2011 and 2010, the outstanding balance on the CLO Fund liabilities issued by consolidated CLO Funds exceeds their fair value by approximately $174.2 million and

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**Notes to Consolidated Financial Statements**

**4. CLO FUNDS – (continued)**

$178.1 million, respectively. The investors in the CLO Funds' liabilities have no recourse to the general credit of Trimaran. At December 31, 2011 and 2010, CLO Fund liabilities are recorded at fair value using current information, notably price quotations provided by independent brokers which have less observable inputs and as such are classified as Level 3 within the fair value hierarchy.

The CLO Funds that are consolidated herein have issued rated and unrated notes to finance their investments. Debt is presented at fair value with the difference between amortized book value and fair value recorded as unrealized gain/loss.

The following table presents the fair value hierarchy levels of the CLO investments held and CLO Fund liabilities issued by the CLOs, which are measured at fair value as of December 31, 2011 and December 31, 2010:

| | December 31, 2011 | | | |
|---|---|---|---|---|
| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | *($ in millions)* | | | |
| Assets | | | | |
| Investments of CLO funds | $ 1,349.0 | $ — | $ 1,349.0 | $ — |
| Liabilities | | | | |
| CLO fund liabilities | 1,260.1 | — | — | 1,260.1 |

The following table shows a reconciliation of the beginning and ending fair value measurements for Level 3 liabilities related to the CLO Funds using significant unobservable inputs:

| | For the Year Ended December 31, | |
|---|---|---|
| | 2011 | 2010 |
| | *($ in millions)* | |
| **Beginning balance** | $ 1,264.0 | $ 1,161.2 |
| Repayment of debt | 4.6 | 2.8 |
| Unrealized appreciation/(depreciation) | 0.7 | 105.6 |
| **Ending balance** | 1,260.1 | 1,264.0 |
| Changes in unrealized appreciation/(depreciation) included in net realized and unrealized loss related to liabilities still held at the reporting date | 0.7 | 105.6 |

Trimaran's policy for transfers between levels is to recognize such transfer at the beginning of the reporting period in which they occur. There were no transfers in or out of Level 3, Level 2 and Level 1 for the periods presented.

For the years ended December 31, 2011 and December 31, 2010, the consolidated debt of the CLOs incurred interest expense of $36.4million and $33.0million, respectively, with such amounts included in the accompanying Consolidated Statements of Operations as Interest Expense of CLO Fund liabilities.

**5. TERM LOANS**

On August 2, 2007, Trimaran entered into a Loan Agreement, as amended on March 16, 2009 (the "Loan Agreement"), with Natixis Financial Products, Inc. ("Lender") to borrow up to $10 million in Term Loans. Under the Loan Agreement, the period allowing drawdowns expired in December 2007. Borrowings under the Loan Agreement have a maturity date of August 2, 2012.

**TRIMARAN ADVISORS, L.L.C.**

**Notes to Consolidated Financial Statements**

**5. TERM LOANS – (continued)**

Borrowings under the Loan Agreement bear interest at a rate equal to LIBOR plus 3.00% per annum or the Prime Rate plus 1.75% per annum depending upon the nature of the loan. For all periods presented, interest was based on LIBOR plus 3.00% and interest rates for borrowing under the Term Loans ranged from 3.25% to 5.21%.

Trimaran has elected the fair value option in accordance with FASB ASC Topic 825 ("ASC 825"), *Financial Instruments*, for the Term Loans which are recorded at fair value in accordance with ASC 810. Trimaran believes that accounting for the Term Loans at fair value most closely reflects Trimaran's obligations.

Trimaran's valuation methodology utilizes a discounted cash flow analysis based on: (i) cash flow projections for the loan (which take into account the relevant amortization schedule in effect at each valuation measurement date) and (ii) market (discount) rates that Trimaran believes were commensurate for the nature, type and risk of the position at each respective valuation measurement date. The unpaid principal balance on the Term Loans is $1.9 million and $2.5 million as of December 31, 2011 and December 31, 2010, respectively.

The following table presents the fair value hierarchy levels of the Term Loans which are measured at fair value as of December 31, 2011 and December 31, 2010:

| | | Natixis Loan (Term Loans) | | |
|---|---|---|---|---|
| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | *($ in millions)* | | | |
| Term loans outstanding as of: | | | | |
| December 31, 2011 | $ 1.9 | $ — | $ — | $ 1.9 |
| December 31, 2010 | 2.3 | — | — | 2.3 |

The following table shows a reconciliation of the beginning and ending fair value measurements for Level 3 liabilities related to the Term Loans using significant unobservable inputs:

| | For the Year Ended December 31, | |
|---|---|---|
| | 2011 | 2010 |
| | *($ in millions)* | |
| **Beginning Balance** | $ 2.3 | $ 2.3 |
| Repayment of debt | 0.5 | 0.4 |
| Unrealized appreciation/(depreciation) | 0.2 | 0.4 |
| **Ending balance** | 1.9 | 2.3 |
| Changes in unrealized appreciation/(depreciation) included in net realized and unrealized loss related to liabilities still held at the reporting date | 0.2 | 0.4 |

Trimaran's policy for transfers between levels is to recognize such transfer at the beginning of the reporting period in which they occur. There were no transfers in or out of Level 3, Level 2 and Level 1 for the periods presented.

Interest on the Company's Term loans is accrued and generally paid quarterly. The CLO Funds managed by Trimaran that are consolidated herein, have issued rated and unrated bonds to finance their operations. Interest on CLO Fund liabilities other than the unrated, junior subordinated tranches is calculated by the trustee. The interest expense for the unrated, junior subordinated tranches is based on effective yield. Interest is accrued and generally paid quarterly.

**TRIMARAN ADVISORS, L.L.C.**

**Notes to Consolidated Financial Statements**

**5. TERM LOANS – (continued)**

During the years ended December 31, 2011, December 31, 2010 and December 31, 2009, the Company incurred interest expense on the Term Loans of $0.07 million, $0.09 million and $0.11 million, respectively, with such amounts included in the accompanying Consolidated Statements of Operations as part of Interest Expense of Term Loan.

**6. INCOME TAXES**

Trimaran is a Delaware limited liability company and intends to be treated as a partnership for U.S. federal income tax purposes. In general, partnerships are not subject to entity-level tax on their income, but the income of a partnership is taxable to its owners on a flow-through basis. However, certain aspects of the Company's business are subject to New York City unincorporated business tax. For the years ended December 31, 2011, 2010 and 2009, the Company was subject to unincorporated business tax of $43,544, $3,561, and $37,621, respectively, included on the accompanying consolidated statement of operations.

The Company accounts for income taxes in accordance with FASB ASC 740, Income Taxes. The Company also applies the accounting principles related to the accounting for uncertainty in income taxes. These principles provide guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company has no liabilities for unrecognized tax benefits for the years ended December 31, 2011 and 2010.

In accordance with federal and state income tax regulations, income taxes related to the Company's income are not levied on the Company and are the responsibility of the Company's members.

**7. PROPERTY AND EQUIPMENT**

As of December 31, 2011 and 2010, property and equipment consist of the following:

| | For the Year Ended December 31, | |
|---|---|---|
| | 2011 | 2010 |
| Leasehold improvements | $ 452,931 | $ 452,931 |
| Software | 71,201 | 71,201 |
| Computer | 94,654 | 90,994 |
| Furniture and fixtures | 74,824 | 74,824 |
| Telephone | 37,572 | 37,572 |
| | 731,182 | 727,522 |
| Less: Accumulated depreciation and amortization | (474,595) | (405,702) |
| | $ 256,587 | $ 321,820 |

Depreciation and amortization expense of $68,893, $71,258 and $87,906 is included on the accompanying consolidated statement of operations for the years ended December 31, 2011, 2010 and 2009, respectively.

**8. 401(K) PLAN**

The Company maintains a 401(k) profit sharing plan. Employees who are 21 years of age are eligible to participate after 6 months of service. Each year, employees can make salary contributions up to the lesser of 90% of eligible compensation or the annual Internal Revenue Service limitations. The Company matched 50% of the employee contributions up to a maximum of 6% of the employees' eligible compensation contributed to the plan for the year ended December 31, 2009 and the period January 1, 2010 through May 31, 2010. The Company ceased employer contributions beginning June 1, 2010. Employer contributions to the 401(k) plan were $18,461 and $81,056 for the years ended December 31, 2010 and 2009, respectively.

**TRIMARAN ADVISORS, L.L.C.**

**Notes to Consolidated Financial Statements**

## 9. COMMITMENTS AND CONTINGENCIES

### CLO Funds

The CLO funds have purchase commitments (net of sale commitments) to fund approximately $24.1 million and $3.1 million of investments as of December 31, 2011 and December 2010, respectively.

### Leases

Commencing on January 16, 2007, Trimaran jointly with Trimaran Fund Management, LLC, entered into a three-year non-cancelable lease agreement for office space which expired on January 30, 2010. On June 29, 2009, the Company entered into an agreement extending the term of the lease until January 31, 2011, on July 22, 2010, the Company extended the term of the lease until January 31, 2012 and on September 16, 2011, the Company extended the term of the lease until January 31, 2013. The agreement between the Company and Trimaran Fund Management, LLC relates to the monthly allocation of rent expense based on a percentage agreed upon between such parties.

The following table summarizes our future minimum lease payments as of December 31, 2011:

| Contractual Obligations | 2012 | 2013 | Thereafter |
|---|---|---|---|
| Lease (rent) obligations | $ 555,411 | $ 48,264 | $ — |

Rent and Related Expenses approximated $0.5 million, $0.5 million and $0.3 million for the years ended December 31, 2011, 2010 and 2009, respectively.

## 10. RELATED PARTY TRANSACTIONS

During 2011, 2010 and 2009, the Company allocated $468,236, $527,761 and $381,213, respectively, of overhead expense to an affiliate based upon common use of office space and other resources. The amount due from this affiliate at December 31, 2011 and 2010 was $982,112 and $522,209, respectively, which is included in other assets in the consolidated balance sheet. Also during 2011 and 2010 the Company was allocated $663,000 and $670,000, respectively, of personnel expenses from another affiliate based upon time spent on the Company's business by employees of the affiliate. The associated expense is included in compensation in the consolidated statement of operations. At December 31, 2011 and 2010 there are no amounts due to this affiliate related to this expense allocation.

## 11. SUBSEQUENT EVENTS

In accordance with ASC Topic 855, Subsequent Events, Trimaran has evaluated events since December 31, 2011 through May 14, 2012, which is the date these financial statements were available to be issued. The Company has determined that there are no material events that would require their disclosure in the financial statements other than the following:

On February 29, 2012, 100% of the equity interests of Trimaran Advisors, L.L.C., along with the Company's ownership interests in the unrated, junior subordinated tranches of the CLO Funds managed by Trimaran, were acquired by Kohlberg Capital Corporation and its affiliates ("Kohlberg Capital"). The aggregate consideration for the equity interests in Trimaran consisted of $13.0 million in cash and 3,600,000 shares of common stock, par value $0.01 per share, at a fair value of $7.10 per share at the date of issuance, of Kohlberg Capital. The Company's interests in the unrated, junior subordinated tranches of the four CLOs were acquired for $12.0 million in cash. The Company follows the acquisition method of accounting which requires that the assets purchased and the liabilities assumed all be reported at their fair value, with any excess of purchase consideration over the net assets being reported as goodwill. As part of the valuation, intangible assets were identified and a fair value was determined as required by the accounting guidance for business combinations. The Company recognized a $15.7 million intangible asset related to the CLO Fund asset management contracts for the CLOs managed by the Company, which is being amortized over an estimated economic life of 54 months.


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**Prospectus**

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**Stifel Nicolaus Weisel**

**Barclays**

**Janney Montgomery Scott**

**JMP Securities**

**Ladenburg Thalmann & Co. Inc.**

**Sandler O’Neill + Partners, L.P.**

**Wunderlich Securities**

, 2012

## PART C — OTHER INFORMATION

### Item 25. Financial Statements and Exhibits

1. *Financial Statements*

The following financial statements of KCAP Financial, Inc. (the "Company" or "Registrant") are included in this registration statement:

2. *Exhibits*

| Exhibit Number | Description |
|---|---|
| a | Form of Certificate of Incorporation of Kohlberg Capital Corporation (the "Company").(1) |
| b | Form of Bylaws of the Company.(2) |
| d.1 | Specimen certificate of the Company's common stock, par value $0.01 per share.(3) |
| d.2 | Form of Registration Rights Agreement.(4) |
| d.3 | Form of Indenture between the Company and U.S. Bank National Association* |
| d.4 | Statement of Eligibility of Trustee on Form T-1* |
| d.5 | Form of First Supplemental Indenture between the Company and U.S. Bank National Association* |
| d.6 | Form of Note (Filed as Exhibit A to Form of First Supplemental Indenture referred to in Exhibit d.5). |
| e | Dividend Reinvestment Plan.(5) |
| h.1 | Form of Underwriting Agreement.* |
| i.1 | Amended and Restated 2006 Equity Incentive Plan.(6) |
| i.2 | Form of KCAP Financial Non-Qualified Stock Option Certificate.(3) |
| i.3 | Form of Restricted Stock Award Agreement.(7) |
| i.4 | Amended and Restated Non-Employee Director Plan.(8) |
| j | Custodian Agreement by and among the Company and U.S. Bank National Association.(9) |
| k.1 | Form of Overhead Allocation Agreement between the Company and Katonah Debt Advisors, LLC.(10) |
| k.2 | Employment Agreement between the Company and Dayl W. Pearson(21) |
| k.3 | Employment Agreement between the Company and Edward U. Gilpin.(11) |
| k.4 | Employment Agreement between the Company and R. Jon Corless.(21) |
| k.5 | Employment Agreement between Katonah Debt Advisors and E.A. Kratzman.(21) |
| k.6 | Employment Agreement between Katonah Debt Advisors and Daniel P. Gilligan.(21) |
| k.7 | Form of Indemnification Agreement for Officers and Directors of the Company.(12) |
| k.8 | Indenture, dated as of March 16, 2011, by and between the Company and U.S. Bank National Association, as trustee relating to the 8.75% Convertible Senior Note Due 2016.(13) |
| k.9 | 8.75% Convertible Senior Note Due 2016 (included as part of Exhibit k.8). |
| k.10 | Employment Agreement, dated February 29, 2012, by and among, Jay R. Bloom and Trimaran Advisors, L.L.C., and, solely as to the last three sentences of Section 1(a) and Section 2(d), the Company.(14) |
| k.11 | Employment Agreement, dated February 29, 2012,by and among, Dean C. Kehler and Trimaran Advisors, L.L.C., and, solely as to the last three sentences of Section 1(a) and Section 2(d), the Company.(15) |
| k.12 | Note Purchase Agreement, dated as of February 24, 2012, by and among the Company, Credit Suisse AG, Cayman Islands Branch, 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.(16) |
| k.13 | Collateral Administration Agreement, dated as of February 24, 2012, by and among the Company, KCAP Funding, Credit Suisse AG, Cayman Islands Branch, The Bank of New York Mellon Trust Company, National Association, as collateral administrator and collateral agent.(17) |
| k.14 | Purchase and Sale Agreement, dated February 29, 2012, by and among Kohlberg Capital Corporation (the "Company"), Commodore Holdings, L.L.C., Trimaran Advisors, L.L.C., HBK Caravelle, L.L.C., Trimaran Fund Management, L.L.C., Jay R. Bloom, and Dean C. Kehler.(18) |
| k.15 | Escrow Agreement, dated February 29, 2012, by and among Commodore Holdings, L.L.C., Trimaran Fund Management, L.L.C., HBK Caravelle, L.L.C. and The Bank of New York Mellon, as escrow agent.(19) |
| l | Opinion of Sutherland Asbill & Brennan LLP, counsel to the Company.* |
| n.1 | Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm, with respect to report dated March 15, 2012, relating to KCAP Financial, Inc.* |
| n.2 | Consent of Grant Thornton LLP, Independent Certified Public Accountants, with respect to report dated March 15, 2012, relating to Katonah Debt Advisors, L.L.C.* |
| n.3 | Consent of Grant Thornton LLP, Independent Certified Public Accountants, with respect to report dated March 14, 2012, relating to Trimaran Advisors, L.L.C.* |

| Exhibit Number | Description |
|---|---|
| n.4 | Report of Grant Thornton LLP, Independent Registered Public Accounting Firm, with respect to the debt obligations and indebtedness of KCAP Financial, Inc.(21) |
| r | Code of Ethics of the Company adopted under Rule 17j-1.(3).(20) |
| 99.1 | Statement of Computation of Ratios of Earnings to Fixed Charges* |

* Filed herewith

(1) Incorporated by reference to exhibit (a) included in Pre-Effective Amendment No. 1 on Form N-2, as filed on October 6, 2006 (File No. 333-136714).

(2) Incorporated by reference to Exhibit 3.1of the Current Report on Form 8-K, as filed on March 1, 2012 (File No. 814-00735).

(3) Incorporated by reference to exhibit (d)(1) included in Pre-Effective Amendment No. 1 on Form N-2, as filed on October 6, 2006 (File No. 333-136714).

(4) Incorporated by reference to exhibit (d)(2) included in Pre-Effective Amendment No. 2 on Form N-2, as filed on November 20, 2006 (File No. 333-136714).

(5) Incorporated by reference to exhibit (d)(2) included in Pre-Effective Amendment No. 2 on Form N-2, as filed on November 20, 2006 (File No. 333-136714).

(6) Incorporated by reference to Exhibit 10.1 of the Current Report on Form 8-K, as filed on June 19, 2008 (File No. 814-00735).

(7) Incorporated by reference to Exhibit 10.2 of the Current Report on Form 8-K, as filed on June 19, 2008 (File No. 814-00735).

(8) Incorporated by reference to Exhibit 4.1 included in the Registration Statement on form S-8, as filed on July 28, 2011 (File No. 333-175838).

(9) Incorporated by reference to exhibit (j) included in Pre-Effective Amendment No. 2 on Form N-2, as filed on November 20, 2006 (File No. 333-136714).

(10) Incorporated by reference to exhibit (k)(5) included in Pre-Effective Amendment No. 2 on Form N-2, as filed on November 20, 2006 (File No. 333-136714).

(11) Incorporated by reference to Exhibit 10.1of the Current Report on Form 8-K, as filed on June 5, 2012 (File No. 814-00735).

(12) Incorporated by reference to exhibit (k)(11) included in Pre-Effective Amendment No. 3 on Form N-2, as filed on November 24, 2006 (File No. 333-136714).

(13) Incorporated by reference to Exhibit 4.1of the Current Report on Form 8-K, as filed on March 16, 2011 (File No. 814-00735).

(14) Incorporated by reference to Exhibit 10.3 of the Current Report on Form 8-K, as filed on March 1, 2012 (File No. 814-00735).

(15) Incorporated by reference to Exhibit 10.4 of the Current Report on Form 8-K, as filed on March 1, 2012 (File No. 814-00735).

(16) Incorporated by reference to Exhibit 10.1 of the Current Report on Form 8-K, as filed on March 1, 2012 (File No. 814-00735).

(17) Incorporated by reference to Exhibit 10.2 of the Current Report on Form 8-K, as filed on March 1, 2012 (File No. 814-00735).

(18) Incorporated by reference to Exhibit 2.1 of the Current Report on Form 8-K, as filed on March 1, 2012 (File No. 814-00735).

(19) Incorporated by reference to Exhibit 2.2 of the Current Report on Form 8-K, as filed on March 1, 2012 (File No. 814-00735).

(20) Incorporated by reference to the similarly lettered exhibit included in Pre-Effective Amendment No. 2 to the Registration Statement on Form N-2, as filed on November 20, 2006 (File No. 333-136714).

(21) Incorporated by reference to the similarly lettered exhibit included in the Registration Statement on Form N-2, as filed on August 2, 2012 (File No. 333-183032).

**Item 26. Marketing Arrangements**

None.

**Item 27. Other Expenses of Issuance and Distribution**

The following table sets forth the estimated expenses payable by the Registrant in connection with the offering:

| | Amount |
|---|---|
| SEC registration fee | $ 3,438 |
| FINRA filing fee | 5,000 |
| Accounting fees and expenses | 100,000 |
| Legal fees and expenses | 150,000 |
| Printing expenses | 25,000 |
| New York Stock Exchange Listing Fee | 17,700 |
| Total | $ 301,138 |

The amounts set forth above, with the exception of the Securities and Exchange Commission fee, are in each case estimated. All of the expenses set forth above will be borne by the Registrant.

**Item 28. Persons Controlled by or Under Common Control**

The following table sets forth each of the Registrant's direct and indirect subsidiaries, the state under whose laws the subsidiary is organized, and the percentage of voting securities or membership interests owned by the Registrant in such subsidiary.

| | |
|---|---|
| Katonah Debt Advisors, L.L.C.(1) | Delaware |
| KCAP Funding | Cayman Islands |
| Katonah Management Holdings LLC(1) | Delaware |
| Katonah X Management LLC(1)(2) | Delaware |
| Katonah 2007-I Management LLC(1)(2) | Delaware |
| Katonah 2008-II Management LLC(1)(2) | Delaware |
| Commodore Holdings, L.L.C.(1) | Delaware |
| Trimaran Advisors, L.L.C.(1)(3) | Delaware |

(1) Represents a wholly-owned portfolio company that is not consolidated for financial reporting purposes.

(2) A wholly-owned subsidiary of Katonah Management Holdings LLC.

(3) A wholly-owned subsidiary of Commodore Holdings, L.L.C.

**Item 29. Number of Holders of Securities**

The following table sets forth the number of record holders of the Registrant's common stock at September 28, 2012.

| Title of Class | Number of Record Holders |
|---|---|
| Common Stock | 18 |

**Item 30. Indemnification**

The information contained under the heading "Management — Limitation on Liability of Directors and Officers and Indemnification" is incorporated herein by reference.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the Registrant pursuant to the provisions described above, or otherwise, the Registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the Registrant of expenses incurred or paid by a director, officer or controlling person in the successful defense of an action, suit or proceeding) is asserted by a director, officer or controlling person in connection with the securities being registered, the Registrant will, unless in the opinion of its counsel the matter has

been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

The Registrant carries liability insurance for the benefit of its directors and officers (other than with respect to claims resulting from the willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office) on a claims-made basis of up to $10 million.

**Item 31. Business and Other Connections of Investment Adviser**

Not applicable.

**Item 32. Location of Accounts and Records**

The Registrant maintains physical possession of each account, book or other document required to be maintained by Section 31(a) of the Investment Company Act of 1940, as amended, and the rules and regulations thereunder at the offices of:

(1) The Registrant, 295 Madison Avenue, 6th Floor, New York, New York 10017;

(2) The Custodian, U.S. Bank National Association, Corporate Trust Services, One Federal Street, 3rd Floor, Boston, MA 02110; and

(3) The Transfer Agent, American Stock Transfer & Trust Company, 59 Maiden Lane, New York, New York 10038.

**Item 33. Management Services**

Not applicable.

**Item 34. Undertakings**

(1) The Registrant hereby undertakes to suspend the offering of its common stock until it amends its prospectus if (a) subsequent to the effective date of its registration statement, the NAV declines more than 10 percent from its NAV as of the effective date of the Registration Statement or (b) the NAV increases to an amount greater than its net proceeds as stated in the prospectus.

(2) Not applicable.

(3) Not applicable.

(4) Not applicable.

(5) (a) For the purposes of determining any liability under the Securities Act of 1933, the information omitted from the form of prospectus filed as part of a registration statement in reliance upon Rule 430A and contained in the form of prospectus filed by the Registrant under Rule 497(h) under the Securities Act of 1933 shall be deemed to be part of the Registration Statement as of the time it was declared effective.

(b) For the purpose of determining any liability under the Securities Act of 1933, each post-effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of the securities at that time shall be deemed to be the initial bona fide offering thereof.

(6) Not applicable.

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## SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the Registrant has duly caused this Amendment No. 1 to the registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of New York, and State of New York, on the 3rd day of October, 2012.

**KCAP FINANCIAL, INC.**

By: /s/ Dayl W. Pearson

**Name: Dayl W. Pearson**

**Title: President and CEO**

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed by the following persons in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /s/ Dayl W. Pearson<br>**Dayl W. Pearson** | President and Chief Executive Officer; Director (principal executive officer) | October 3, 2012 |
| /s/ Edward U. Gilpin<br>**Edward U. Gilpin** | Chief Financial Officer, Secretary and Treasurer (principal financial and accounting officer) | October 3, 2012 |
| *<br>**Christopher Lacovara** | Director | October 3, 2012 |
| *<br>**Gary Cademartori** | Director | October 3, 2012 |
| *<br>**C. Michael Jacobi** | Director | October 3, 2012 |
| *<br>**Albert G. Pastino** | Director | October 3, 2012 |
| *<br>**C. Turney Stevens, Jr.** | Director | October 3, 2012 |
| *<br>**Jay R. Bloom** | Director | October 3, 2012 |
| *<br>**Dean C. Kehler** | Director | October 3, 2012 |
| * Dayl W. Pearson<br>**Dayl W. Pearson**<br>*As Attorney-in-Fact* | | |

Form of

**KCAP FINANCIAL, INC.**

**Issuer**

**and**

**U.S. BANK NATIONAL ASSOCIATION**

**Trustee**

**Indenture**

**Dated as of [_____], 2012**

**Providing for the Issuance**

**Of**

**Debt Securities**

**KCAP FINANCIAL, INC.**
**Reconciliation and tie between Trust Indenture Act of 1939**
**and Indenture, dated as of [_____], 2012**

| Trust Indenture Act Section | | Indenture Section |
|---|---|---|
| § 310 | (a)(1) | 607 |
| | (a)(2) | 607 |
| | (b) | 609 |
| § 312 | (c) | 701 |
| § 314 | (a) | 704 |
| | (a)(4) | 1005 |
| | (c)(1) | 102 |
| | (c)(2) | 102 |
| | (e) | 102 |
| § 315 | (b) | 601 |
| § 316 | (a) (last sentence) | 101 (“Outstanding”) |
| | (a)(1)(A) | 502,512 |
| | (a)(1)(B) | 513 |
| | (b) | 508 |
| § 317 | (a)(1) | 503 |
| | (a)(2) | 504 |
| § 318 | (a) | 111 |
| | (c) | 111 |

NOTE: This reconciliation and tie shall not, for any purpose, be deemed to be a part of the Indenture.

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INDENTURE, dated as of [_____], 2012, between KCAP FINANCIAL, INC., a Delaware corporation (hereinafter called the "Company"), having its principal office at [_____], and U.S. BANK NATIONAL ASSOCIATION, a national banking association, as Trustee (hereinafter called the "Trustee"), having its [_____].

**RECITALS OF THE COMPANY**

The Company deems it necessary to issue from time to time for its lawful purposes debt securities (hereinafter called the "Securities") evidencing its secured or unsecured indebtedness, which may or may not be convertible into or exchangeable for any securities of any Person (including the Company), and has duly authorized the execution and delivery of this Indenture to provide for the issuance from time to time of the Securities, to be issued in one or more series, unlimited as to principal amount, to bear such rates of interest, to mature at such times and to have such other provisions as shall be fixed as hereinafter provided.

This Indenture (as defined herein) is subject to the provisions of the Trust Indenture Act of 1939, as amended, that are required to be part of this Indenture and shall, to the extent applicable, be governed by such provisions.

All things necessary to make this Indenture a valid and legally binding agreement of the Company, in accordance with its terms, have been done.

NOW, THEREFORE, THIS INDENTURE WITNESSETH:

For and in consideration of the premises and the purchase of the Securities by the Holders (as defined herein) thereof, it is mutually covenanted and agreed, for the equal and proportionate benefit of all Holders of the Securities, or of a series thereof, as follows:

**ARTICLE ONE**

**DEFINITIONS AND OTHER PROVISIONS OF GENERAL APPLICATION**

**SECTION 101. Definitions.**

For all purposes of this Indenture, except as otherwise expressly provided or unless the context otherwise requires:

(1) the terms defined in this Article have the meanings assigned to them in this Article, and include the plural as well as the singular and, pursuant to Section 301, any such item may, with respect to any particular series of Securities, be amended or modified or specified as being inapplicable;

(2) all other terms used herein that are defined in the Trust Indenture Act (as defined herein), either directly or by reference therein, have the meanings assigned to them therein, and the terms "cash transaction" and "self-liquidating paper", as used in Section 311 of the Trust Indenture Act, shall have the meanings assigned to them in the rules of the Commission (as defined herein) adopted under the Trust Indenture Act;

(3) all accounting terms not otherwise defined herein have the meanings assigned to them in accordance with generally accepted accounting principles in the United States of America; and

(4) the words "herein", "hereof" and "hereunder" and other words of similar import refer to this Indenture as a whole and not to any particular Article, Section or other subdivision.

Certain terms, used in other Articles herein, are defined in those Articles.

"Act", when used with respect to any Holder of a Security, has the meaning specified in Section 104.

"Additional Amounts" means any additional amounts that are required by a Security or by or pursuant to a Board Resolution, under circumstances specified therein, to be paid by the Company in respect of certain taxes imposed on certain Holders and that are owing to such Holders.

"Affiliate" of any specified Person means any other Person directly or indirectly controlling or controlled by or under direct or indirect common control with such specified Person. For the purposes of this definition, "control" when used with respect to any specified Person means the power to direct the management and policies of such Person, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise; and the terms "controlling" and "controlled" have meanings correlative to the foregoing.

"Authenticating Agent" means any authenticating agent appointed by the Trustee pursuant to Section 612 to act on behalf of the Trustee to authenticate Securities of one or more series.

"Authorized Newspaper" means a newspaper, in the English language or in an official language of the country of publication, customarily published on each Business Day, whether or not published on Saturdays, Sundays or holidays, and of general circulation in each place in connection with which the term is used or in the financial community of each such place. Where successive publications are required to be made in Authorized Newspapers, the successive publications may be made in the same or in different newspapers in the same city meeting the foregoing requirements and in each case on any Business Day.

"Board of Directors" means the board of directors of the Company, the executive committee or any committee of that board duly authorized to act hereunder.

"Board Resolution" means a copy of a resolution certified by the Secretary or an Assistant Secretary of the Company to have been duly adopted by the Board of Directors and to be in full force and effect on the date of such certification, and delivered to the Trustee.

"Business Day", when used with respect to any Place of Payment or any other particular location referred to in this Indenture or in the Securities, means, unless otherwise specified with respect to any Securities pursuant to Section 301, each Monday, Tuesday, Wednesday, Thursday and Friday that is not a day on which banking institutions in that Place of Payment or particular location are authorized or obligated by law or executive order to close.

"Commission" means the Securities and Exchange Commission, as from time to time constituted, created under the Securities Exchange Act of 1934, or, if at any time after execution of this instrument such Commission is not existing and performing the duties now assigned to it under the Trust Indenture Act, then the body performing such duties on such date.

"Company" means the Person named as the "Company" in the first paragraph of this Indenture until a successor Person shall have become such pursuant to the applicable provisions of this Indenture, and thereafter "Company" shall mean such successor corporation.

"Company Request" and "Company Order" mean, respectively, a written request or order signed in the name of the Company by the Chief Executive Officer, President or a Vice President of the Company, and by the Chief Financial Officer, Chief Operating Officer, Secretary or an Assistant Secretary of the Company, and delivered to the Trustee.

"Conversion Date" has the meaning specified in Section 312(d).

"Conversion Event" means the cessation of use of (i) a Foreign Currency both by the government of the country which issued such currency and for the settlement of transactions by a central bank or other public institutions of or within the international banking community, (ii) the Euro within Economic and Monetary Union of the European Union or (iii) any currency unit (or composite currency) other than the Euro for the purposes for which it was established.

"Corporate Trust Office" means the principal office of the Trustee at which at any time its corporate trust business shall be administered, which office at the date hereof for purposes of Section 1002 only is located at 100 Wall Street, Suite 1600, New York, NY 10005, Attention: KCAP Financial, Inc., and for all other purposes is located at 1 Federal Street, 3rd Floor, Boston, MA 02110, Attention: KCAP Financial, Inc., or such other address as the Trustee may designate from time to time by notice to the Holders and the Company, or the principal corporate trust office of any successor Trustee (or such other address as such successor Trustee may designate from time to time by notice to the Holders and the Company).

"corporation" includes corporations, associations, companies and business trusts.

"Currency" means any currency or currencies, composite currency or currency unit or currency units issued by the government of one or more countries or by any reorganized confederation or association of such governments.

"Default" means any event that is, or after notice or passage of time or both would be, an Event of Default.

"Defaulted Interest" has the meaning specified in Section 307.

"Depository" means the clearing agency registered under the Exchange Act that is designated to act as the Depository for global Securities. DTC shall be the initial Depository, until a successor shall have been appointed and become such pursuant to the applicable provisions of this Indenture, and thereafter, "Depository" shall mean or include such successor.

"Dollar" or " $" means a dollar or other equivalent unit in such coin or currency of the United States of America as at the time shall be legal tender for the payment of public and private debts.

"DTC" means The Depository Trust Company.

"Euro" means the euro or other equivalent unit in such official coin or currency of the European Union.

"Election Date" has the meaning specified in Section 312(h).

"Event of Default" has the meaning specified in Article Five.

"Exchange Rate Agent", with respect to Securities of or within any series, means, unless otherwise specified with respect to any Securities pursuant to Section 301, a bank that is a member of the New York Clearing House Association, designated pursuant to Section 301 or Section 313.

"Exchange Rate Officer's Certificate" means a certificate setting forth (i) the applicable Market Exchange Rate or the applicable bid quotation and (ii) the Dollar or Foreign Currency amounts of principal (and premium, if any) and interest, if any (on an aggregate basis and on the basis of a Security having the lowest denomination principal amount determined in accordance with Section 302 in the relevant Currency), payable with respect to a Security of any series on the basis of such Market Exchange Rate or the applicable bid quotation signed by the Chief Financial Officer or any Vice President of the Company.

"Foreign Currency" means any Currency, including, without limitation, the Euro issued by the government of one or more countries other than the United States of America or by any recognized confederation or association of such governments.

"Government Obligations" means securities that are (i) direct obligations of the United States of America or the government that issued the Foreign Currency in which the Securities of a particular series are payable, for the payment of which its full faith and credit is pledged or (ii) obligations of a Person controlled or supervised by and acting as an agency or instrumentality of the United States of America or such government that issued the Foreign Currency in which the Securities of such series are payable, the timely payment of which is unconditionally guaranteed as a full faith and credit obligation by the United States of America or such other government, which, in either case, are not callable or redeemable at the option of the issuer thereof, and shall also include a depository receipt issued by a bank or trust company as custodian with respect to any such Government Obligation or a specific payment of interest on or principal of any such Government Obligation held by such custodian for the account of the holder of a depository receipt; provided that (except as required by law) such custodian is not authorized to make any deduction from the amount payable to the holder of such depository receipt from any amount received by the custodian in respect of the Government Obligation or the specific payment of interest on or principal of the Government Obligation evidenced by such depository receipt.

"Holder" means the Person in whose name a Security is registered in the Security Register.

"Indenture" means this instrument as originally executed or as it may from time to time be supplemented or amended by one or more indentures supplemental hereto entered into pursuant to the applicable provisions hereof, and shall include the terms of particular series of Securities established as contemplated by Section 301; provided, however, that, if at any time more than one Person is acting as Trustee under this instrument, "Indenture" shall mean, with respect to any one or more series of Securities for which such Person is Trustee, this instrument as originally executed or as it may from time to time be supplemented or amended by one or more indentures supplemental hereto entered into pursuant to the applicable provisions hereof and shall include the terms of the or those particular series of Securities for which such Person is Trustee established as contemplated by Section 301, exclusive, however, of any provisions or terms that relate solely to other series of Securities for which such Person is not Trustee, regardless of when such terms or provisions were adopted, and exclusive of any provisions or terms adopted by means of one or more indentures supplemental hereto executed and delivered after such Person had become such Trustee but to which such Person, as such Trustee, was not a party.

"Indexed Security" means a Security as to which all or certain interest payments and/or the principal amount payable at Maturity are determined by reference to prices, changes in prices, or differences between prices, of securities, Currencies, intangibles, goods, articles or commodities or by such other objective price, economic or other measures as are specified in or pursuant to Section 301 hereof.

"Interest", when used with respect to an Original Issue Discount Security which by its terms bears interest only after Maturity, means interest payable after Maturity, and, when used with respect to a Security which provides for the payment of Additional Amounts pursuant to Section 1004, includes such Additional Amounts.

"Interest Payment Date", when used with respect to any Security, means the Stated Maturity of an installment of interest on such Security.

"Market Exchange Rate" means, unless otherwise specified with respect to any Securities pursuant to Section 301, (i) for any conversion involving a currency unit on the one hand and Dollars or any Foreign Currency on the other, the exchange rate between the relevant currency unit and Dollars or such Foreign Currency calculated by the method specified pursuant to Section 301 for the Securities of the relevant series, (ii) for any conversion of Dollars into any Foreign Currency, the noon buying rate for such Foreign Currency for cable transfers quoted in New York City as certified for customs purposes by the Federal Reserve Bank of New York and (iii) for any conversion of one Foreign Currency into Dollars or another Foreign Currency, the spot rate at noon local time in the relevant market at which, in accordance with normal banking procedures, the Dollars or Foreign Currency into which conversion is being made could be purchased with the Foreign Currency from which conversion is being made from major banks located in either New York City, London or any other principal market for Dollars or such purchased Foreign Currency, in each case determined by the Exchange Rate Agent. Unless otherwise specified with respect to any Securities pursuant to Section 301, in the event of the unavailability of any of the exchange rates provided for in the foregoing clauses (i), (ii) and (iii), the Exchange Rate Agent shall use, in its sole discretion and without liability on its part, such quotation of the Federal Reserve Bank of New York as of the most recent available date, or quotations from one or more major banks in New York City, London or other principal market for such currency or currency unit in question, or such other quotations as the Exchange Rate Agent shall deem appropriate. Unless otherwise specified by the Exchange Rate Agent, if there is more than one market for dealing in any currency or currency unit by reason of foreign exchange regulations or otherwise, the market to be used in respect of such currency or currency unit shall be that upon which a nonresident issuer of securities designated in such currency or currency unit would purchase such currency or currency unit in order to make payments in respect of such securities as determined by the Exchange Rate Agent, in its sole discretion.

"Maturity", when used with respect to any Security, means the date on which the principal of such Security or an installment of principal becomes due and payable as therein or herein provided, whether at the Stated Maturity or by declaration of acceleration, notice of redemption, notice of option to elect repayment, notice of exchange or conversion or otherwise.

"Notice of Default" has the meaning provided in Section 501.

"Officers' Certificate" means a certificate signed by the Chief Executive Officer, President or a Vice President of the Company, and by the Chief Financial Officer, Chief Operating Officer, Secretary or an Assistant Secretary of the Company, and delivered to the Trustee.

"Opinion of Counsel" means a written opinion of counsel, who may be counsel for the Company or who may be an employee of or other counsel for the Company and who shall be reasonably satisfactory to the Trustee.

"Original Issue Discount Security" means any Security that provides for an amount less than the principal amount thereof to be due and payable upon a declaration of acceleration of the Maturity thereof pursuant to Section 502.

"Outstanding", when used with respect to Securities or any series of Securities, means, as of the date of determination, all Securities or all Securities of such series, as the case may be, theretofore authenticated and delivered under this Indenture, except:

(i) Securities theretofore cancelled by the Trustee or delivered to the Trustee for cancellation;

(ii) Securities, or portions thereof, for whose payment or redemption or repayment at the option of the Holder money in the necessary amount has been theretofore deposited with the Trustee or any Paying Agent (other than the Company) in trust or set aside and segregated in trust by the Company (if the Company shall act as its own Paying Agent) for the Holders of such Securities, provided that, if such Securities are to be redeemed, notice of such redemption has been duly given pursuant to this Indenture or provision therefor satisfactory to the Trustee has been made;

(iii) Securities, except to the extent provided in Sections 1402 and 1403, with respect to which the Company has effected defeasance and/or covenant defeasance as provided in Article Fourteen;

(iv) Securities that have been changed into any other securities of the Company or any other Person in accordance with this Indenture if the terms of such Securities provide for convertibility or exchangeability pursuant to Section 301; and

(v) Securities which have been paid pursuant to Section 306 or in exchange for or in lieu of which other Securities have been authenticated and delivered pursuant to this Indenture, other than any such Securities in respect of which there shall have been presented to the Trustee proof satisfactory to it that such Securities are held by a protected purchaser in whose hands such Securities are valid obligations of the Company;

provided, however, that in determining whether the Holders of the requisite principal amount of the Outstanding Securities have given any request, demand, authorization, direction, notice, consent or waiver hereunder or are present at a meeting of Holders for quorum purposes, and for the purpose of making the calculations required by TIA Section 313, (i) the principal amount of an Original Issue Discount Security that may be counted in making such determination or calculation and that shall be deemed to be Outstanding for such purpose shall be equal to the amount of principal thereof that would be (or shall have been declared to be) due and payable, at the time of such determination, upon a declaration of acceleration of the Maturity thereof pursuant to Section 502, (ii) the principal amount of any Security denominated in a Foreign Currency that may be counted in making such determination or calculation and that shall be deemed Outstanding for such purpose shall be equal to the Dollar equivalent, determined as of the date such Security is originally issued by the Company as set forth in an Exchange Rate Officer's Certificate delivered to the Trustee, of the principal amount (or, in the case of an Original Issue Discount Security or Indexed Security, the Dollar equivalent as of such date of original issuance of the amount determined as provided in clause (i) above or (iii) below, respectively) of such Security, (iii) the principal amount of any Indexed Security that may be counted in making such determination or calculation and that shall be deemed outstanding for such purpose shall be equal to the principal face amount of such Indexed Security at original issuance, unless otherwise provided with respect to such Security pursuant to Section 301, and (iv) Securities owned by the Company or any other obligor upon the Securities or any Affiliate of the Company or of such other obligor shall be disregarded and deemed not to be Outstanding, except that, in determining whether the Trustee shall be protected in making such calculation or in relying upon any such request, demand, authorization, direction, notice, consent or waiver or upon any such determination as to the presence of a quorum, only Securities which a Responsible Officer of the Trustee actually knows to be so owned shall be so disregarded. Securities so owned which have been pledged in good faith may be regarded as Outstanding if the pledgee establishes to the satisfaction of the Trustee the pledgee's right so to act with respect to such Securities and that the pledgee is not the Company or any other obligor upon the Securities or any Affiliate of the Company or of such other obligor.

"Paying Agent" means any Person authorized by the Company to pay the principal of (or premium, if any) or interest, if any, on any Securities on behalf of the Company.

"Person" means any individual, corporation, partnership, joint venture, association, joint-stock company, limited liability company, trust, unincorporated organization or government or any agency or political subdivision thereof, or any other entity.

"Place of Payment", when used with respect to the Securities of or within any series, means the place or places where the principal of (and premium, if any) and interest, if any, on such Securities are payable as specified and as contemplated by Sections 301 and 1002.

"Predecessor Security" of any particular Security means every previous Security evidencing all or a portion of the same debt as that evidenced by such particular Security; and, for the purposes of this definition, any Security authenticated and delivered under Section 306 in exchange for or in lieu of a mutilated, destroyed, lost or stolen Security shall be deemed to evidence the same debt as the mutilated, destroyed, lost or stolen Security.

"Redemption Date", when used with respect to any Security to be redeemed, in whole or in part, means the date fixed for such redemption by or pursuant to this Indenture.

"Redemption Price", when used with respect to any Security to be redeemed, means the price at which it is to be redeemed pursuant to this Indenture.

"Registered Security" means any Security that is registered in the Security Register.

"Regular Record Date" for the interest payable on any Interest Payment Date on the Registered Securities of or within any series means the date specified for that purpose as contemplated by Section 301, whether or not a Business Day.

"Repayment Date" means, when used with respect to any Security to be repaid at the option of the Holder, means the date fixed for such repayment by or pursuant to this Indenture.

"Repayment Price" means, when used with respect to any Security to be repaid at the option of the Holder, means the price at which it is to be repaid by or pursuant to this Indenture.

"Responsible Officer", when used with respect to the Trustee, means any officer of the Trustee assigned by the Trustee to administer its corporate trust matters and who shall have direct responsibility for the administration of this Indenture.

"Security" or "Securities" has the meaning stated in the first recital of this Indenture and, more particularly, means any Security or Securities authenticated and delivered under this Indenture; provided, however, that, if at any time there is more than one Person acting as Trustee under this Indenture, "Securities" with respect to the Indenture as to which such Person is Trustee shall have the meaning stated in the first recital of this Indenture and shall more particularly mean Securities authenticated and delivered under this Indenture, exclusive, however, of Securities of any series as to which such Person is not Trustee.

"Security Register" and "Security Registrar" have the respective meanings specified in Section 305.

"Senior Indebtedness" means the principal of (and premium, if any) and unpaid interest on (a) indebtedness of the Company (including indebtedness of others guaranteed by the Company), whether outstanding on the date hereof or thereafter created, incurred, assumed or guaranteed, for money borrowed, that has been designated by the Company as "Senior Indebtedness" for purposes of this Indenture by a Company Order delivered to the Trustee, (b) Senior Securities, and (c) renewals, extensions, modifications and refinancings of any such indebtedness.

"Senior Security" or "Senior Securities" means any Security or Securities designated pursuant to Section 301 as a Senior Security.

"Special Record Date" for the payment of any Defaulted Interest on the Registered Securities of or within any series means a date fixed by the Trustee pursuant to Section 307.

"Stated Maturity", when used with respect to any Security or any installment of principal thereof or interest thereon, means the date specified in such Security as the fixed date on which the principal of such Security or such installment of principal or interest is due and payable, as such date may be extended pursuant to the provisions of Section 308.

"Subordinated Indebtedness" means the principal of (and premium, if any) and unpaid interest on (a) indebtedness of the Company (including indebtedness of others guaranteed by the Company), whether outstanding on the date hereof or thereafter created, incurred, assumed or guaranteed, for money borrowed, which in the instrument creating or evidencing the same or pursuant to which the same is outstanding it is provided that such indebtedness ranks junior in right of payment to the Company's Senior Indebtedness, equally and *pari passu* in right of payment with all other Subordinated Indebtedness, (b) Subordinated Securities, and (c) renewals, extensions, modifications and refinancings of any such Subordinated Indebtedness.

"Subordinated Security" or "Subordinated Securities" means any Security or Securities designated pursuant to Section 301 as a Subordinated Security.

"Subsidiary" means (1) any corporation a majority of the outstanding voting stock of which is owned, directly or indirectly, by the Company or by one or more other Subsidiaries of the Company, (2) any other Person (other than a corporation) in which such Person, one or more Subsidiaries of such Person, or such Person and one or more Subsidiaries of such Person, directly or indirectly, at the date of determination thereof has a majority ownership interest, or (3) a partnership in which such Person or a Subsidiary of such Person is, at the time, a general partner and in which such Person, directly or indirectly, at the date of determination thereof has a majority ownership interest. For the purposes of this definition, "voting stock" means stock having voting power for the election of directors, whether at all times or only so long as no senior class of stock has such voting power by reason of any contingency.

"Trust Indenture Act" or "TIA" means the Trust Indenture Act of 1939, as amended, as in force at the date as of which this Indenture was executed, except as provided in Section 905.

"Trustee" means the Person named as the "Trustee" in the first paragraph of this Indenture until a successor Trustee shall have become such pursuant to the applicable provisions of this Indenture, and thereafter "Trustee" shall mean or include each Person who is then a Trustee hereunder; provided, however, that if at any time there is more than one such Person, "Trustee" as used with respect to the Securities of any series shall mean only the Trustee with respect to Securities of that series.

"United States" means, unless otherwise specified with respect to any Securities pursuant to Section 301, the United States of America (including the states and the District of Columbia), its territories, its possessions and other areas subject to its jurisdiction.

"United States person" means, unless otherwise specified with respect to any Securities pursuant to Section 301, any individual who is a citizen or resident of the United States, a corporation, partnership or other entity created or organized in or under the laws of the United States, any state thereof or the District of Columbia (other than a partnership that is not treated as a United States person under any applicable Treasury regulations), any estate the income of which is subject to United States federal income taxation regardless of its source, or any trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust. Notwithstanding the preceding sentence, to the extent provided in the Treasury regulations, certain trusts in existence on August 20, 1996, and treated as United States persons prior to such date that elect to continue to be treated as United States persons, will also be United States persons.

"Valuation Date" has the meaning specified in Section 312(c).

"Yield to Maturity" means the yield to maturity, computed at the time of issuance of a Security (or, if applicable, at the most recent redetermination of interest on such Security) and as set forth in such Security in accordance with generally accepted United States bond yield computation principles.

**SECTION 102. Compliance Certificates and Opinions.**

Upon any application or request by the Company to the Trustee to take any action under any provision of this Indenture, the Company shall furnish to the Trustee an Officers' Certificate stating that all conditions precedent, if any, provided for in this Indenture relating to the proposed action have been complied with and an Opinion of Counsel stating that in the opinion of such counsel all such conditions precedent, if any, have been complied with, except that in the case of any such application or request as to which the furnishing of such documents is specifically required by any provision of this Indenture relating to such particular application or request, no additional certificate or opinion need be furnished.

Every certificate or opinion with respect to compliance with a condition or covenant provided for in this Indenture (other than pursuant to Section 1005) shall include:

(1) a statement that each individual signing such certificate or opinion has read such condition or covenant and the definitions herein relating thereto;

(2) a brief statement as to the nature and scope of the examination or investigation upon which the statements or opinions contained in such certificate or opinion are based;

(3) a statement that, in the opinion of each such individual, he or she has made such examination or investigation as is necessary to enable such individual to express an informed opinion as to whether or not such condition or covenant has been complied with; and

(4) a statement as to whether, in the opinion of each such individual, such condition or covenant has been complied with.

**SECTION 103. Form of Documents Delivered to Trustee.**

In any case where several matters are required to be certified by, or covered by an opinion of, any specified Person, it is not necessary that all such matters be certified by, or covered by the opinion of, only one such Person, or that they be so certified or covered by only one document, but one such Person may certify or give an opinion as to some matters and one or more other such Persons as to other matters, and any such Person may certify or give an opinion as to such matters in one or several documents.

Any certificate or opinion of an officer of the Company may be based, insofar as it relates to legal matters, upon an Opinion of Counsel, or a certificate or representations by counsel, unless such officer knows, or in the exercise of reasonable care should know, that the opinion, certificate or representations with respect to the matters upon which his certificate or opinion is based are erroneous. Any such Opinion of Counsel or certificate or representations may be based, insofar as it relates to factual matters, upon a certificate or opinion of, or representations by, an officer or officers of the Company stating that the information as to such factual matters is in the possession of the Company, unless such counsel knows, or in the exercise of reasonable care should know, that the certificate or opinion or representations as to such matters are erroneous.

Where any Person is required to make, give or execute two or more applications, requests, consents, certificates, statements, opinions or other instruments under this Indenture, they may, but need not, be consolidated and form one instrument.

**SECTION 104. Acts of Holders.**

(a) Any request, demand, authorization, direction, notice, consent, waiver or other action provided by this Indenture to be given or taken by Holders of the Outstanding Securities of all series or one or more series, as the case may be, may be embodied in and evidenced by one or more instruments of substantially similar tenor signed by such Holders in person or by agents duly appointed in writing. Any request, demand, authorization, direction, notice, consent, waiver or other action provided by this Indenture to be given or taken by Holders of Securities of such series may, alternatively, be embodied in and evidenced by the record of Holders of Securities of such series voting in favor thereof, either in person or by proxies duly appointed in writing, at any meeting of Holders of Securities of such series duly called and held in accordance with the provisions of Article Fifteen, or a combination of such instruments and any such record. Except as herein otherwise expressly provided, such action shall become effective when such instrument or instruments or record or both are delivered to the Trustee and, where it is hereby expressly required, to the Company. Such instrument or instruments and any such record (and the action embodied therein and evidenced thereby) are herein sometimes referred to as the “Act” of the Holders signing such instrument or instruments or so voting at any such meeting. Proof of execution of any such instrument or of a writing appointing any such agent, or of the holding by any Person of a Security, shall be sufficient for any purpose of this Indenture and conclusive in favor of the Trustee and the Company and any agent of the Trustee or the Company, if made in the manner provided in this Section. The record of any meeting of Holders of Securities shall be proved in the manner provided in Section 1506.

(b) The fact and date of the execution by any Person of any such instrument or writing may be proved by the affidavit of a witness of such execution or by a certificate of a notary public or other officer authorized by law to take acknowledgments of deeds, certifying that the individual signing such instrument or writing acknowledged to him or her the execution thereof. Where such execution is by a signer acting in a capacity other than his individual capacity, such certificate or affidavit shall also constitute sufficient proof of his authority. The fact and date of the execution of any such instrument or writing or the authority of the Person executing the same may also be proved in any other reasonable manner that the Trustee deems sufficient.

(c) The ownership of Registered Securities shall be proved by the Security Register.

(d) If the Company shall solicit from the Holders of Registered Securities any request, demand, authorization, direction, notice, consent, waiver or other Act, the Company may, at its option, in or pursuant to a Board Resolution, fix in advance a record date for the determination of Holders entitled to give such request, demand, authorization, direction, notice, consent, waiver or other Act, but the Company shall have no obligation to do so. Such record date shall be the record date specified in or pursuant to such Board Resolution. If such a record date is fixed, such request, demand, authorization, direction, notice, consent, waiver or other Act may be given before or after such record date, but only the Holders of record at the close of business on such record date shall be deemed to be Holders for the purposes of determining whether Holders of the requisite proportion of Outstanding Securities have authorized or agreed or consented to such request, demand, authorization, direction, notice, consent, waiver or other Act, and for that purpose the Outstanding Securities shall be computed as of such record date; provided that no such authorization, agreement or consent by the Holders on such record date shall be deemed effective unless it shall become effective pursuant to the provisions of this Indenture not later than eleven months after the record date.

(e) Any request, demand, authorization, direction, notice, consent, waiver or other Act of the Holder of any Security shall bind every future Holder of the same Security and the Holder of every Security issued upon the registration of transfer thereof or in exchange therefor or in lieu thereof in respect of anything done, omitted or suffered to be done by the Trustee, any Security Registrar, any Paying Agent, any Authenticating Agent or the Company in reliance thereon, whether or not notation of such action is made upon such Security.

**SECTION 105. Notices, Etc., to Trustee and Company.**

Any request, demand, authorization, direction, notice, consent, waiver or Act of Holders or other document provided or permitted by this Indenture to be made upon, given or furnished to, or filed with,

(1) the Trustee by any Holder or by the Company shall be sufficient for every purpose hereunder if made, given, furnished, filed or mailed, first-class postage prepaid in writing to or with the Trustee at its Corporate Trust Office, Attention: KCAP Financial, Inc. (Eric Donaghey, Vice President), or at any other address previously furnished in writing to the Company by the Trustee, or

(2) the Company by the Trustee or by any Holder shall be sufficient for every purpose hereunder (unless otherwise herein expressly provided) if in writing and mailed, first-class postage prepaid, to the Company addressed to it at the address of its principal office specified in the first paragraph of this Indenture, to the attention of its Secretary or at any other address previously furnished in writing to the Trustee by the Company.

**SECTION 106. Notice to Holders; Waiver.**

Where this Indenture provides for notice of any event to Holders of Registered Securities by the Company or the Trustee, such notice shall be sufficiently given (unless otherwise herein expressly provided) if in writing and mailed, first-class postage prepaid, to each such Holder affected by such event, at his address as it appears in the Security Register, not later than the latest date, and not earlier than the earliest date, prescribed for the giving of such notice. In any case where notice to Holders of Registered Securities is given by mail, neither the failure to mail such notice, nor any defect in any notice so mailed, to any particular Holder shall affect the sufficiency of such notice with respect to other Holders of Registered Securities. Any notice mailed to a Holder in the manner herein prescribed shall be conclusively deemed to have been received by such Holder, whether or not such Holder actually receives such notice.

If by reason of the suspension of or irregularities in regular mail service or by reason of any other cause it shall be impracticable to give such notice by mail, then such notification to Holders of Registered Securities as shall be made with the approval of the Trustee shall constitute a sufficient notification to such Holders for every purpose hereunder.

Any request, demand, authorization, direction, notice, consent or waiver required or permitted under this Indenture shall be in the English language, except that any published notice may be in an official language of the country of publication.

Where this Indenture provides for notice in any manner, such notice may be waived in writing by the Person entitled to receive such notice, either before or after the event, and such waiver shall be the equivalent of such notice. Waivers of notice by Holders shall be filed with the Trustee, but such filing shall not be a condition precedent to the validity of any action taken in reliance upon such waiver.

**SECTION 107. Conflict with TIA.**

If any provision of this Indenture limits, qualifies or conflicts with a provision of the TIA that is required under the TIA to be a part of and govern this Indenture, the provision of the TIA shall control. If any provision of this Indenture modifies or excludes any provision of the TIA that may be so modified or excluded, the provision of the TIA shall be deemed to apply to this Indenture as so modified or only to the extent not so excluded, as the case may be.

**SECTION 108. Effect of Headings and Table of Contents.**

The Article and Section headings herein and the Table of Contents are for convenience only and shall not affect the construction hereof.

**SECTION 109. Successors and Assigns.**

All covenants and agreements in this Indenture by the Company shall bind its successors and assigns, whether so expressed or not.

**SECTION 110. Separability Clause.**

In case any provision in this Indenture or in any Security shall be invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby.

**SECTION 111. Benefits of Indenture.**

Nothing in this Indenture or in the Securities, express or implied, shall give to any Person, other than the parties hereto, any Security Registrar, any Paying Agent, any Authenticating Agent and their successors hereunder and the Holders any benefit or any legal or equitable right, remedy or claim under this Indenture.

**SECTION 112. Governing Law.**

This Indenture and the Securities shall be governed by and construed in accordance with the law of the State of New York without regard to principles of conflicts of laws. This Indenture is subject to the provisions of the Trust Indenture Act that are required to be part of this Indenture and shall, to the extent applicable, be governed by such provisions.

**SECTION 113. Legal Holidays.**

In any case where any Interest Payment Date, Redemption Date, Repayment Date, sinking fund payment date, Stated Maturity or Maturity of any Security shall not be a Business Day at any Place of Payment, then (notwithstanding any other provision of this Indenture or any Security other than a provision in the Securities of any series which specifically states that such provision shall apply in lieu of this Section), payment of principal (or premium, if any) or interest, if any, need not be made at such Place of Payment on such date, but may be made on the next succeeding Business Day at such Place of Payment with the same force and effect as if made on the Interest Payment Date, Redemption Date, Repayment Date or sinking fund payment date, or at the Stated Maturity or Maturity; provided that no interest shall accrue on the amount so payable for the period from and after such Interest Payment Date, Redemption Date, Repayment Date, sinking fund payment date, Stated Maturity or Maturity, as the case may be.

**SECTION 114. Submission to Jurisdiction.**

The Company hereby irrevocably submits to the non-exclusive jurisdiction of any New York state or federal court sitting in The City of New York in any action or proceeding arising out of or relating to the Indenture and the Securities of any series, and the Company hereby irrevocably agrees that all claims in respect of such action or proceeding may be heard and determined in such New York state or federal court. The Company hereby irrevocably waives, to the fullest extent it may effectively do so, the defense of an inconvenient forum to the maintenance of such action or proceeding.

## ARTICLE TWO

## SECURITIES FORMS

**SECTION 201. Forms of Securities.**

The Registered Securities of each series, the temporary global Securities of each series, if any, and the permanent global Securities of each series, if any, shall be in substantially the forms as shall be established in one or more indentures supplemental hereto or approved from time to time by or pursuant to a Board Resolution in accordance with Section 301, shall have such appropriate insertions, omissions, substitutions and other variations as are required or permitted by this Indenture or any indenture supplemental hereto, and may have such letters, numbers or other marks of identification or designation and such legends or endorsements placed thereon as the Company may deem appropriate and as are not inconsistent with the provisions of this Indenture, or as may be required to comply with any law or with any rule or regulation made pursuant thereto or with any rule or regulation of any stock exchange on which the Securities may be listed, or to conform to usage.

The definitive Securities shall be printed, lithographed or engraved or produced by any combination of these methods on a steel engraved border or steel engraved borders or may be produced in any other manner, all as determined by the officers executing such Securities, as evidenced by their execution of such Securities.

**SECTION 202. Form of Trustee's Certificate of Authentication.**

Subject to Section 611, the Trustee's certificate of authentication shall be in substantially the following form:

This is one of the Securities of the series designated therein referred to in the within-mentioned Indenture.

U.S. Bank National Association, as Trustee

By _____

Authorized Officer

**SECTION 203. Securities Issuable in Global Form.**

If Securities of or within a series are issuable in global form, as specified as contemplated by Section 301, then, notwithstanding clause (8) of Section 301 and the provisions of Section 302, any such Security shall represent such of the Outstanding Securities of such series as shall be specified therein and may provide that it shall represent the aggregate amount of Outstanding Securities of such series from time to time endorsed thereon and that the aggregate amount of Outstanding Securities of such series represented thereby may from time to time be increased or decreased to reflect exchanges. Any endorsement of a Security in global form to reflect the amount, or any increase or decrease in the amount, of Outstanding Securities represented thereby shall be made by the Trustee or the Security Registrar in such manner and upon instructions given by such Person or Persons as shall be specified therein or in the Company Order to be delivered to the Trustee pursuant to Section 303 or 304. Subject to the provisions of Section 303 and, if applicable, Section 304, the Trustee or the Security Registrar shall deliver and redeliver any Security in permanent global form in the manner and upon instructions given by the Person or Persons specified therein or in the applicable Company Order. If a Company Order pursuant to Section 303 or 304 has been, or simultaneously is, delivered, any instructions by the Company with respect to endorsement, delivery or redelivery of a Security in global form shall be in writing but need not comply with Section 102 and need not be accompanied by an Opinion of Counsel.

The provisions of the last sentence of Section 303 shall apply to any Security represented by a Security in global form if such Security was never issued and sold by the Company and the Company delivers to the Trustee or the Security Registrar the Security in global form together with written instructions (which need not comply with Section 102 and need not be accompanied by an Opinion of Counsel) with regard to the reduction in the principal amount of Securities represented thereby, together with the written statement contemplated by the last sentence of Section 303.

Notwithstanding the provisions of Section 307, unless otherwise specified as contemplated by Section 301, payment of principal of (and premium, if any) and interest, if any, on any Security in permanent global form shall be made to the Person or Persons specified therein.

Notwithstanding the provisions of Section 309 and except as provided in the preceding paragraph, the Company, the Trustee and any agent of the Company and the Trustee shall treat as the Holder of such principal amount of Outstanding Securities represented by a permanent global Security, the Holder of such permanent global Security.

Unless otherwise specified as contemplated by Section 301 for the Securities evidenced thereby, every global Security authenticated and delivered hereunder shall bear a legend in substantially the following form:

THIS SECURITY IS A GLOBAL SECURITY WITHIN THE MEANING OF THE INDENTURE HEREINAFTER REFERRED TO AND IS REGISTERED IN THE NAME OF A DEPOSITORY OR A NOMINEE THEREOF. THIS SECURITY MAY NOT BE EXCHANGED IN WHOLE OR IN PART FOR A SECURITY REGISTERED, AND NO TRANSFER OF THIS SECURITY IN WHOLE OR IN PART MAY BE REGISTERED, IN THE NAME OF ANY PERSON OTHER THAN SUCH DEPOSITORY OR A NOMINEE THEREOF, EXCEPT IN THE LIMITED CIRCUMSTANCES DESCRIBED IN THE INDENTURE.

## ARTICLE THREE

## THE SECURITIES

**SECTION 301. Amount Unlimited; Issuable in Series.**

The aggregate principal amount of Securities which may be authenticated and delivered under this Indenture is unlimited.

The Securities may be issued in one or more series as Registered Securities and shall be designated as Senior Securities or Subordinated Securities. Senior Securities are unsubordinated, shall rank equally and *pari passu* with all of the Company's other Senior Indebtedness and senior to all of the Company's Subordinated Indebtedness. Subordinated Securities shall rank junior to the Company's Senior Indebtedness and equally and *pari passu* with all of the Company's other Subordinated Indebtedness. There shall be established in one or more Board Resolutions or pursuant to authority granted by one or more Board Resolutions and, subject to Section 303, set forth, or determined in the manner provided, in an Officers' Certificate, or established in one or more indentures supplemental hereto, prior to the issuance of Securities of any series, any or all of the following, as applicable (each of which (except for the matters set forth in clauses (1), (2) and (15) below), if so provided, may be determined from time to time by the Company with respect to unissued Securities of the series when issued from time to time):

(1) the title of the Securities of the series including CUSIP numbers (which shall distinguish the Securities of such series from all other series of Securities);

(2) any limit upon the aggregate principal amount of the Securities of the series that may be authenticated and delivered under this Indenture (except for Securities authenticated and delivered upon registration of transfer of, or in exchange for, or in lieu of, other Securities of the series pursuant to Section 304, 305, 306, 906, 1107 or 1305, and except for any Securities which, pursuant to Section 303, are deemed never to have been authenticated and delivered hereunder);

(3) the date or dates, or the method by which such date or dates will be determined or extended, on which the principal of the Securities of the series shall be payable;

(4) the rate or rates at which the Securities of the series shall bear interest, if any, or the method by which such rate or rates shall be determined, the date or dates from which such interest shall accrue or the method by which such date or dates shall be determined, the Interest Payment Dates on which such interest will be payable and the Regular Record Date, if any, for the interest payable on any Registered Security on any Interest Payment Date, or the method by which such date shall be determined, the basis upon which such interest shall be calculated if other than that of a 360-day year of twelve 30-day months;

(5) the place or places, if any, other than or in addition to the Borough of Manhattan, The City of New York, where the principal of (and premium, if any) and interest, if any, on Securities of the series shall be payable, any Registered Securities of the series may be surrendered for registration of transfer, Securities of the series may be surrendered for exchange, where Securities of that series that are convertible or exchangeable may be surrendered for conversion or exchange, as applicable, and where notices or demands to or upon the Company in respect of the Securities of the series and this Indenture may be served;

(6) the period or periods within which, or the date or dates on which, the price or prices at which, the Currency or Currencies in which, and other terms and conditions upon which Securities of the series may be redeemed, in whole or in part, at the option of the Company, if the Company is to have the option;

(7) the obligation, if any, of the Company to redeem, repay or purchase Securities of the series pursuant to any sinking fund or analogous provision or at the option of a Holder thereof, and the period or periods within which or the date or dates on which, the price or prices at which, the Currency or Currencies in which, and other terms and conditions upon which Securities of the series shall be redeemed, repaid or purchased, in whole or in part, pursuant to such obligation;

(8) if other than denominations of $1,000 and any integral multiple thereof, the denomination or denominations in which any Registered Securities of the series shall be issuable;

(9) if other than the Trustee, the identity of each Security Registrar and/or Paying Agent;

(10) if other than the principal amount thereof, the portion of the principal amount of Securities of the series that shall be payable upon declaration of acceleration of the Maturity thereof pursuant to Section 502, upon redemption of the Securities of the series which are redeemable before their Stated Maturity, upon surrender for repayment at the option of the Holder, or which the Trustee shall be entitled to claim pursuant to Section 504 or the method by which such portion shall be determined;

(11) if other than Dollars, the Currency or Currencies in which payment of the principal of (or premium, if any) or interest, if any, on the Securities of the series shall be made or in which the Securities of the series shall be denominated and the particular provisions applicable thereto in accordance with, in addition to or in lieu of any of the provisions of Section 312;

(12) whether the amount of payments of principal of (or premium, if any) or interest, if any, on the Securities of the series may be determined with reference to an index, formula or other method (which index, formula or method may be based, without limitation, on one or more Currencies, commodities, equity indices or other indices), and the manner in which such amounts shall be determined;

(13) whether the principal of (or premium, if any) or interest, if any, on the Securities of the series are to be payable, at the election of the Company or a Holder thereof, in one or more Currencies other than that in which such Securities are denominated or stated to be payable, the period or periods within which (including the Election Date), and the terms and conditions upon which, such election may be made, and the time and manner of determining the exchange rate between the Currency or Currencies in which such Securities are denominated or stated to be payable and the Currency or Currencies in which such Securities are to be paid, in each case in accordance with, in addition to or in lieu of any of the provisions of Section 312;

(14) provisions, if any, granting special rights to the Holders of Securities of the series upon the occurrence of such events as may be specified;

(15) any deletions from, modifications of or additions to the Events of Default or covenants (including any deletions from, modifications of or additions to any of the provisions of Section 1007) of the Company with respect to Securities of the series, whether or not such Events of Default or covenants are consistent with the Events of Default or covenants set forth herein;

(16) whether any Securities of the series are to be issuable initially in temporary global form and whether any Securities of the series are to be issuable in permanent global form and, if so, whether beneficial owners of interests in any such permanent global Security may exchange such interests for Securities of such series in certificated form and of like tenor of any authorized form and denomination and the circumstances under which any such exchanges may occur, if other than in the manner provided in Section 305, and the circumstances under which and the place or places where such exchanges may be made and if Securities of the series are to be issuable as a global Security, the identity of the depository for such series;

(17) the date as of which any temporary global Security representing Outstanding Securities of the series shall be dated if other than the date of original issuance of the first Security of the series to be issued;

(18) the Person to whom any interest on any Registered Security of the series shall be payable, if other than the Person in whose name such Security (or one or more Predecessor Securities) is registered at the close of business on the Regular Record Date for such interest, and the extent to which, or the manner in which, any interest payable on a temporary global Security on an Interest Payment Date will be paid; and the extent to which, or the manner in which, any interest payable on a permanent global Security on an Interest Payment Date will be paid if other than in the manner provided in Section 307;

(19) the applicability, if any, of Sections 1402 and/or 1403 to the Securities of the series and any provisions in modification of, in addition to or in lieu of any of the provisions of Article Fourteen;

(20) if the Securities of such series are to be issuable in definitive form (whether upon original issue or upon exchange of a temporary Security of such series) only upon receipt of certain certificates or other documents or satisfaction of other conditions, then the form and/or terms of such certificates, documents or conditions;

(21) whether, under what circumstances and the Currency in which, the Company will pay Additional Amounts as contemplated by Section 1004 on the Securities of the series to any Holder who is not a United States person (including any modification to the definition of such term) in respect of any tax, assessment or governmental charge and, if so, whether the Company will have the option to redeem such Securities rather than pay such Additional Amounts (and the terms of any such option);

(22) the designation of the initial Exchange Rate Agent, if any;

(23) if the Securities of the series are to be issued upon the exercise of warrants, the time, manner and place for such Securities to be authenticated and delivered;

(24) if the Securities of the series are to be convertible into or exchangeable for any securities of any Person (including the Company), the terms and conditions upon which such Securities will be so convertible or exchangeable;

(25) if the Securities of the series are to be secured, the terms and conditions upon which such Securities will be so secured;

(26) the appointment of any calculation agent, foreign currency exchange agent or other additional agents;

(27) if the Securities of the series are to be listed on a securities exchange, the name of such exchange may be indicated; and

(28) any other terms of the series (which terms shall not be inconsistent with the provisions of this Indenture or the requirements of the Trust Indenture Act).

All Securities of any one series shall be substantially identical except as to denomination and except as may otherwise be provided in or pursuant to the Board Resolution referred to above (subject to Section 303) and set forth in the Officers' Certificate referred to above or in any such indenture supplemental hereto. All Securities of any one series need not be issued at the same time and, unless otherwise provided, a series may be reopened, without the consent of the Holders, for issuances of additional Securities of such series.

If any of the terms of the Securities of any series are established by action taken pursuant to one or more Board Resolutions, a copy of an appropriate record of such action(s) shall be certified by the Secretary or an Assistant Secretary of the Company and delivered to the Trustee at or prior to the delivery of the Officers' Certificate setting forth the terms of the Securities of such series.

**SECTION 302. Denominations.**

The Securities of each series shall be issuable in such denominations as shall be specified as contemplated by Section 301. With respect to Securities of any series denominated in Dollars, in the absence of any such provisions with respect to the Securities of any series, the Registered Securities of such series, other than Registered Securities issued in global form (which may be of any denomination) shall be issuable in denominations of $1,000 and any integral multiple thereof.

**SECTION 303. Execution, Authentication, Delivery and Dating.**

The Securities shall be executed on behalf of the Company by its Chief Executive Officer, its President its Chief Operating Officer, its Chief Financial Officer or any of its Vice Presidents and attested by its Secretary or any of its Assistant Secretaries. The signature of any of these officers on the Securities may be manual or facsimile signatures of the present or any future such authorized officer and may be imprinted or otherwise reproduced on the Securities.

Securities bearing the manual or facsimile signatures of individuals who were at any time the proper officers of the Company shall bind the Company, notwithstanding that such individuals or any of them have ceased to hold such offices prior to the authentication and delivery of such Securities or did not hold such offices at the date of such Securities.

At any time and from time to time after the execution and delivery of this Indenture, the Company may deliver Securities of any series executed by the Company, to the Trustee for authentication, together with a Company Order and an Officers' Certificate and Opinion of Counsel in accordance with Section 102 for the authentication and delivery of such Securities, and the Trustee in accordance with the Company Order shall authenticate and deliver such Securities. If all the Securities of any series are not to be issued at one time and if the Board Resolution or supplemental indenture establishing such series shall so permit, such Company Order may set forth procedures acceptable to the Trustee for the issuance of such Securities and determining the terms of particular Securities of such series, such as interest rate, maturity date, date of issuance and date from which interest shall accrue. In authenticating such Securities, and accepting the additional responsibilities under this Indenture in relation to such Securities, the Trustee shall be entitled to receive, and shall be fully protected in relying upon,

(i) an Opinion of Counsel stating,

(a) that the form or forms of such Securities have been established in conformity with the provisions of this Indenture;

(b) that the terms of such Securities have been established in conformity with the provisions of this Indenture; and

(c) that such Securities, when completed by appropriate insertions and executed and delivered by the Company to the Trustee for authentication in accordance with this Indenture, authenticated and delivered by the Trustee in accordance with this Indenture and issued by the Company in the manner and subject to any conditions specified in such Opinion of Counsel, will constitute legal, valid and binding obligations of the Company, enforceable in accordance with their terms, subject to applicable bankruptcy, insolvency, reorganization and other similar laws of general applicability relating to or affecting the enforcement of creditors' rights, to general equitable principles and to such other qualifications as such counsel shall conclude do not materially affect the rights of Holders of such Securities; and

(ii) an Officers' Certificate stating, to the best of the knowledge of the signers of such certificate, that no Event of Default with respect to any of the Securities shall have occurred and be continuing.

Notwithstanding the provisions of Section 301 and of this Section 303, if all the Securities of any series are not to be issued at one time, it shall not be necessary to deliver an Officers' Certificate otherwise required pursuant to Section 301 or the Company Order, Opinion of Counsel or Officers' Certificate otherwise required pursuant to the preceding paragraph at the time of issuance of each Security of such series, but such order, opinion and certificates, with appropriate modifications to cover such future issuances, shall be delivered at or before the time of issuance of the first Security of such series.

If such form or terms have been so established, the Trustee shall not be required to authenticate such Securities if the issue of such Securities pursuant to this Indenture will affect the Trustee's own rights, duties, obligations or immunities under the Securities and this Indenture or otherwise in a manner that is not reasonably acceptable to the Trustee. Notwithstanding the generality of the foregoing, the Trustee will not be required to authenticate Securities denominated in a Foreign Currency if the Trustee reasonably believes that it would be unable to perform its duties with respect to such Securities.

Each Registered Security shall be dated the date of its authentication.

No Security shall be entitled to any benefit under this Indenture or be valid or obligatory for any purpose unless there appears on such Security a certificate of authentication substantially in the form provided for herein duly executed by the Trustee or an Authenticating Agent by manual signature of an authorized signatory, and such certificate upon any Security shall be conclusive evidence, and the only evidence, that such Security has been duly authenticated and delivered hereunder and is entitled to the benefits of this Indenture. Notwithstanding the foregoing, if any Security shall have been authenticated and delivered hereunder but never issued and sold by the Company, and the Company shall deliver such Security to the Trustee for cancellation as provided in Section 310 together with a written statement (which need not comply with Section 102 and need not be accompanied by an Opinion of Counsel) stating that such Security has never been issued and sold by the Company, for all purposes of this Indenture such Security shall be deemed never to have been authenticated and delivered hereunder and shall never be entitled to the benefits of this Indenture.

**SECTION 304. Temporary Securities.**

Pending the preparation of definitive Securities of any series, the Company may execute, and upon Company Order the Trustee shall authenticate and deliver, temporary Securities that are printed, lithographed, typewritten, mimeographed or otherwise produced, in any authorized denomination, substantially of the tenor of the definitive Securities in lieu of which they are issued, in registered form and with such appropriate insertions, omissions, substitutions and other variations as the officers executing such Securities may determine, as conclusively evidenced by their execution of such Securities. In the case of Securities of any series, such temporary Securities may be in global form.

Except in the case of temporary Securities in global form (which shall be exchanged as provided in or pursuant to a Board Resolution), if temporary Securities of any series are issued, the Company will cause definitive Securities of that series to be prepared without unreasonable delay. After the preparation of definitive Securities of such series, the temporary Securities of such series shall be exchangeable for definitive Securities of such series upon surrender of the temporary Securities of such series at the office or agency of the Company in a Place of Payment for that series, without charge to the Holder. Upon surrender for cancellation of any one or more temporary Securities of any series, the Company shall execute and the Trustee shall authenticate and deliver in exchange therefor a like principal amount and like tenor of definitive Securities of the same series of authorized denominations. Until so exchanged, the temporary Securities of any series shall in all respects be entitled to the same benefits under this Indenture as definitive Securities of such series.

**SECTION 305. Registration, Registration of Transfer and Exchange.**

The Company shall cause to be kept at the Corporate Trust Office of the Trustee or in any office or agency of the Company in a Place of Payment a register for each series of Securities (the registers maintained in such office or in any such office or agency of the Company in a Place of Payment being herein sometimes referred to collectively as the "Security Register") in which, subject to such reasonable regulations as it may prescribe, the Company shall provide for the registration of Registered Securities and of transfers of Registered Securities. The Security Register shall be in written form or any other form capable of being converted into written form within a reasonable time. The Trustee, at its Corporate Trust Office, is hereby initially appointed "Security Registrar" for the purpose of registering Registered Securities and transfers of Registered Securities on such Security Register as herein provided, and for facilitating exchanges of temporary global Securities for permanent global Securities or definitive Securities, or both, or of permanent global Securities for definitive Securities, or both, as herein provided. In the event that the Trustee shall cease to be Security Registrar, it shall have the right to examine the Security Register at all reasonable times.

Upon surrender for registration of transfer of any Registered Security of any series at any office or agency of the Company in a Place of Payment for that series, the Company shall execute, and the Trustee shall authenticate and deliver, in the name of the designated transferee or transferees, one or more new Registered Securities of the same series, of any authorized denominations and of a like aggregate principal amount, bearing a number not contemporaneously outstanding and containing identical terms and provisions.

At the option of the Holder, Registered Securities of any series may be exchanged for other Registered Securities of the same series, of any authorized denomination or denominations and of a like aggregate principal amount, containing identical terms and provisions, upon surrender of the Registered Securities to be exchanged at any such office or agency. Whenever any Registered Securities are so surrendered for exchange, the Company shall execute, and the Trustee shall authenticate and deliver, the Registered Securities that the Holder making the exchange is entitled to receive.

Whenever any Securities are so surrendered for exchange, the Company shall execute, and the Trustee shall authenticate and deliver, the Securities that the Holder making the exchange is entitled to receive.

Notwithstanding the foregoing, except as otherwise specified as contemplated by Section 301, any permanent global Security shall be exchangeable only as provided in this paragraph. If any beneficial owner of an interest in a permanent global Security is entitled to exchange such interest for Securities of such series and of like tenor and principal amount of another authorized form and denomination, as specified as contemplated by Section 301 and provided that any applicable notice provided in the permanent global Security shall have been given, then without unnecessary delay but in any event not later than the earliest date on which such interest may be so exchanged, the Company shall deliver to the Trustee definitive Securities in aggregate principal amount equal to the principal amount of such beneficial owner's interest in such permanent global Security, executed by the Company. On or after the earliest date on which such interests may be so exchanged, such permanent global Security shall be surrendered by the depository specified as contemplated by Section 3.01 or such other depository as shall be specified in the Company Order with respect thereto to the Trustee, as the Company's agent for such purpose, or to the Security Registrar, to be exchanged, in whole or from time to time in part, for definitive Securities of the same series without charge and the Trustee shall authenticate and deliver, in exchange for each portion of such permanent global Security, an equal aggregate principal amount of definitive Securities of the same series of authorized denominations and of like tenor as the portion of such permanent global Security to be exchanged; provided, however, that no such exchanges may occur during a period beginning at the opening of business 15 days before any selection of Securities to be redeemed and ending on the relevant Redemption Date if the Security for which exchange is requested may be among those selected for redemption. If a Registered Security is issued in exchange for any portion of a permanent global Security after the close of business at the office or agency where such exchange occurs on (i) any Regular Record Date and before the opening of business at such office or agency on the relevant Interest Payment Date, or (ii) any Special Record Date and before the opening of business at such office or agency on the related proposed date for payment of Defaulted Interest or interest, as the case may be, will not be payable on such Interest Payment Date or proposed date for payment, as the case may be, in respect of such Registered Security, but will be payable on such Interest Payment Date or proposed date for payment, as the case may be, only to the Person to whom interest in respect of such portion of such permanent global Security is payable in accordance with the provisions of this Indenture.

All Securities issued upon any registration of transfer or exchange of Securities shall be valid obligations of the Company, evidencing the same debt and entitled to the same benefits under this Indenture, as the Securities surrendered upon such registration of transfer or exchange.

Every Registered Security presented or surrendered for registration of transfer or for exchange shall (if so required by the Company or the Security Registrar or any transfer agent) be duly endorsed, or be accompanied by a written instrument of transfer in form satisfactory to the Company and the Security Registrar, duly executed by the Holder thereof or his attorney or any transfer agent duly authorized in writing.

No service charge shall be made for any registration of transfer or exchange of Securities, but the Company or the Trustee may require payment of a sum sufficient to cover any tax or other governmental charge that may be imposed in connection with any registration of transfer or exchange of Securities, other than exchanges pursuant to Section 304, 906, 1107 or 1305 not involving any transfer.

The Company shall not be required (i) to issue, register the transfer of or exchange any Security if such Security may be among those selected for redemption during a period beginning at the opening of business 15 days before selection of the Securities to be redeemed under Section 1103 and ending at the close of business on the day of the mailing of the relevant notice of redemption, or (ii) to register the transfer of or exchange any Registered Security so selected for redemption in whole or in part, except, in the case of any Registered Security to be redeemed in part, the portion thereof not to be redeemed or (iii) to issue, register the transfer of or exchange any Security that has been surrendered for repayment at the option of the Holder, except the portion, if any, of such Security not to be so repaid.

**SECTION 306. Mutilated, Destroyed, Lost and Stolen Securities.**

If any mutilated Security is surrendered to the Trustee or the Company, together with, in proper cases, such security or indemnity as may be required by the Company or the Trustee to save each of them or any agent of either of them harmless, the Company shall execute and the Trustee shall authenticate and deliver in exchange therefor a new Security of the same series and principal amount, containing identical terms and provisions and bearing a number not contemporaneously outstanding.

If there shall be delivered to the Company and to the Trustee (i) evidence to their satisfaction of the destruction, loss or theft of any Security, and (ii) such security or indemnity as may be required by them to save each of them and any agent of either of them harmless, then, in the absence of notice to the Company or the Trustee that such Security has been acquired by a protected purchaser, the Company shall, subject to the following paragraph, execute and upon its request the Trustee shall authenticate and deliver, in lieu of any such destroyed, lost or stolen Security, a new Security of the same series and principal amount, containing identical terms and provisions and bearing a number not contemporaneously outstanding.

Notwithstanding the provisions of the previous two paragraphs, in case any such mutilated, destroyed, lost or stolen Security has become or is about to become due and payable, the Company in its discretion may, instead of issuing a new Security, pay such Security.

Upon the issuance of any new Security under this Section, the Company may require the payment of a sum sufficient to cover any tax or other governmental charge that may be imposed in relation thereto and any other expenses (including the fees and expenses of the Trustee) connected therewith.

Every new Security of any series issued pursuant to this Section in lieu of any destroyed, lost or stolen Security shall constitute an original additional contractual obligation of the Company, whether or not the destroyed, lost or stolen Security shall be at any time enforceable by anyone, and shall be entitled to all the benefits of this Indenture equally and proportionately with any and all other Securities of that series duly issued hereunder.

The provisions of this Section are exclusive and shall preclude (to the extent lawful) all other rights and remedies with respect to the replacement or payment of mutilated, destroyed, lost or stolen Securities.

**SECTION 307. Payment of Interest; Interest Rights Preserved; Optional Interest Reset.**

(a) Except as otherwise specified with respect to a series of Securities in accordance with the provisions of Section 301, interest, if any, on any Registered Security that is payable, and is punctually paid or duly provided for, on any Interest Payment Date shall be paid to the Person in whose name that Security (or one or more Predecessor Securities) is registered at the close of business on the Regular Record Date for such interest at the office or agency of the Company maintained for such purpose pursuant to Section 1002; provided, however, that each installment of interest, if any, on any Registered Security may at the Company's option be paid by (i) mailing a check for such interest, payable to or upon the written order of the Person entitled thereto pursuant to Section 309, to the address of such Person as it appears on the Security Register or (ii) transfer to an account maintained by the payee located in the United States.

Except as otherwise specified with respect to a series of Securities in accordance with the provisions of Section 301, any interest on any Registered Security of any series that is payable, but is not punctually paid or duly provided for, on any Interest Payment Date (herein called "Defaulted Interest") shall forthwith cease to be payable to the registered Holder thereof on the relevant Regular Record Date by virtue of having been such Holder, and such Defaulted Interest may be paid by the Company, at its election in each case, as provided in clause (1) or (2) below:

(1) The Company may elect to make payment of any Defaulted Interest to the Persons in whose names the Registered Securities of such series (or their respective Predecessor Securities) are registered at the close of business on a Special Record Date for the payment of such Defaulted Interest, which shall be fixed in the following manner. The Company shall notify the Trustee in writing of the amount of Defaulted Interest proposed to be paid on each Registered Security of such series and the date of the proposed payment (which shall not be less than 20 days after such notice is received by the Trustee), and at the same time the Company shall deposit with the Trustee an amount of money in the Currency in which the Securities of such series are payable (except as otherwise specified pursuant to Section 301 for the Securities of such series and except, if applicable, as provided in Sections 312(b), 312(d) and 312(e)) equal to the aggregate amount proposed to be paid in respect of such Defaulted Interest or shall make arrangements satisfactory to the Trustee for such deposit on or prior to the date of the proposed payment, such money when deposited to be held in trust for the benefit of the Persons entitled to such Defaulted Interest as in this clause provided. Thereupon the Trustee shall fix a Special Record Date for the payment of such Defaulted Interest which shall be not more than 15 days and not less than 10 days prior to the date of the proposed payment and not less than 10 days after the receipt by the Trustee of the notice of the proposed payment. The Trustee shall promptly notify the Company of such Special Record Date and, in the name and at the expense of the Company, shall cause notice of the proposed payment of such Defaulted Interest and the Special Record Date therefor to be mailed, first-class postage prepaid, to each Holder of Registered Securities of such series at his address as it appears in the Security Register not less than 10 days prior to such Special Record Date. Notice of the proposed payment of such Defaulted Interest and the Special Record Date therefor having been mailed as aforesaid, such Defaulted Interest shall be paid to the Persons in whose names the Registered Securities of such series (or their respective Predecessor Securities) are registered at the close of business on such Special Record Date and shall no longer be payable pursuant to the following clause (2).

(2) The Company may make payment of any Defaulted Interest on the Registered Securities of any series in any other lawful manner not inconsistent with the requirements of any securities exchange on which such Securities may be listed, and upon such notice as may be required by such exchange, if, after notice given by the Company to the Trustee of the proposed payment pursuant to this clause, such manner of payment shall be deemed practicable by the Trustee.

(b) The provisions of this Section 307(b) may be made applicable to any series of Securities pursuant to Section 301 (with such modifications, additions or substitutions as may be specified pursuant to such Section 301). The interest rate (or the spread or spread multiplier used to calculate such interest rate, if applicable) on any Security of such series may be reset by the Company on the date or dates specified on the face of such Security (each an "Optional Reset Date"). The Company may exercise such option with respect to such Security by notifying the Trustee of such exercise at least 45 but not more than 60 days prior to an Optional Reset Date for such Security. Not later than 35 days prior to each Optional Reset Date, the Trustee shall transmit, in the manner provided for in Section 106, to the Holder of any such Security a notice (the "Reset Notice") indicating whether the Company has elected to reset the interest rate (or the spread or spread multiplier used to calculate such interest rate, if applicable), and if so (i) such new interest rate (or such new spread or spread multiplier, if applicable) and (ii) the provisions, if any, for redemption during the period from such Optional Reset Date to the next Optional Reset Date or if there is no such next Optional Reset Date, to the Stated Maturity of such Security (each such period a "Subsequent Interest Period"), including the date or dates on which or the period or periods during which and the price or prices at which such redemption may occur during the Subsequent Interest Period.

Notwithstanding the foregoing, not later than 20 days prior to the Optional Reset Date, the Company may, at its option, revoke the interest rate (or the spread or spread multiplier used to calculate such interest rate, if applicable) provided for in the Reset Notice and establish a higher interest rate (or a spread or spread multiplier providing for a higher interest rate, if applicable) for the Subsequent Interest Period by causing the Trustee to transmit, in the manner provided for in Section 106, notice of such higher interest rate (or such higher spread or spread multiplier providing for a higher interest rate, if applicable) to the Holder of such Security. Such notice shall be irrevocable. All Securities with respect to which the interest rate (or the spread or spread multiplier used to calculate such interest rate, if applicable) is reset on an Optional Reset Date, and with respect to which the Holders of such Securities have not tendered such Securities for repayment (or have validly revoked any such tender) pursuant to the next succeeding paragraph, will bear such higher interest rate (or such higher spread or spread multiplier providing for a higher interest rate, if applicable).

The Holder of any such Security will have the option to elect repayment by the Company of the principal of such Security on each Optional Reset Date at a price equal to the principal amount thereof plus interest accrued to such Optional Reset Date. In order to obtain repayment on an Optional Reset Date, the Holder must follow the procedures set forth in Article Thirteen for repayment at the option of Holders except that the period for delivery or notification to the Trustee shall be at least 25 but not more than 35 days prior to such Optional Reset Date and except that, if the Holder has tendered any Security for repayment pursuant to the Reset Notice, the Holder may, by written notice to the Trustee, revoke such tender or repayment until the close of business on the tenth day before such Optional Reset Date.

Subject to the foregoing provisions of this Section and Section 305, each Security delivered under this Indenture upon registration of transfer of or in exchange for or in lieu of any other Security shall carry the rights to interest accrued and unpaid, and to accrue, that were carried by such other Security.

**SECTION 308. Optional Extension of Maturity.**

The provisions of this Section 308 may be made applicable to any series of Securities pursuant to Section 301 (with such modifications, additions or substitutions as may be specified pursuant to such Section 301). The Stated Maturity of any Security of such series may be extended at the option of the Company for the period or periods specified on the face of such Security (each an "Extension Period") up to but not beyond the date (the "Final Maturity") set forth on the face of such Security. The Company may exercise such option with respect to any Security by notifying the Trustee of such exercise at least 45 but not more than 60 days prior to the Stated Maturity of such Security in effect prior to the exercise of such option (the "Original Stated Maturity"). If the Company exercises such option, the Trustee shall transmit, in the manner provided for in Section 106, to the Holder of such Security not later than 35 days prior to the Original Stated Maturity a notice (the "Extension Notice"), prepared by the Company, indicating (i) the election of the Company to extend the Stated Maturity, (ii) the new Stated Maturity, (iii) the interest rate (or spread, spread multiplier or other formula to calculate such interest rate, if applicable), if any, applicable to the Extension Period and (iv) the provisions, if any, for redemption during such Extension Period. Upon the Trustee's transmittal of the Extension Notice, the Stated Maturity of such Security shall be extended automatically and, except as modified by the Extension Notice and as described in the next paragraph, such Security will have the same terms as prior to the transmittal of such Extension Notice.

Notwithstanding the foregoing, not later than 20 days before the Original Stated Maturity of such Security, the Company may, at its option, revoke the interest rate (or spread, spread multiplier or other formula to calculate such interest rate, if applicable) provided for in the Extension Notice and establish a higher interest rate (or spread, spread multiplier or other formula to calculate such higher interest rate, if applicable) for the Extension Period by causing the Trustee to transmit, in the manner provided for in Section 106, notice of such higher interest rate (or spread, spread multiplier or other formula to calculate such interest rate, if applicable) to the Holder of such Security. Such notice shall be irrevocable. All Securities with respect to which the Stated Maturity is extended will bear such higher interest rate.

If the Company extends the Stated Maturity of any Security, the Holder will have the option to elect repayment of such Security by the Company on the Original Stated Maturity at a price equal to the principal amount thereof, plus interest accrued to such date. In order to obtain repayment on the Original Stated Maturity once the Company has extended the Stated Maturity thereof, the Holder must follow the procedures set forth in Article Thirteen for repayment at the option of Holders, except that the period for delivery or notification to the Trustee shall be at least 25 but not more than 35 days prior to the Original Stated Maturity and except that, if the Holder has tendered any Security for repayment pursuant to an Extension Notice, the Holder may by written notice to the Trustee revoke such tender for repayment until the close of business on the tenth day before the Original Stated Maturity.

**SECTION 309. Persons Deemed Owners.**

Prior to due presentment of a Registered Security for registration of transfer, the Company, the Trustee and any agent of the Company or the Trustee shall treat the Person in whose name such Registered Security is registered as the owner of such Registered Security for the purpose of receiving payment of principal of (and premium, if any) and (subject to Sections 305 and 307) interest, if any, on such Registered Security and for all other purposes whatsoever, whether or not such Registered Security be overdue, and neither the Company, the Trustee nor any agent of the Company or the Trustee shall be affected by notice to the contrary.

None of the Company, the Trustee, any Paying Agent or the Security Registrar will have any responsibility or liability for any aspect of the records relating to or payments made on account of beneficial ownership interests of a Security in global form or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

Notwithstanding the foregoing, with respect to any global temporary or permanent Security, nothing herein shall prevent the Company, the Trustee, or any agent of the Company or the Trustee, from giving effect to any written certification, proxy or other authorization furnished by any depository, as a Holder, with respect to such global Security or impair, as between such depository and owners of beneficial interests in such global Security, the operation of customary practices governing the exercise of the rights of such depository (or its nominee) as Holder of such global Security.

**SECTION 310. Cancellation.**

All Securities surrendered for payment, redemption, repayment at the option of the Holder, registration of transfer or exchange or for credit against any sinking fund payment shall, if surrendered to any Person other than the Trustee, be delivered to the Trustee, and any such Securities surrendered directly to the Trustee for any such purpose shall be promptly cancelled by the Trustee. The Company may at any time deliver to the Trustee for cancellation any Securities previously authenticated and delivered hereunder which the Company may have acquired in any manner whatsoever, and may deliver to the Trustee (or to any other Person for delivery to the Trustee) for cancellation any Securities previously authenticated hereunder which the Company has not issued and sold, and all Securities so delivered shall be promptly cancelled by the Trustee. If the Company shall so acquire any of the Securities, however, such acquisition shall not operate as a redemption or satisfaction of the indebtedness represented by such Securities unless and until the same are surrendered to the Trustee for cancellation. No Securities shall be authenticated in lieu of or in exchange for any Securities cancelled as provided in this Section, except as expressly permitted by this Indenture. Cancelled Securities held by the Trustee shall be destroyed by the Trustee in accordance with its customary procedures, unless by a Company Order the Company directs the Trustee to deliver a certificate of such destruction to the Company or to return them to the Company.

**SECTION 311. Computation of Interest.**

Except as otherwise specified as contemplated by Section 301 with respect to Securities of any series, interest, if any, on the Securities of each series shall be computed on the basis of a 360-day year consisting of twelve 30-day months.

**SECTION 312. Currency and Manner of Payments in Respect of Securities.**

(a) Unless otherwise specified with respect to any Securities pursuant to Section 301, with respect to Registered Securities of any series not permitting the election provided for in paragraph (b) below or the Holders of which have not made the election provided for in paragraph (b) below, payment of the principal of (and premium, if any, on) and interest, if any, on any Registered Security of such series will be made in the Currency in which such Registered Security is payable. The provisions of this Section 312 may be modified or superseded with respect to any Securities pursuant to Section 301.

(b) It may be provided pursuant to Section 301, if so expressly specified with respect to Registered Securities of any series, that Holders shall have the option, subject to paragraphs (d) and (e) below, to receive payments of principal of (or premium, if any, on) or interest, if any, on such Registered Securities in any of the Currencies which may be designated for such election by delivering to the Trustee for such series of Registered Securities a written election with signature guarantees and in the applicable form established pursuant to Section 301, not later than the close of business on the Election Date immediately preceding the applicable payment date. If a Holder so elects to receive such payments in any such Currency, such election will remain in effect for such Holder or any transferee of such Holder until changed by such Holder or such transferee by written notice to the Trustee for such series of Registered Securities (but any such change must be made not later than the close of business on the Election Date immediately preceding the next payment date to be effective for the payment to be made on such payment date and no such change of election may be made with respect to payments to be made on any Registered Security of such series with respect to which an Event of Default has occurred or with respect to which the Company has deposited funds pursuant to Article Four or Fourteen or with respect to which a notice of redemption has been given by the Company or a notice of option to elect repayment has been sent by such Holder or such transferee). Any Holder of any such Registered Security who shall not have delivered any such election to the Trustee of such series of Registered Securities not later than the close of business on the applicable Election Date will be paid the amount due on the applicable payment date in the relevant Currency as provided in Section 312(a). The Trustee for each such series of Registered Securities shall notify the Exchange Rate Agent as soon as practicable after the Election Date of the aggregate principal amount of Registered Securities for which Holders have made such written election.

(c) Unless otherwise specified pursuant to Section 301, if the election referred to in paragraph (b) above has been provided for pursuant to Section 301, then, not later than the fourth Business Day after the Election Date for each payment date for Registered Securities of any series, the Exchange Rate Agent will deliver to the Company a written notice specifying the Currency in which Registered Securities of such series are payable, the respective aggregate amounts of principal of (and premium, if any, on) and interest, if any, on the Registered Securities to be paid on such payment date, specifying the amounts in such Currency so payable in respect of the Registered Securities as to which the Holders of Registered Securities denominated in any Currency shall have elected to be paid in another Currency as provided in paragraph (b) above. Unless the Trustee is acting as the Exchange Rate Agent, the Trustee shall have no obligation to complete the actual exchange of distribution amounts from one Currency to another Currency. If the election referred to in paragraph (b) above has been provided for pursuant to Section 301 and if at least one Holder has made such election, then, unless otherwise specified pursuant to Section 301, on the second Business Day preceding such payment date the Company will deliver to the Trustee for such series of Registered Securities an Exchange Rate Officer's Certificate in respect of the Dollar or Foreign Currency or Currencies payments to be made on such payment date. Unless otherwise specified pursuant to Section 301, the Dollar or Foreign Currency or Currencies amount receivable by Holders of Registered Securities who have elected payment in a Currency as provided in paragraph (b) above shall be determined by the Company on the basis of the applicable Market Exchange Rate in effect on the second Business Day (the "Valuation Date") immediately preceding each payment date, and such determination shall be conclusive and binding for all purposes, absent manifest error.

(d) If a Conversion Event occurs with respect to a Foreign Currency in which any of the Securities are denominated or payable other than pursuant to an election provided for pursuant to paragraph (b) above, then with respect to each date for the payment of principal of (and premium, if any) and interest, if any, on the applicable Securities denominated or payable in such Foreign Currency occurring after the last date on which such Foreign Currency was used (the "Conversion Date"), the Dollar shall be the currency of payment for use on each such payment date. Unless otherwise specified pursuant to Section 301, the Dollar amount to be paid by the Company to the Trustee of each such series of Securities and by such Trustee or any Paying Agent to the Holders of such Securities with respect to such payment date shall be, in the case of a Foreign Currency other than a currency unit, the Dollar Equivalent of the Foreign Currency or, in the case of a currency unit, the Dollar Equivalent of the Currency Unit, in each case as determined by the Exchange Rate Agent in the manner provided in paragraph (f) or (g) below.

(e) Unless otherwise specified pursuant to Section 301, if the Holder of a Registered Security denominated in any Currency shall have elected to be paid in another Currency as provided in paragraph (b) above, and a Conversion Event occurs with respect to such elected Currency, such Holder shall receive payment in the Currency in which payment would have been made in the absence of such election; and if a Conversion Event occurs with respect to the Currency in which payment would have been made in the absence of such election, such Holder shall receive payment in Dollars as provided in paragraph (d) of this Section 312.

(f) The "Dollar Equivalent of the Foreign Currency" shall be determined by the Exchange Rate Agent and shall be obtained for each subsequent payment date by converting the specified Foreign Currency into Dollars at the Market Exchange Rate on the Conversion Date.

(g) The "Dollar Equivalent of the Currency Unit" shall be determined by the Exchange Rate Agent and subject to the provisions of paragraph (h) below shall be the sum of each amount obtained by converting the Specified Amount of each Component Currency into Dollars at the Market Exchange Rate for such Component Currency on the Valuation Date with respect to each payment.

(h) For purposes of this Section 312, the following terms shall have the following meanings:

A "Component Currency" shall mean any currency which, on the Conversion Date, was a component currency of the relevant currency unit.

A "Specified Amount" of a Component Currency shall mean the number of units of such Component Currency or fractions thereof which were represented in the relevant currency unit on the Conversion Date. If after the Conversion Date the official unit of any Component Currency is altered by way of combination or subdivision, the Specified Amount of such Component Currency shall be divided or multiplied in the same proportion. If after the Conversion Date two or more Component Currencies are consolidated into a single currency, the respective Specified Amounts of such Component Currencies shall be replaced by an amount in such single currency equal to the sum of the respective Specified Amounts of such consolidated Component Currencies expressed in such single currency, and such amount shall thereafter be a Specified Amount and such single currency shall thereafter be a Component Currency. If after the Conversion Date any Component Currency shall be divided into two or more currencies, the Specified Amount of such Component Currency shall be replaced by amounts of such two or more currencies, having an aggregate Dollar Equivalent value at the Market Exchange Rate on the date of such replacement equal to the Dollar Equivalent of the Specified Amount of such former Component Currency at the Market Exchange Rate immediately before such division, and such amounts shall thereafter be Specified Amounts and such currencies shall thereafter be Component Currencies. If, after the Conversion Date of the relevant currency unit, a Conversion Event (other than any event referred to above in this definition of "Specified Amount") occurs with respect to any Component Currency of such currency unit and is continuing on the applicable Valuation Date, the Specified Amount of such Component Currency shall, for purposes of calculating the Dollar Equivalent of the Currency Unit, be converted into Dollars at the Market Exchange Rate in effect on the Conversion Date of such Component Currency.

An "Election Date" shall mean the Regular Record Date for the applicable series of Registered Securities or at least 16 days prior to Maturity, as the case may be, or such other prior date for any series of Registered Securities as specified pursuant to clause 13 of Section 301 by which the written election referred to in Section 312(b) may be made.

All decisions and determinations of the Exchange Rate Agent regarding the Dollar Equivalent of the Foreign Currency, the Dollar Equivalent of the Currency Unit, the Market Exchange Rate and changes in the Specified Amounts as specified above shall be in its sole discretion and shall, in the absence of manifest error, be conclusive for all purposes and irrevocably binding upon the Company, the Trustee for the appropriate series of Securities and all Holders of such Securities denominated or payable in the relevant Currency. The Exchange Rate Agent shall promptly give written notice to the Company and the Trustee for the appropriate series of Securities of any such decision or determination.

In the event that the Company determines in good faith that a Conversion Event has occurred with respect to a Foreign Currency, the Company will immediately give written notice thereof to the Trustee of the appropriate series of Securities and to the Exchange Rate Agent (and such Trustee will promptly thereafter give notice in the manner provided in Section 106 to the affected Holders) specifying the Conversion Date. In the event the Company so determines that a Conversion Event has occurred with respect to any other currency unit in which Securities are denominated or payable, the Company will immediately give written notice thereof to the Trustee of the appropriate series of Securities and to the Exchange Rate Agent (and such Trustee will promptly thereafter give notice in the manner provided in Section 106 to the affected Holders) specifying the Conversion Date and the Specified Amount of each Component Currency on the Conversion Date. In the event the Company determines in good faith that any subsequent change in any Component Currency as set forth in the definition of Specified Amount above has occurred, the Company will similarly give written notice to the Trustee of the appropriate series of Securities and to the Exchange Rate Agent.

The Trustee of the appropriate series of Securities shall be fully justified and protected in relying and acting upon information received by it from the Company and the Exchange Rate Agent and shall not otherwise have any duty or obligation to determine the accuracy or validity of such information independent of the Company or the Exchange Rate Agent.

**SECTION 313. Appointment and Resignation of Successor Exchange Rate Agent.**

(a) Unless otherwise specified pursuant to Section 301, if and so long as the Securities of any series (i) are denominated in a Foreign Currency or (ii) may be payable in a Foreign Currency, or so long as it is required under any other provision of this Indenture, then the Company will engage and maintain with respect to each such series of Securities, or as so required, at least one Exchange Rate Agent. The Company will cause the Exchange Rate Agent to make the necessary foreign exchange determinations at the time and in the manner specified pursuant to Section 301 for the purpose of determining the applicable rate of exchange and, if applicable, for the purpose of converting the issued Foreign Currency into the applicable payment Currency for the payment of principal (and premium, if any) and interest, if any, pursuant to Section 312.

(b) No resignation of the Exchange Rate Agent and no appointment of a successor Exchange Rate Agent pursuant to this Section shall become effective until the acceptance of appointment by the successor Exchange Rate Agent as evidenced by a written instrument delivered to the Company and the Trustee of the appropriate series of Securities accepting such appointment executed by the successor Exchange Rate Agent.

(c) If the Exchange Rate Agent shall resign, be removed or become incapable of acting, or if a vacancy shall occur in the office of the Exchange Rate Agent for any cause, with respect to the Securities of one or more series, the Company, by or pursuant to a Board Resolution, shall promptly appoint a successor Exchange Rate Agent or Exchange Rate Agents with respect to the Securities of that or those series (it being understood that any such successor Exchange Rate Agent may be appointed with respect to the Securities of one or more or all of such series and that, unless otherwise specified pursuant to Section 301, at any time there shall only be one Exchange Rate Agent with respect to the Securities of any particular series that are originally issued by the Company on the same date and that are initially denominated and/or payable in the same Currency).

**SECTION 314. CUSIP Numbers.**

The Company in issuing the Securities may use "CUSIP" numbers (if then generally in use), and, if so, the Trustee shall indicate the respective "CUSIP" numbers of the Securities in notices of redemption as a convenience to Holders; provided that any such notice may state that no representation is made as to the correctness of such numbers either as printed on the Securities or as contained in any notice of redemption and that reliance may be placed only on the other identification numbers printed on the Securities, and any such redemption shall not be affected by any defect in or omission of such numbers. The Company shall advise the Trustee as promptly as practicable in writing of any change in the CUSIP numbers.

## ARTICLE FOUR

## SATISFACTION AND DISCHARGE

**SECTION 401. Satisfaction and Discharge of Indenture.**

Except as set forth below, this Indenture shall upon Company Request cease to be of further effect with respect to any series of Securities specified in such Company Request (except as to any surviving rights of registration of transfer or exchange of Securities of such series expressly provided for herein or pursuant hereto, any surviving rights of tender for repayment at the option of the Holders and any right to receive Additional Amounts, as provided in Section 1004), and the Trustee, upon receipt of a Company Order, and at the expense of the Company, shall execute proper instruments acknowledging satisfaction and discharge of this Indenture as to such series when

(1) either

(A) all Securities of such series theretofore authenticated and delivered (other than (i) Securities of such series which have been destroyed, lost or stolen and which have been replaced or paid as provided in Section 306 and (ii) Securities of such series for whose payment money has theretofore been deposited in trust with the Trustee or any Paying Agent or segregated and held in trust by the Company and thereafter repaid to the Company or discharged from such trust, as provided in Section 1003) have been delivered to the Trustee for cancellation; or

(B) all Securities of such series

(i) have become due and payable, or

(ii) will become due and payable at their Stated Maturity within one year, or

(iii) if redeemable at the option of the Company, are to be called for redemption within one year under arrangements satisfactory to the Trustee for the giving of notice of redemption by the Trustee in the name, and at the expense, of the Company,

and the Company, in the case of (i), (ii) or (iii) above, has irrevocably deposited or caused to be deposited with the Trustee as trust funds in trust for such purpose, solely for the benefit of the Holders, an amount in the Currency in which the Securities of such series are payable, sufficient to pay and discharge the entire indebtedness on such Securities not theretofore delivered to the Trustee for cancellation, for principal (and premium, if any) and interest, if any, to the date of such deposit (in the case of Securities which have become due and payable) or to the Stated Maturity or Redemption Date, as the case may be;

(2) the Company has irrevocably paid or caused to be irrevocably paid all other sums payable hereunder by the Company; and

(3) the Company has delivered to the Trustee an Officers' Certificate and an Opinion of Counsel, each stating that all conditions precedent herein provided for relating to the satisfaction and discharge of this Indenture as to such series have been complied with.

Notwithstanding the satisfaction and discharge of this Indenture, the obligations of the Company to the Trustee and any predecessor Trustee under Section 606, the obligations of the Company to any Authenticating Agent under Section 612 and, if money shall have been deposited with the Trustee pursuant to subclause (B) of clause (1) of this Section, the obligations of the Trustee under Section 402 and the last paragraph of Section 1003 shall survive any termination of this Indenture.

**SECTION 402. Application of Trust Funds.**

Subject to the provisions of the last paragraph of Section 1003, all money deposited with the Trustee pursuant to Section 401 shall be held in trust and applied by it, in accordance with the provisions of the Securities and this Indenture, to the payment, either directly or through any Paying Agent (including the Company acting as its own Paying Agent) as the Trustee may determine, to the Persons entitled thereto, of the principal (and premium, if any) and interest, if any, for whose payment such money has been deposited with or received by the Trustee, but such money need not be segregated from other funds except to the extent required by law.

## ARTICLE FIVE

## REMEDIES

**SECTION 501. Events of Default.**

"Event of Default", wherever used herein with respect to any particular series of Securities, means any one of the following events (whatever the reason for such Event of Default and whether or not it shall be voluntary or involuntary or be effected by operation of law or pursuant to any judgment, decree or order of any court or any order, rule or regulation of any administrative or governmental body), unless it is either inapplicable to a particular series or is specifically deleted or modified in or pursuant to the supplemental indenture or a Board Resolution establishing such series of Securities or is in the form of Security for such series:

(1) default in the payment of any interest upon any Security of that series when such interest becomes due and payable, and continuance of such default for a period of 30 days; or

(2) default in the payment of the principal of (or premium, if any, on) any Security of that series when it becomes due and payable at its Maturity; or

(3) default in the deposit of any sinking fund payment, when and as due by the terms of any Security of that series, and continuance of such default for a period of 2 Business Days; or

(4) default in the performance, or breach, of any covenant or agreement of the Company in this Indenture with respect to any Security of that series (other than a covenant or agreement a default in whose performance or whose breach is elsewhere in this Section specifically dealt with or which has expressly been included in this Indenture solely for the benefit of a series of Securities other than that series), and continuance of such default or breach for a period of 60 days after there has been given, by registered or certified mail, to the Company by the Trustee or to the Company and the Trustee by the Holders of at least 25% in principal amount of the Outstanding Securities of that series a written notice specifying such default or breach and requiring it to be remedied and stating that such notice is a "Notice of Default" hereunder;

(5) the Company, pursuant to or within the meaning of any Bankruptcy Law:

(A) commences a voluntary case or proceeding under any Bankruptcy Law,

(B) consents to the commencement of any bankruptcy or insolvency case or proceeding against it, or files a petition or answer or consent seeking reorganization or relief against it,

(C) consents to the entry of a decree or order for relief against it in an involuntary case or proceeding,

(D) consents to the filing of such petition or to the appointment of or taking possession by a Custodian of the Company or for all or substantially all of its property, or

(E) makes an assignment for the benefit of creditors, or admits in writing of its inability to pay its debts generally as they become due or takes any corporate action in furtherance of any such action; or

(6) a court of competent jurisdiction enters an order or decree under any Bankruptcy Law that:

(A) is for relief against the Company in an involuntary case or proceeding, or

(B) adjudges the Company bankrupt or insolvent, or approves as properly filed a petition seeking reorganization, arrangement, adjustment or composition of or in respect of the Company, or

(C) appoints a Custodian of the Company or for all or substantially all of its property, or

(D) orders the winding up or liquidation of the Company,

and the continuance of any such decree or order for relief or any such other decree or order unstayed and in effect for a period of 60 consecutive days; or

(7) if, pursuant to Sections 18(a)(1)(c)(ii) and 61 of the Investment Company Act of 1940, as amended, on the last business day of each of twenty-four consecutive calendar months Securities of that series shall have an asset coverage (as such term is used in the Investment Company Act of 1940) of less than 100 per centum;

(8) any other Event of Default provided with respect to Securities of that series.

The term "Bankruptcy Law" means title 11, U.S. Code or any applicable federal or state bankruptcy, insolvency, reorganization or other similar law. The term "Custodian" means any custodian, receiver, trustee, assignee, liquidator, sequestrator or other similar official under any Bankruptcy Law.

**SECTION 502. Acceleration of Maturity; Rescission and Annulment.**

If an Event of Default with respect to Securities of any series at the time Outstanding occurs and is continuing, then and in every such case the Trustee or the Holders of not less than 25% in principal amount of the Outstanding Securities of that series may (and the Trustee shall at the request of such Holders) declare the principal (or, if any Securities are Original Issue Discount Securities or Indexed Securities, such portion of the principal as may be specified in the terms thereof) of all the Securities of that series to be due and payable immediately, by a notice in writing to the Company (and to the Trustee if given by the Holders), and upon any such declaration such principal or specified portion thereof shall become immediately due and payable.

Any application by the Trustee for written instructions from the requisite amount of Holders (as determined pursuant to this Indenture) may, at the option of the Trustee, set forth in writing any action proposed to be taken or omitted by the Trustee under this Indenture and the date on and/or after which such action shall be taken or such omission shall be effective. The Trustee shall not be liable for any action taken by, or omission of, the Trustee in accordance with a proposal included in such application on or after the date specified in such application unless prior to taking any such action (or the effective date in the case of an omission), the Trustee shall have received written instructions from the requisite amount of Holders (as determined pursuant to this Indenture) in response to such application specifying the action to be taken or omitted.

At any time after such a declaration of acceleration with respect to Securities of any series has been made and before a judgment or decree for payment of the money due has been obtained by the Trustee as hereinafter provided in this Article, the Holders of a majority in principal amount of the Outstanding Securities of that series, by written notice to the Company and the Trustee, may rescind and annul such declaration and its consequences if:

(1) the Company has paid or deposited with the Trustee a sum sufficient to pay in the Currency in which the Securities of such series are payable (except as otherwise specified pursuant to Section 301 for the Securities of such series and except, if applicable, as provided in Sections 312(b), 312(d) and 312(e)):

(A) all overdue installments of interest, if any, on all Outstanding Securities of that series,

(B) the principal of (and premium, if any, on) all Outstanding Securities of that series which have become due otherwise than by such declaration of acceleration and interest thereon at the rate or rates borne by or provided for in such Securities,

(C) to the extent that payment of such interest is lawful, interest upon overdue installments of interest at the rate or rates borne by or provided for in such Securities, and

(D) all sums paid or advanced by the Trustee hereunder and the reasonable compensation, expenses, disbursements and advances of the Trustee, its agents and counsel; and

(2) all Events of Default with respect to Securities of that series, other than the nonpayment of the principal of (or premium, if any) or interest on Securities of that series that have become due solely by such declaration of acceleration, have been cured or waived as provided in Section 513.

No such rescission shall affect any subsequent default or impair any right consequent thereon.

**SECTION 503. Collection of Indebtedness and Suits for Enforcement by Trustee.**

The Company covenants that if:

(1) default is made in the payment of any installment of interest on any Security of any series when such interest becomes due and payable and such default continues for a period of 30 days, or

(2) default is made in the payment of the principal of (or premium, if any, on) any Security of any series at its Maturity,

then the Company will, upon demand of the Trustee, pay to the Trustee, for the benefit of the Holders of Securities of such series, the whole amount then due and payable on such Securities for principal (and premium, if any) and interest, if any, with interest upon any overdue principal (and premium, if any) and, to the extent that payment of such interest shall be legally enforceable, upon any overdue installments of interest, if any, at the rate or rates borne by or provided for in such Securities, and, in addition thereto, such further amount as shall be sufficient to cover the costs and expenses of collection, including the reasonable compensation, expenses, disbursements and advances of the Trustee, its agents and counsel.

If the Company fails to pay such amounts forthwith upon such demand, the Trustee, in its own name and as trustee of an express trust, may institute a judicial proceeding for the collection of the sums so due and unpaid, and may prosecute such proceeding to judgment or final decree, and may enforce the same against the Company or any other obligor upon Securities of such series and collect the moneys adjudged or decreed to be payable in the manner provided by law out of the property of the Company or any other obligor upon such Securities of such series, wherever situated.

If an Event of Default with respect to Securities of any series occurs and is continuing, the Trustee may in its discretion proceed to protect and enforce its rights and the rights of the Holders of Securities of such series by such appropriate judicial proceedings as the Trustee shall deem most effectual to protect and enforce any such rights, whether for the specific enforcement of any covenant or agreement in this Indenture or in aid of the exercise of any power granted herein, or to enforce any other proper remedy.

**SECTION 504. Trustee May File Proofs of Claim.**

In case of the pendency of any receivership, insolvency, liquidation, bankruptcy, reorganization, arrangement, adjustment, composition or other judicial proceeding relative to the Company or any other obligor upon the Securities or the property of the Company or of such other obligor or their creditors, the Trustee (irrespective of whether the principal of the Securities of any series shall then be due and payable as therein expressed or by declaration or otherwise and irrespective of whether the Trustee shall have made any demand on the Company for the payment of any overdue principal, premium or interest) shall be entitled and empowered, by intervention in such proceeding or otherwise:

(i) to file and prove a claim for the whole amount of principal (or in the case of Original Issue Discount Securities or Indexed Securities, such portion of the principal as may be provided for in the terms thereof) (and premium, if any) and interest, if any, owing and unpaid in respect of the Securities and to file such other papers or documents, and take such other actions, including serving on a committee of creditors, as may be necessary or advisable in order to have the claims of the Trustee (including any claim for the reasonable compensation, expenses, disbursements and advances of the Trustee, its agents and counsel) and of the Holders allowed in such judicial proceeding, and

(ii) to collect and receive any moneys or other property payable or deliverable on any such claims and to distribute the same; and any custodian, receiver, assignee, trustee, liquidator, sequestrator (or other similar official) in any such judicial proceeding is hereby authorized by each Holder of Securities of such series to make such payments to the Trustee, and in the event that the Trustee shall consent to the making of such payments directly to the Holders, to pay to the Trustee any amount due to it for the reasonable compensation, expenses, disbursements and advances of the Trustee and any predecessor Trustee, their agents and counsel, and any other amounts due the Trustee or any predecessor Trustee under Section 606.

Subject to Article Eight and Section 902 and unless otherwise provided as contemplated by Section 301, nothing herein contained shall be deemed to authorize the Trustee to authorize or consent to or accept or adopt on behalf of any Holder of a Security any plan of reorganization, arrangement, adjustment or composition affecting the Securities or the rights of any Holder thereof, or to authorize the Trustee to vote in respect of the claim of any Holder of a Security in any such proceeding.

**SECTION 505. Trustee May Enforce Claims Without Possession of Securities.**

All rights of action and claims under this Indenture or any of the Securities may be prosecuted and enforced by the Trustee without the possession of any of the Securities or the production thereof in any proceeding relating thereto, and any such proceeding instituted by the Trustee shall be brought in its own name and as trustee of an express trust, and any recovery of judgment shall, after provision for the payment of the reasonable compensation, expenses, disbursements and advances of the Trustee, its agents and counsel, be for the ratable benefit of the Holders of the Securities in respect of which such judgment has been recovered.

**SECTION 506. Application of Money Collected.**

Any money collected by the Trustee pursuant to this Article shall be applied in the following order, at the date or dates fixed by the Trustee and, in case of the distribution of such money on account of principal (or premium, if any) or interest, if any, upon presentation of the Securities and the notation thereon of the payment if only partially paid and upon surrender thereof if fully paid:

FIRST: To the payment of all amounts due the Trustee and any predecessor Trustee under Section 606 and any other agent hereunder;

SECOND: To the payment of the amounts then due and unpaid upon the Securities for principal (and premium, if any) and interest, if any, in respect of which or for the benefit of which such money has been collected, giving effect to Article XVI, if applicable, but otherwise ratably, without preference or priority of any kind, according to the aggregate amounts due and payable on such Securities for principal (and premium, if any) and interest, if any, respectively; and

THIRD: To the payment of the remainder, if any, to the Company or any other Person or Persons entitled thereto.

**SECTION 507. Limitation on Suits.**

No Holder of any Security of any series shall have any right to institute any proceeding, judicial or otherwise, with respect to this Indenture, or for the appointment of a receiver or trustee, or for any other remedy hereunder, unless:

(1) such Holder has previously given written notice to the Trustee of a continuing Event of Default with respect to the Securities of that series;

(2) the Holders of not less than 25% in principal amount of the Outstanding Securities of that series shall have made written request to the Trustee to institute proceedings in respect of such Event of Default in its own name as Trustee hereunder;

(3) such Holder or Holders have offered to the Trustee reasonable indemnity, security or both against the costs, expenses and liabilities to be incurred in compliance with such request;

(4) the Trustee for 60 days after its receipt of such notice, request and offer of indemnity and/or security has failed to institute any such proceeding; and

(5) no direction inconsistent with such written request has been given to the Trustee during such 60-day period by the Holders of a majority in principal amount of the Outstanding Securities of that series;

it being understood and intended that no one or more of such Holders shall have any right in any manner whatever by virtue of, or by availing of, any provision of this Indenture to affect, disturb or prejudice the rights of any other of such Holders, or to obtain or to seek to obtain priority or preference over any other of such Holders or to enforce any right under this Indenture, except in the manner herein provided and for the equal and ratable benefit of all such Holders.

**SECTION 508. Unconditional Right of Holders to Receive Principal, Premium and Interest.**

Notwithstanding any other provision in this Indenture, the Holder of any Security shall have the right which is absolute and unconditional to receive payment of the principal of (and premium, if any) and (subject to Sections 305 and 307) interest, if any, on such Security on the Stated Maturity or Maturities expressed in such Security (or, in the case of redemption, on the Redemption Date or, in the case of repayment at the option of the Holders on the Repayment Date) and to institute suit for the enforcement of any such payment, and such rights shall not be impaired without the consent of such Holder.

**SECTION 509. Restoration of Rights and Remedies.**

If the Trustee or any Holder of a Security has instituted any proceeding to enforce any right or remedy under this Indenture and such proceeding has been discontinued or abandoned for any reason, or has been determined adversely to the Trustee or to such Holder, then and in every such case the Company, the Trustee and the Holders of Securities shall, subject to any determination in such proceeding, be restored severally and respectively to their former positions hereunder and thereafter all rights and remedies of the Trustee and the Holders shall continue as though no such proceeding had been instituted.

**SECTION 510. Rights and Remedies Cumulative.**

Except as otherwise provided with respect to the replacement or payment of mutilated, destroyed, lost or stolen Securities in the last paragraph of Section 306, no right or remedy herein conferred upon or reserved to the Trustee or to the Holders of Securities is intended to be exclusive of any other right or remedy, and every right and remedy shall, to the extent permitted by law, be cumulative and in addition to every other right and remedy given hereunder or now or hereafter existing at law or in equity or otherwise. The assertion or employment of any right or remedy hereunder, or otherwise, shall not prevent the concurrent assertion or employment of any other appropriate right or remedy.

**SECTION 511. Delay or Omission Not Waiver.**

No delay or omission of the Trustee or of any Holder of any Security to exercise any right or remedy accruing upon any Event of Default shall impair any such right or remedy or constitute a waiver of any such Event of Default or an acquiescence therein. Every right and remedy given by this Article or by law to the Trustee or to the Holders may be exercised from time to time, and as often as may be deemed expedient, by the Trustee or by the Holders of Securities, as the case may be.

**SECTION 512. Control by Holders of Securities.**

Subject to Section 602, the Holders of a majority in principal amount of the Outstanding Securities of any series shall have the right to direct the time, method and place of conducting any proceeding for any remedy available to the Trustee or exercising any trust or power conferred on the Trustee with respect to the Securities of such series, provided that

(1) such direction shall not be in conflict with any rule of law or with this Indenture,

(2) the Trustee may take any other action deemed proper by the Trustee that is not inconsistent with such direction

(3) the Trustee need not take any action that might involve it in personal liability or be unjustly prejudicial to the Holders of Securities of such series not consenting, and

(4) the Trustee may demand security or indemnity reasonably satisfactory to it in accordance with Section 602.

**SECTION 513. Waiver of Past Defaults.**

Subject to Section 502, the Holders of not less than a majority in principal amount of the Outstanding Securities of any series may on behalf of the Holders of all the Securities of such series waive any past default hereunder with respect to Securities of such series and its consequences, except a default

(1) in the payment of the principal of (or premium, if any) or interest, if any, on any Security of such series, or

(2) in respect of a covenant or provision hereof which under Article Nine cannot be modified or amended without the consent of the Holder of each Outstanding Security of such series affected.

Upon any such waiver, such default shall cease to exist, and any Event of Default arising therefrom shall be deemed to have been cured, for every purpose of this Indenture; but no such waiver shall extend to any subsequent or other default or Event of Default or impair any right consequent thereon.

**SECTION 514. Waiver of Stay or Extension Laws.**

The Company covenants (to the extent that it may lawfully do so) that it will not at any time insist upon, or plead, or in any manner whatsoever claim or take the benefit or advantage of, any stay or extension law wherever enacted, now or at any time hereafter in force, that may affect the covenants or the performance of this Indenture; and the Company (to the extent that it may lawfully do so) hereby expressly waives all benefit or advantage of any such law, and covenants that it will not hinder, delay or impede the execution of any power herein granted to the Trustee, but will suffer and permit the execution of every such power as though no such law had been enacted.

## ARTICLE SIX

## THE TRUSTEE

**SECTION 601. Notice of Defaults.**

Within 90 days after the occurrence of any Default hereunder with respect to the Securities of any series, the Trustee shall transmit in the manner and to the extent provided in TIA Section 313(c), notice of such Default hereunder known to the Trustee, unless such Default shall have been cured or waived; provided, however, that, except in the case of a Default in the payment of the principal of (or premium, if any) or interest, if any, on any Security of such series, or in the payment of any sinking or purchase fund installment with respect to the Securities of such series, the Trustee shall be protected in withholding such notice if and so long as the board of directors, the executive committee or a trust committee of directors and/or Responsible Officers of the Trustee in good faith determines that the withholding of such notice is in the interest of the Holders of the Securities of such series; and provided further that in the case of any Default or breach of the character specified in Section 501 (4) with respect to the Securities of such series, no such notice to Holders shall be given until at least 60 days after the occurrence thereof.

**SECTION 602. Certain Rights of Trustee.**

(1) Prior to the time when the occurrence of an Event of Default becomes known to a Responsible Officer of the Trustee and after the curing or waiving of all such Events of Default with respect to a series of Securities that may have occurred:

(a) the duties and obligations of the Trustee shall with respect to the Securities of any series be determined solely by the express provisions of this Indenture, including without limitation Section 107 of this Indenture, and the Trustee shall not be liable with respect to the Securities except for the performance of such duties and obligations as are specifically set forth in this Indenture, including without limitation Section 107 of this Indenture, and no implied covenants or obligations shall be read into this Indenture against the Trustee;

(b) in the absence of bad faith on the part of the Trustee, the Trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, upon any certificates or opinions furnished to the Trustee and conforming to the requirements of this Indenture; but in the case of any such certificates or opinions that by any provision hereof are specifically required to be furnished to the Trustee, the Trustee shall be under a duty to examine the same to determine whether or not they conform on their face to the requirements of this Indenture (but need not confirm or investigate the accuracy of any mathematical calculations or other facts stated herein); and

(c) The Trustee shall not be liable for any error of judgment made in good faith by a Responsible Officer or Responsible Officers, unless it shall be proved that the Trustee was negligent in ascertaining the pertinent facts.

(2) The Trustee may rely and shall be protected in acting or refraining from acting upon any resolution, certificate, statement, instrument, opinion, report, notice, request, direction, consent, order, bond, debenture, note, coupon or other paper or document believed by it to be genuine and to have been signed or presented by the proper party or parties.

(3) Any request or direction of the Company mentioned herein shall be sufficiently evidenced by a Company Request or Company Order (other than delivery of any Security, to the Trustee for authentication and delivery pursuant to Section 303 which shall be sufficiently evidenced as provided therein) and any resolution of the Board of Directors may be sufficiently evidenced by a Board Resolution.

(4) Whenever in the administration of this Indenture the Trustee shall deem it desirable that a matter be proved or established prior to taking, suffering or omitting any action hereunder, the Trustee (unless other evidence be herein specifically prescribed) may require and, in the absence of bad faith on its part, rely upon a Board Resolution, an Opinion of Counsel or an Officers' Certificate.

(5) The Trustee may consult with counsel and the written advice of such counsel or any Opinion of Counsel shall be full and complete authorization and protection in respect of any action taken, suffered or omitted by it hereunder in good faith and in reliance thereon.

(6) The Trustee shall be under no obligation to exercise any of the rights or powers vested in it by this Indenture at the request or direction of any of the Holders of Securities of any series pursuant to this Indenture, unless such Holders shall have offered to the Trustee security or indemnity reasonably satisfactory to it against the costs, expenses and liabilities which might be incurred by it in compliance with such request or direction.

(7) The Trustee shall not be bound to make any investigation into the facts or matters stated in any resolution, certificate, statement, instrument, opinion, report, notice, request, direction, consent, order, bond, debenture, note, coupon or other paper or document, but the Trustee, in its discretion, may make such further inquiry or investigation into such facts or matters as it may see fit, and, if the Trustee shall determine to make such further inquiry or investigation, it shall be entitled upon reasonable notice and at reasonable times during normal business hours to examine the books, records and premises of the Company, personally or by agent or attorney.

(8) The Trustee may execute any of the trusts or powers hereunder or perform any duties hereunder either directly or by or through agents or attorneys and the Trustee shall not be responsible for any misconduct or negligence on the part of any agent or attorney appointed with due care by it hereunder.

(9) The Trustee shall not be deemed to have notice of any Default or Event of Default unless a Responsible Officer of the Trustee has actual knowledge thereof or unless written notice of any event which is in fact such a default is received by the Trustee at the Corporate Trust Office of the Trustee, and such notice references the Securities and this Indenture.

(10) The rights, privileges, protections, immunities and benefits given to the Trustee, including, without limitation, its right to be indemnified, are extended to, and shall be enforceable by, the Trustee in each of its capacities hereunder.

(11) The permissive rights of the Trustee enumerated herein shall not be construed as duties and the Trustee shall not be answerable for other than its own negligent action, its own negligent failure to act or its own willful misconduct with respect to such permissive rights.

(12) The Trustee shall not be liable with respect to any action taken or omitted to be taken by it in good faith in accordance with the direction of the Holders of less than a majority in principal amount of the Outstanding Securities of a series relating to the time, method and place of conducting any proceeding for any remedy available to the Trustee, or exercising any trust or power conferred upon the Trustee under this Indenture with respect to such Securities.

(13) The Trustee shall not be liable for any action taken or omitted to be taken by it in good faith and believed by it to be authorized or within the discretion or rights or powers conferred upon it by this Indenture.

(14) The Trustee may request that the Company deliver an Officers' Certificate setting forth the names of individuals and/or titles of officers authorized at such time to take specified actions pursuant to this Indenture, which Officers' Certificate may be signed by any person authorized to sign an Officers' Certificate, including any person specified as so authorized in any such certificate previously delivered and not superseded.

(15) In no event shall the Trustee be liable for special, indirect, punitive or consequential loss or damage of any kind (including, but not limited to, loss of profit) irrespective of whether the Trustee has been advised of the likelihood of such loss or damage and regardless of the form of action.

(16) The Trustee shall not be responsible or liable for any failure or delay in the performance of its obligations under this Indenture arising out of or caused, directly or indirectly, by circumstances beyond its reasonable control, including without limitation, acts of God; earthquakes; fire; flood; terrorism; wars and other military disturbances; sabotage; epidemics; riots; interruptions; loss or malfunctions of utilities, computer (hardware or software) or communications services; accidents; labor disputes; acts of civil or military authorities and governmental action.

The Trustee shall not be required to expend or risk its own funds or otherwise incur any financial liability in the performance of any of its duties hereunder, or in the exercise of any of its rights or powers, if it shall have reasonable grounds for believing that repayment of such funds or adequate indemnity against such risk or liability is not reasonably assured to it.

The parties hereto acknowledge that in order to help the United States government fight the funding of terrorism and money laundering activities, pursuant to Federal regulations that became effective on October 1, 2003 (Section 326 of the USA PATRIOT Act) all financial institutions are required to obtain, verify, record and update information that identifies each person establishing a relationship or opening an account. The parties to this Agreement agree that they will provide to the Trustee such information as it may request, from time to time, in order for the Trustee to satisfy the requirements of the USA PATRIOT Act, including but not limited to the name, address, tax identification number and other information that will allow it to identify the individual or entity who is establishing the relationship or opening the account and may also ask for formation documents such as articles of incorporation or other identifying documents to be provided.

**SECTION 603. Not Responsible for Recitals or Issuance of Securities.**

The recitals contained herein and in the Securities, except the Trustee's certificate of authentication, shall be taken as the statements of the Company, and neither the Trustee nor any Authenticating Agent assumes any responsibility for their correctness. The Trustee makes no representations as to the validity or sufficiency of this Indenture or of the Securities, except that the Trustee represents that it is duly authorized to execute and deliver this Indenture, authenticate the Securities and perform its obligations hereunder and that the statements made by it in a Statement of Eligibility on Form T-1 supplied to the Company are true and accurate, subject to the qualifications set forth therein. Neither the Trustee nor any Authenticating Agent shall be accountable for the use or application by the Company of Securities or the proceeds thereof.

**SECTION 604. May Hold Securities.**

The Trustee, any Paying Agent, Security Registrar, Authenticating Agent or any other agent of the Company, in its individual or any other capacity, may become the owner or pledgee of Securities and, subject to TIA Sections 310(b) and 311, may otherwise deal with the Company with the same rights it would have if it were not Trustee, Paying Agent, Security Registrar, Authenticating Agent or such other agent.

**SECTION 605. Money Held in Trust.**

Money held by the Trustee in trust hereunder need not be segregated from other funds except to the extent required by law. The Trustee shall be under no liability for interest on any money received by it hereunder except as otherwise agreed with the Company.

**SECTION 606. Compensation and Reimbursement and Indemnification of Trustee.**

The Company agrees:

(1) To pay to the Trustee or any predecessor Trustee from time to time such compensation for all services rendered by it hereunder as has been agreed upon from time to time in writing (which compensation shall not be limited by any provision of law in regard to the compensation of a trustee of an express trust).

(2) Except as otherwise expressly provided herein, to reimburse each of the Trustee and any predecessor Trustee upon its request for all reasonable expenses, disbursements and advances incurred or made by the Trustee or any predecessor Trustee in accordance with any provision of this Indenture (including the reasonable compensation and the expenses and disbursements of its agents and counsel), except any such expense, disbursement or advance as may be attributable to its negligence or willful misconduct.

(3) To indemnify each of the Trustee or any predecessor Trustee and their respective officers, directors, employees, representatives and agents, for, and to hold it harmless against, any loss, liability or expense incurred without negligence or willful misconduct on its own part, arising out of or in connection with the acceptance or administration of the trust or trusts hereunder, including the costs and expenses (including reasonable fees and expenses of its agents and counsel) of defending itself against any claim or liability in connection with the exercise or performance of any of its powers or duties hereunder.

As security for the performance of the obligations of the Company under this Section, the Trustee shall have a claim prior to the Securities upon all property and funds held or collected by the Trustee as such, except funds held in trust for the payment of principal of (or premium, if any) or interest, if any, on particular Securities.

When the Trustee incurs expenses or renders services after an Event of Default specified in Section 501 occurs, the expenses and compensation for such services are intended to constitute expenses of administration under Title 11, U.S. Code, or any similar Federal, State or analogous foreign law for the relief of debtors.

The provisions of this Section 606 shall survive the resignation or removal of the Trustee and the satisfaction, termination or discharge of this Indenture.

**SECTION 607. Corporate Trustee Required; Eligibility.**

There shall at all times be a Trustee hereunder that shall be eligible to act as Trustee under TIA Section 310(a)(1) and shall have a combined capital and surplus of at least $50,000,000. If such corporation publishes reports of condition at least annually, pursuant to law or to the requirements of Federal, State, Territorial or the District of Columbia supervising or examining authority, then for the purposes of this Section, the combined capital and surplus of such corporation shall be deemed to be its combined capital and surplus as set forth in its most recent report of condition so published. If at any time the Trustee shall cease to be eligible in accordance with the provisions of this Section, it shall resign immediately in the manner and with the effect hereinafter specified in this Article.

**SECTION 608. Disqualification; Conflicting Interests.**

If the Trustee has or shall acquire a conflicting interest within the meaning of the Trust Indenture Act, the Trustee shall either eliminate such interest or resign, to the extent and in the manner provided by, and subject to the provisions of, the Trust Indenture Act and this Indenture.

**SECTION 609. Resignation and Removal; Appointment of Successor.**

(a) No resignation or removal of the Trustee and no appointment of a successor Trustee pursuant to this Article shall become effective until the acceptance of appointment by the successor Trustee in accordance with the applicable requirements of Section 610. All outstanding fees, expenses and indemnities of the Trustee shall be satisfied by the Company upon resignation or removal.

(b) The Trustee may resign at any time with respect to the Securities of one or more series by giving written notice thereof to the Company.

(c) The Trustee may be removed at any time with respect to the Securities of any series by (i) the Company, by an Officers' Certificate delivered to the Trustee, provided that contemporaneously therewith (x) the Company immediately appoints a successor Trustee with respect to the Securities of such series meeting the requirements of Section 607 hereof and (y) the terms of Section 610 hereof are complied with in respect of such appointment (the Trustee being removed hereby agreeing to execute the instrument contemplated by Section 610(b) hereof, if applicable, under such circumstances) and provided further that no Default with respect to such Securities shall have occurred and then be continuing at such time, or (ii) Act of the Holders of a majority in principal amount of the Outstanding Securities of such series delivered to the Trustee and to the Company.

(d) If at any time:

(1) the Trustee shall fail to comply with the provisions of TIA Section 310(b) after written request therefor by the Company or by any Holder of a Security who has been a bona fide Holder of a Security for at least six months, or

(2) the Trustee shall cease to be eligible under Section 607 and shall fail to resign after written request therefor by the Company or by any Holder of a Security who has been a bona fide Holder of a Security for at least six months, or

(3) the Trustee shall become incapable of acting or shall be adjudged a bankrupt or insolvent or a receiver of the Trustee or of its property shall be appointed or any public officer shall take charge or control of the Trustee or of its property or affairs for the purpose of rehabilitation, conservation or liquidation, then, in any such case, (i) the Company by or pursuant to a Board Resolution may remove the Trustee and appoint a successor Trustee with respect to all Securities, or (ii) subject to TIA Section 315(e), any Holder of a Security who has been a bona fide Holder of a Security for at least six months may, on behalf of himself and all others similarly situated, petition any court of competent jurisdiction for the removal of the Trustee with respect to all Securities and the appointment of a successor Trustee or Trustees.

(e) If an instrument of acceptance by a successor Trustee shall not have been delivered to the Trustee within 30 days after the giving of a notice of resignation or the delivery of an Act of removal, the Trustee resigning or being removed may petition any court of competent jurisdiction for the appointment of a successor Trustee.

(f) If the Trustee shall resign, be removed or become incapable of acting, or if a vacancy shall occur in the office of Trustee for any cause with respect to the Securities of one or more series, the Company, by or pursuant to a Board Resolution, shall promptly appoint a successor Trustee or Trustees with respect to the Securities of that or those series (it being understood that any such successor Trustee may be appointed with respect to the Securities of one or more or all of such series and that at any time there shall be only one Trustee with respect to the Securities of any particular series). If, within one year after such resignation, removal or incapability, or the occurrence of such vacancy, a successor Trustee with respect to the Securities of any series shall be appointed by Act of the Holders of a majority in principal amount of the Outstanding Securities of such series delivered to the Company and the retiring Trustee, the successor Trustee so appointed shall, forthwith upon its acceptance of such appointment, become the successor Trustee with respect to the Securities of such series and to that extent supersede the successor Trustee appointed by the Company. If no successor Trustee with respect to the Securities of any series shall have been so appointed by the Company or the Holders of Securities and accepted appointment in the manner hereinafter provided, any Holder of a Security who has been a bona fide Holder of a Security of such series for at least six months may, on behalf of himself and all others similarly situated, petition any court of competent jurisdiction for the appointment of a successor Trustee with respect to Securities of such series.

(g) The Company shall give notice of each resignation and each removal of the Trustee with respect to the Securities of any series and each appointment of a successor Trustee with respect to the Securities of any series in the manner provided for notices to the Holders of Securities in Section 106. Each notice shall include the name of the successor Trustee with respect to the Securities of such series and the address of its Corporate Trust Office.

**SECTION 610. Acceptance of Appointment by Successor.**

(a) In case of the appointment hereunder of a successor Trustee with respect to all Securities, every such successor Trustee shall execute, acknowledge and deliver to the Company and to the retiring Trustee an instrument accepting such appointment, and thereupon the resignation or removal of the retiring Trustee shall become effective and such successor Trustee, without any further act, deed or conveyance, shall become vested with all the rights, powers, trusts and duties of the retiring Trustee; but, on request of the Company or the successor Trustee, such retiring Trustee shall, upon payment of its charges, execute and deliver an instrument transferring to such successor Trustee all the rights, powers and trusts of the retiring Trustee, and shall duly assign, transfer and deliver to such successor Trustee all property and money held by such retiring Trustee hereunder, subject nevertheless to its claim, if any, provided for in Section 606.

(b) In case of the appointment hereunder of a successor Trustee with respect to the Securities of one or more (but not all) series, the Company, the retiring Trustee and each successor Trustee with respect to the Securities of one or more series shall execute and deliver an indenture supplemental hereto wherein each successor Trustee shall accept such appointment and that (1) shall contain such provisions as shall be necessary or desirable to transfer and confirm to, and to vest in, each successor Trustee all the rights, powers, trusts and duties of the retiring Trustee with respect to the Securities of that or those series to which the appointment of such successor Trustee relates, (2) if the retiring Trustee is not retiring with respect to all Securities, shall contain such provisions as shall be deemed necessary or desirable to confirm that all the rights, powers, trusts and duties of the retiring Trustee with respect to the Securities of that or those series as to which the retiring Trustee is not retiring shall continue to be vested in the retiring Trustee, and (3) shall add to or change any of the provisions of this Indenture as shall be necessary to provide for or facilitate the administration of the trusts hereunder by more than one Trustee, it being understood that nothing herein or in such supplemental indenture shall constitute such Trustees co-trustees of the same trust and that each such Trustee shall be trustee of a trust or trusts hereunder separate and apart from any trust or trusts hereunder administered by any other such Trustee; and upon the execution and delivery of such supplemental indenture the resignation or removal of the retiring Trustee shall become effective to the extent provided therein and each such successor Trustee, without any further act, deed or conveyance, shall become vested with all the rights, powers, trusts and duties of the retiring Trustee with respect to the Securities of that or those series to which the appointment of such successor Trustee relates; but, on request of the Company or any successor Trustee, such retiring Trustee shall duly assign, transfer and deliver to such successor Trustee all property and money held by such retiring Trustee hereunder with respect to the Securities of that or those series to which the appointment of such successor Trustee relates. Whenever there is a successor Trustee with respect to one or more (but less than all) series of securities issued pursuant to this Indenture, the terms “Indenture” and “Securities” shall have the meanings specified in the provisos to the respective definition of those terms in Section 101 which contemplate such situation.

(c) Upon request of any such successor Trustee, the Company shall execute any and all instruments for more fully and certainly vesting in and confirming to such successor Trustee all such rights, powers and trusts referred to in paragraph (a) or (b) of this Section, as the case may be.

(d) No successor Trustee shall accept its appointment unless at the time of such acceptance such successor Trustee shall be qualified and eligible under this Article.

**SECTION 611. Merger, Conversion, Consolidation or Succession to Business.**

Any corporation into which the Trustee may be merged or converted or with which it may be consolidated, or any corporation resulting from any merger, conversion or consolidation to which the Trustee shall be a party, or any corporation succeeding to all or substantially all of the corporate trust business of the Trustee, shall be the successor of the Trustee hereunder, provided such corporation shall be otherwise qualified and eligible under this Article, without the execution or filing of any paper or any further act on the part of any of the parties hereto. In case any Securities shall have been authenticated, but not delivered, by the Trustee then in office, any successor by merger, conversion or consolidation to such authenticating Trustee may adopt such authentication and deliver the Securities so authenticated with the same effect as if such successor Trustee had itself authenticated such Securities. In case any Securities shall not have been authenticated by such predecessor Trustee, any such successor Trustee may authenticate and deliver such Securities, in either its own name or that of its predecessor Trustee, with the full force and effect which this Indenture provides for the certificate of authentication of the Trustee; provided, however, that the right to adopt the certificate of authentication of any predecessor Trustee or to authenticate Securities in the name of any predecessor Trustee shall apply only to its successor or successors by merger, conversion or consolidation.

**SECTION 612. Appointment of Authenticating Agent.**

At any time when any of the Securities remain Outstanding, the Trustee may appoint an Authenticating Agent or Agents (which may be an Affiliate or Affiliates of the Company) with respect to one or more series of Securities that shall be authorized to act on behalf of the Trustee to authenticate Securities of such series issued upon original issue or upon exchange, registration of transfer or partial redemption thereof, and Securities so authenticated shall be entitled to the benefits of this Indenture and shall be valid and obligatory for all purposes as if authenticated by the Trustee hereunder. Any such appointment shall be evidenced by an instrument in writing signed by a Responsible Officer of the Trustee, a copy of which instrument shall be promptly furnished to the Company. Wherever reference is made in this Indenture to the authentication and delivery of Securities by the Trustee or the Trustee's certificate of authentication, such reference shall be deemed to include authentication and delivery on behalf of the Trustee by an Authenticating Agent and a certificate of authentication executed on behalf of the Trustee by an Authenticating Agent. Each Authenticating Agent shall be acceptable to the Company and, except as may otherwise be provided pursuant to Section 301, shall at all times be a bank or trust company or corporation organized and doing business and in good standing under the laws of the United States of America or of any State or the District of Columbia, authorized under such laws to act as Authenticating Agent, eligible to serve as trustee hereunder pursuant to Section 607. If such Authenticating Agent publishes reports of condition at least annually, pursuant to law or the requirements of the aforesaid supervising or examining authority, then for the purposes of this Section, the combined capital and surplus of such Authenticating Agent shall be deemed to be its combined capital and surplus as set forth in its most recent report of condition so published. In case at any time an Authenticating Agent shall cease to be eligible in accordance with the provisions of this Section, such Authenticating Agent shall resign immediately in the manner and with the effect specified in this Section.

Any corporation into which an Authenticating Agent may be merged or converted or with which it may be consolidated, or any corporation resulting from any merger, conversion or consolidation to which such Authenticating Agent shall be a party, or any corporation succeeding to the corporate agency or corporate trust business of an Authenticating Agent, shall continue to be an Authenticating Agent, provided such corporation shall be otherwise eligible under this Section, without the execution or filing of any paper or further act on the part of the Trustee or the Authenticating Agent.

An Authenticating Agent for any series of Securities may at any time resign by giving written notice of resignation to the Trustee for such series and to the Company. The Trustee for any series of Securities may at any time terminate the agency of an Authenticating Agent by giving written notice of termination to such Authenticating Agent and to the Company. Upon receiving such a notice of resignation or upon such a termination, or in case at any time such Authenticating Agent shall cease to be eligible in accordance with the provisions of this Section, the Trustee for such series may appoint a successor Authenticating Agent which shall be acceptable to the Company and shall promptly give written notice of such appointment to all Holders of Securities of the series with respect to which such Authenticating Agent will serve in the manner set forth in Section 106. Any successor Authenticating Agent upon acceptance of its appointment hereunder shall become vested with all the rights, powers and duties of its predecessor hereunder, with like effect as if originally named as an Authenticating Agent herein. No successor Authenticating Agent shall be appointed unless eligible under the provisions of this Section.

The Company agrees to pay to each Authenticating Agent from time to time reasonable compensation including reimbursement of its reasonable expenses for its services under this Section.

If an appointment with respect to one or more series is made pursuant to this Section, the Securities of such series may have endorsed thereon, in addition to or in lieu of the Trustee's certificate of authentication, an alternate certificate of authentication substantially in the following form:

This is one of the Securities of the series designated therein referred to in the within-mentioned Indenture.

U.S. Bank National Association, as Trustee

By: _____
as Authenticating Agent

By: _____
Authorized Officer

If all of the Securities of a series may not be originally issued at one time, and the Trustee does not have an office capable of authenticating Securities upon original issuance located in a Place of Payment where the Company wishes to have Securities of such series authenticated upon original issuance, the Trustee, if so requested by the Company in writing (which writing need not comply with Section 102 and need not be accompanied by an Opinion of Counsel), shall appoint in accordance with this Section an Authenticating Agent (which, if so requested by the Company, shall be an Affiliate of the Company) having an office in a Place of Payment designated by the Company with respect to such series of Securities, provided that the terms and conditions of such appointment are acceptable to the Trustee.

## ARTICLE SEVEN

## HOLDERS' LISTS AND REPORTS BY TRUSTEE AND COMPANY

**SECTION 701. Company to Furnish Trustee Names and Addresses of Holders.**

The Company will furnish or cause to be furnished to the Trustee:

(a) Semi-annually, not later than March 15 and September 15 in each year, a list, in such form as the Trustee may reasonably require, of the names and addresses of the Holders of Securities of each series as of the preceding March 1 or September 1, as the case may be; and

(b) At such other times as the Trustee may request in writing, within thirty (30) calendar days after receipt by the Company of any such request, a list of similar form and content as of a date not more than fifteen (15) calendar days prior to the time such list is furnished;

*Excluding* from any such list names and addresses received by the Trustee in its capacity as Security Registrar.

**SECTION 702. Preservation of Information; Communications to Holders.**

(a) The Trustee shall preserve, in as current a form as is reasonably practicable, the names and addresses of Holders contained in the most recent list furnished to the Trustee as provided in Section 701 and the names and addresses of Holders received by the Trustee in its capacity as Security Registrar. The Trustee may destroy any list furnished to it as provided in Section 701 upon receipt of a new list so furnished.

(b) The rights of Holders to communicate with other Holders with respect to their rights under this Indenture or under the Securities, and the corresponding rights and duties of the Trustee, shall be as provided by the Trust Indenture Act.

(c) Every Holder of Securities, by receiving and holding the same, agrees with the Company and the Trustee that neither the Company nor the Trustee nor any Authenticating Agent nor any Paying Agent nor any Security Registrar nor any agent of any of them shall be held accountable by reason of the disclosure of any information as to the names and addresses of the Holders of Securities in accordance with TIA Section 312, regardless of the source from which such information was derived, and that the Trustee shall not be held accountable by reason of mailing any material pursuant to a request made under TIA Section 312(b).

**SECTION 703. Reports by Trustee.**

Within 60 days after May 15 of each year commencing with the first May 15 after the first issuance of Securities pursuant to this Indenture, the Trustee shall transmit by mail to all Holders of Securities in the manner and to the extent provided in TIA Section 313(c) a brief report dated as of such May 15 which meets the requirements of TIA Section 313(a).

A copy of each such report shall, at the time of such transmission to Holders, be filed by the Trustee with each stock exchange, if any, upon which the Securities are listed, with the Commission and with the Company. The Company will promptly notify the Trustee of the listing of the Securities on any stock exchange. In the event that, on any such reporting date, no events have occurred under the applicable sections of the TIA within the 12 months preceding such reporting date, the Trustee shall be under no duty or obligation to provide such reports.

**SECTION 704. Reports by Company.**

The Company will:

(1) file with the Trustee, within 15 days after the Company is required to file the same with the Commission, copies of the annual reports and of the information, documents, and other reports (or copies of such portions of any of the foregoing as the Commission may from time to time by rules and regulations prescribe) which the Company may be required to file with the Commission pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934; or, if the Company is not required to file information, documents or reports pursuant to either of such Sections, then it will file with the Trustee and the Commission, in accordance with rules and regulations prescribed from time to time by the Commission, such of the supplementary and periodic information, documents and reports which may be required pursuant to Section 13 of the Securities Exchange Act of 1934 in respect of a security listed and registered on a national securities exchange as may be prescribed from time to time in such rules and regulations; and

(2) file with the Trustee and the Commission, in accordance with rules and regulations prescribed from time to time by the Commission, such additional information, documents and reports with respect to compliance by the Company with the conditions and covenants of this Indenture as may be required from time to time by such rules and regulations.

The Trustee shall transmit by mail to the Holders of Securities, within 30 days after the filing thereof with the Trustee, in the manner and to the extent provided in TIA Section 313(c), such summaries of any information, documents and reports required to be filed by the Company pursuant to subparagraphs (1) and (2) of this Section as may be required by rules and regulations prescribed from time to time by the Commission. In no event shall the Trustee be obligated to determine whether or not any report, information or document shall have been filed with the Commission.

**SECTION 705. Calculation of Original Issue Discount.**

The Company shall file with the Trustee promptly at the end of each calendar year a written notice specifying the amount of original issue discount (including daily rates and accrual periods), if any, accrued on Outstanding Securities as of the end of such year.

## ARTICLE EIGHT

## CONSOLIDATION, MERGER, CONVEYANCE OR TRANSFER

**SECTION 801. Company May Consolidate, Etc., Only on Certain Terms.**

The Company shall not consolidate with or merge with or into any other corporation or convey or transfer all or substantially all of its properties and assets to any Person, unless:

(1) either the Company shall be the continuing corporation, or the corporation (if other than the Company) formed by such consolidation or into which the Company is merged or the Person which acquires by conveyance or transfer the properties and assets of the Company substantially as an entirety shall expressly assume, by an indenture supplemental hereto, executed and delivered to the Trustee, in form satisfactory to the Trustee, the due and punctual payment of the principal of (and premium, if any) and interest, if any, on all the Securities and the performance of every covenant of this Indenture on the part of the Company to be performed or observed;

(2) immediately after giving effect to such transaction, no Default or Event of Default shall have happened and be continuing; and

(3) the Company and the successor Person have delivered to the Trustee an Officers' Certificate and an Opinion of Counsel each stating that such consolidation, merger, conveyance or transfer and such supplemental indenture comply with this Article and that all conditions precedent herein provided for relating to such transaction have been complied with.

**SECTION 802. Successor Person Substituted.**

Upon any consolidation or merger, or any conveyance or transfer of the properties and assets of the Company substantially as an entirety in accordance with Section 801, the successor corporation formed by such consolidation or into which the Company is merged or the successor Person to which such conveyance or transfer is made shall succeed to, and be substituted for, and may exercise every right and power of, the Company under this Indenture with the same effect as if such successor had been named as the Company herein; and in the event of any such conveyance or transfer, the Company shall be discharged from all obligations and covenants under this Indenture and the Securities and may be dissolved and liquidated.

## ARTICLE NINE

## SUPPLEMENTAL INDENTURES

**SECTION 901. Supplemental Indentures Without Consent of Holders.**

Without the consent of any Holders of Securities, the Company, when authorized by or pursuant to a Board Resolution, and the Trustee, at any time and from time to time, may enter into one or more indentures supplemental hereto, in form reasonably satisfactory to the Trustee, for any of the following purposes:

(1) to evidence the succession of another Person to the Company and the assumption by any such successor of the covenants of the Company herein and in the Securities contained; or

(2) to add to the covenants of the Company for the benefit of the Holders of all or any series of Securities (and if such covenants are to be for the benefit of less than all series of Securities, stating that such covenants are expressly being included solely for the benefit of such series) or to surrender any right or power herein conferred upon the Company; or

(3) to add any additional Events of Default for the benefit of the Holders of all or any series of Securities (and if such Events of Default are to be for the benefit of less than all series of Securities, stating that such Events of Default are expressly being included solely for the benefit of such series); provided, however, that in respect of any such additional Events of Default such supplemental indenture may provide for a particular period of grace after default (which period may be shorter or longer than that allowed in the case of other defaults) or may provide for an immediate enforcement upon such default or may limit the remedies available to the Trustee upon such default or may limit the right of the Holders of a majority in aggregate principal amount of that or those series of Securities to which such additional Events of Default apply to waive such default; or

(4) to change or eliminate any of the provisions of this Indenture; provided that any such change or elimination shall become effective only when there is no Security Outstanding of any series created prior to the execution of such supplemental indenture that is entitled to the benefit of such provision; or

(5) to secure the Securities; or

(6) to establish the form or terms of Securities of any series as permitted by Sections 201 and 301, including the provisions and procedures relating to Securities convertible into or exchangeable for any securities of any Person (including the Company); or

(7) to evidence and provide for the acceptance of appointment hereunder by a successor Trustee with respect to the Securities of one or more series and to add to or change any of the provisions of this Indenture as shall be necessary to provide for or facilitate the administration of the trusts hereunder by more than one Trustee; or

(8) to cure any ambiguity, to correct or supplement any provision herein which may be inconsistent with any other provision herein, or to make any other provisions with respect to matters or questions arising under this Indenture; provided that such action shall not adversely affect the interests of the Holders of Securities of any series in any material respect; or

(9) to supplement any of the provisions of this Indenture to such extent as shall be necessary to permit or facilitate the defeasance and discharge of any series of Securities pursuant to Sections 401, 1402 and 1403; provided that any such action shall not adversely affect the interests of the Holders of Securities of such series or any other series of Securities in any material respect.

**SECTION 902. Supplemental Indentures with Consent of Holders.**

With the consent of the Holders of not less than a majority in aggregate principal amount of all Outstanding Securities affected by such supplemental indenture, by Act of said Holders delivered to the Company and the Trustee, the Company, when authorized by or pursuant to a Board Resolution, and the Trustee may enter into an indenture or indentures supplemental hereto for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of this Indenture that affects such series of Securities or of modifying in any manner the rights of the Holders of such series of Securities under this Indenture; provided, however, that no such supplemental indenture shall, without the consent of the Holder of each Outstanding Security affected thereby:

(1) change the Stated Maturity of the principal of (or premium, if any) or any installment of principal of or interest on, any Security, subject to the provisions of Section 308; or the terms of any sinking fund with respect to any Security; or reduce the principal amount thereof or the rate of interest (or change the manner of calculating the rate of interest, thereon, or any premium payable upon the redemption thereof, or change any obligation of the Company to pay Additional Amounts pursuant to Section 1004 (except as contemplated by Section 801(1) and permitted by Section 901(1)), or reduce the portion of the principal of an Original Issue Discount Security or Indexed Security that would be due and payable upon a declaration of acceleration of the Maturity thereof pursuant to Section 502, or upon the redemption thereof or the amount thereof provable in bankruptcy pursuant to Section 504, or adversely affect any right of repayment at the option of the Holder of any Security, or change any Place of Payment where, or the Currency in which, any Security or any premium or interest thereon is payable, or impair the right to institute suit for the enforcement of any such payment on or after the Stated Maturity thereof (or, in the case of redemption or repayment at the option of the Holder, on or after the Redemption Date or the Repayment Date, as the case may be), or adversely affect any right to convert or exchange any Security as may be provided pursuant to Section 301 herein, or modify the subordination provisions set forth in Article Sixteen in a manner that is adverse to the Holder of any Outstanding Security, or

(2) reduce the percentage in principal amount of the Outstanding Securities of any series, the consent of whose Holders is required for any such supplemental indenture, or the consent of whose Holders is required for any waiver with respect to such series (of compliance with certain provisions of this Indenture or certain defaults hereunder and their consequences) provided for in this Indenture, or reduce the requirements of Section 1504 for quorum or voting, or

(3) modify any of the provisions of this Section, Section 513 or Section 1007, except to increase any such percentage or to provide that certain other provisions of this Indenture cannot be modified or waived without the consent of the Holder of each Outstanding Security affected thereby; provided, however, that this clause shall not be deemed to require the consent of any Holder of a Security with respect to changes in the references to "the Trustee" and concomitant changes in this Section, or the deletion of this proviso, in accordance with the requirements of Sections 610(b) and 901(8).

It shall not be necessary for any Act of Holders under this Section to approve the particular form of any proposed supplemental indenture, but it shall be sufficient if such Act shall approve the substance thereof.

A supplemental indenture that changes or eliminates any covenant or other provision of this Indenture which has expressly been included solely for the benefit of one or more particular series of Securities, or that modifies the rights of the Holders of Securities of such series with respect to such covenant or other provision, shall be deemed not to affect the rights under this Indenture of the Holders of Securities of any other series.

The Company may, but shall not be obligated to, fix a record date for the purpose of determining the Persons entitled to consent to any indenture supplemental hereto. If a record date is fixed, the Holders on such record date, or their duly designated proxies, and only such Persons, shall be entitled to consent to such supplemental indenture, whether or not such Holders remain Holders after such record date; provided, that unless such consent shall have become effective by virtue of the requisite percentage having been obtained prior to the date that is 90 days after such record date, any such consent previously given shall automatically and without further action by any Holder be cancelled and of no further effect.

**SECTION 903. Execution of Supplemental Indentures.**

In executing, or accepting the additional trusts created by, any supplemental indenture permitted by this Article or the modification thereby of the trusts created by this Indenture, the Trustee shall be entitled to receive, and shall be fully protected in relying upon, in addition to the documents required by Section 102 of this Indenture, an Opinion of Counsel stating that the execution of such supplemental indenture is authorized or permitted by this Indenture. The Trustee may, but shall not be obligated to, enter into any such supplemental indenture that affects the Trustee's own rights, duties or immunities under this Indenture or otherwise.

**SECTION 904. Effect of Supplemental Indentures.**

Upon the execution of any supplemental indenture under this Article, this Indenture shall be modified in accordance therewith, and such supplemental indenture shall form a part of this Indenture for all purposes; and every Holder of Securities theretofore or thereafter authenticated and delivered hereunder shall be bound thereby.

**SECTION 905. Conformity with Trust Indenture Act.**

Every supplemental indenture executed pursuant to this Article shall conform to the requirements of the Trust Indenture Act as then in effect.

**SECTION 906. Reference in Securities to Supplemental Indentures.**

Securities of any series authenticated and delivered after the execution of any supplemental indenture pursuant to this Article may, and shall, if required by the Trustee, bear a notation in form approved by the Trustee as to any matter provided for in such supplemental indenture. If the Company shall so determine, new Securities of any series so modified as to conform, in the opinion of the Trustee and the Company, to any such supplemental indenture may be prepared and executed by the Company and authenticated and delivered by the Trustee in exchange for Outstanding Securities of such series.

## ARTICLE TEN

## COVENANTS

**SECTION 1001. Payment of Principal, Premium, if any, and Interest.**

The Company covenants and agrees for the benefit of the Holders of each series of Securities that it will duly and punctually pay the principal of (and premium, if any, on) and interest, if any, on the Securities of that series in accordance with the terms of such series of Securities and this Indenture. Unless otherwise specified with respect to Securities of any series pursuant to Section 301, at the option of the Company, all payments of principal may be paid by check to the registered Holder of the Registered Security or other person entitled thereto against surrender of such Security.

**SECTION 1002. Maintenance of Office or Agency.**

The Company shall maintain in each Place of Payment for any series of Securities an office or agency where Securities of that series may be presented or surrendered for payment, where Securities of that series may be surrendered for registration of transfer or exchange, where Securities of that series that are convertible or exchangeable may be surrendered for conversion or exchange, as applicable, and where notices and demands to or upon the Company in respect of the Securities of that series and this Indenture may be served. The Company will give prompt written notice to the Trustee of the location, and any change in the location, of each such office or agency. If at any time the Company shall fail to maintain any such required office or agency in respect of any series of Securities or shall fail to furnish the Trustee with the address thereof, such presentations, surrenders, notices and demands may be made or served at the Corporate Trust Office of the Trustee, and the Company hereby appoints the Trustee at its Corporate Trust Office as its agent to receive such respective presentations, surrenders, notices and demands.

The Company may also from time to time designate one or more other offices or agencies where the Securities of one or more series may be presented or surrendered for any or all of such purposes, and may from time to time rescind such designations; provided, however, that no such designation or rescission shall in any manner relieve the Company of its obligation to maintain an office or agency in accordance with the requirements set forth above for Securities of any series for such purposes. The Company will give prompt written notice to the Trustee of any such designation or rescission and of any change in the location of any such other office or agency. Unless otherwise specified with respect to any Securities pursuant to Section 301 with respect to a series of Securities, the Company hereby designates as a Place of Payment for each series of Securities the office or agency of the Company in the Borough of Manhattan, The City of New York, and initially appoints the Trustee at its Corporate Trust Office in the Borough of Manhattan, The City of New York as its agent to receive all such presentations, surrenders, notices and demands.

Unless otherwise specified with respect to any Securities pursuant to Section 301, if and so long as the Securities of any series (i) are denominated in a currency other than Dollars or (ii) may be payable in a currency other than Dollars, or so long as it is required under any other provision of the Indenture, then the Company will maintain with respect to each such series of Securities, or as so required, at least one Exchange Rate Agent.

**SECTION 1003. Money for Securities Payments to Be Held in Trust.**

If the Company shall at any time act as its own Paying Agent with respect to any series of any Securities, it will, on or before each due date of the principal of (or premium, if any) or interest, if any, on any of the Securities of that series, segregate and hold in trust for the benefit of the Persons entitled thereto a sum in the Currency in which the Securities of such series are payable (except as otherwise specified pursuant to Section 301 for the Securities of such series and except, if applicable, as provided in Sections 312(b), 312(d) and 312(e)), sufficient to pay the principal (and premium, if any) and interest, if any, on Securities of such series so becoming due until such sums shall be paid to such Persons or otherwise disposed of as herein provided, and will promptly notify the Trustee of its action or failure so to act.

Whenever the Company shall have one or more Paying Agents for any series of Securities, it will, on or before each due date of the principal of (or premium, if any) or interest, if any, on any Securities of that series, deposit with a Paying Agent a sum (in the Currency or Currencies described in the preceding paragraph) sufficient to pay the principal (or premium, if any) or interest, if any, so becoming due, such sum of money to be held in trust for the benefit of the Persons entitled to such principal, premium or interest and (unless such Paying Agent is the Trustee) the Company will promptly notify the Trustee of its action or failure so to act.

The Company may at any time, for the purpose of obtaining the satisfaction and discharge of this Indenture or for any other purpose, pay, or by Company Order direct any Paying Agent to pay, to the Trustee all sums of money held in trust by the Company or such Paying Agent, such sums to be held by the Trustee upon the same trusts as those upon which such sums were held by the Company or such Paying Agent; and, upon such payment by any Paying Agent to the Trustee, such Paying Agent shall be released from all further liability with respect to such sums.

Except as otherwise provided in the Securities of any series, any money deposited with the Trustee or any Paying Agent, or then held by the Company, in trust for the payment of the principal of (or premium, if any) or interest, if any, on any Security of any series and remaining unclaimed for two years after such principal, premium or interest has become due and payable shall be paid to the Company upon Company Request, or (if then held by the Company) shall be discharged from such trust; and the Holder of such Security shall thereafter, as an unsecured general creditor, look only to the Company for payment thereof, and all liability of the Trustee or such Paying Agent with respect to such money held in trust, and all liability of the Company as trustee thereof, shall thereupon cease; provided, however, that the Trustee or such Paying Agent, before being required to make any such repayment, may at the expense of the Company cause to be published once, in an Authorized Newspaper, notice that such money remains unclaimed and that, after a date specified therein, which shall not be less than 30 days from the date of such publication, any unclaimed balance of such money then remaining will be repaid to the Company.

**SECTION 1004. Additional Amounts.**

If the Securities of a series provide for the payment of Additional Amounts, the Company will pay to the Holder of any Security of such series such Additional Amounts as may be specified as contemplated by Section 301. Whenever in this Indenture there is mentioned, in any context, the payment of the principal of (or premium, if any) or interest, if any, on any Security of any series or the net proceeds received on the sale or exchange of any Security of any series, such mention shall be deemed to include mention of the payment of Additional Amounts provided for by the terms of such series established pursuant to Section 301 to the extent that, in such context, Additional Amounts are, were or would be payable in respect thereof pursuant to such terms and express mention of the payment of Additional Amounts (if applicable) in any provisions hereof shall not be construed as excluding Additional Amounts in those provisions hereof where such express mention is not made.

Except as otherwise specified as contemplated by Section 301, if the Securities of a series provide for the payment of Additional Amounts, at least 10 days prior to the first Interest Payment Date with respect to that series of Securities (or if the Securities of that series will not bear interest prior to Maturity, the first day on which a payment of principal premium is made), and at least 10 days prior to each date of payment of principal, premium or interest if there has been any change with respect to the matters set forth in the below-mentioned Officers' Certificate, the Company will furnish the Trustee and the Company's principal Paying Agent or Paying Agents, if other than the Trustee, with an Officers' Certificate instructing the Trustee and such Paying Agent or Paying Agents whether such payment of principal, premium or interest on the Securities of that series shall be made to Holders of Securities of that series who are not United States persons without withholding for or on account of any tax, assessment or other governmental charge described in the Securities of that series. If any such withholding shall be required, then such Officers' Certificate shall specify by country the amount, if any, required to be withheld on such payments to such Holders of Securities of that series and the Company will pay to the Trustee or such Paying Agent the Additional Amounts required by the terms of such Securities. In the event that the Trustee or any Paying Agent, as the case may be, shall not so receive the above-mentioned certificate, then the Trustee or such Paying Agent shall be entitled (i) to assume that no such withholding or deduction is required with respect to any payment of principal or interest with respect to any Securities of a series until it shall have received a certificate advising otherwise and (ii) to make all payments of principal and interest with respect to the Securities of a series without withholding or deductions until otherwise advised. The Company covenants to indemnify the Trustee and any Paying Agent for, and to hold them harmless against, any loss, liability or expense reasonably incurred without negligence or bad faith on their part arising out of or in connection with actions taken or omitted by any of them in reliance on any Officers' Certificate furnished pursuant to this Section or in reliance on the Company's not furnishing such an Officers' Certificate.

**SECTION 1005. Statement as to Compliance.**

(1) The Company will deliver to the Trustee, within 120 days after the end of each fiscal year ending after the date hereof so long as any Security is Outstanding hereunder, a brief certificate from the principal executive officer, principal financial officer or principal accounting officer of the Company as to his or her knowledge of the Company's compliance with all conditions and covenants under this Indenture. For purposes of this Section 1005, such compliance shall be determined without regard to any period of grace or requirement of notice under this Indenture.

(2) The Company will, so long as any series of Securities are Outstanding, deliver to the Trustee, within 5 Business Days of any officer listed in (1) above becoming aware of any Default, Event of Default or default in the performance of any covenant, agreement or condition contained in this Indenture, an Officers' Certificate specifying such Default, Event of Default, default or event of default and what action the Company is taking or proposes to take with respect thereto and the status thereof.

**SECTION 1006. Payment of Taxes and Other Claims.**

The Company will pay or discharge or cause to be paid or discharged, before the same shall become delinquent, (1) all taxes, assessments and governmental charges levied or imposed upon the Company or upon the income, profits or property of the Company, and (2) all lawful claims for labor, materials and supplies that, if unpaid, might by law become a lien upon the property of the Company, except where the failure to do so would not be reasonably expected to have a material adverse effect on the business, assets, financial condition or results of operations of the Company; provided, however, that the Company shall not be required to pay or discharge or cause to be paid or discharged any such tax, assessment, charge or claim whose amount, applicability or validity is being contested in good faith by appropriate proceedings.

**SECTION 1007. Waiver of Certain Covenants.**

As specified pursuant to Section 301(15), for Securities of any series, the Company may omit in any particular instance to comply with any covenant or condition set forth in any covenants of the Company added to Article Ten pursuant to Section 301(14) or Section 301 (15) in connection with the Securities of a series, if before or after the time for such compliance the Holders of at least a majority in aggregate principal amount of all Outstanding Securities of such series, by Act of such Holders, either waive such compliance in such instance or generally waive compliance with such covenant or condition, but no such waiver shall extend to or affect such covenant or condition except to the extent so expressly waived, and, until such waiver shall become effective, the obligations of the Company and the duties of the Trustee in respect of any such covenant or condition shall remain in full force and effect.

## ARTICLE ELEVEN

## REDEMPTION OF SECURITIES

**SECTION 1101. Applicability of Article.**

Securities of any series that are redeemable before their Stated Maturity shall be redeemable in accordance with their terms and (except as otherwise specified as contemplated by Section 301 for Securities of any series) in accordance with this Article.

**SECTION 1102. Election to Redeem; Notice to Trustee.**

The election of the Company to redeem any Securities shall be evidenced by or pursuant to a Board Resolution. In case of any redemption at the election of the Company of less than all of the Securities of any series, the Company shall, at least 60 days prior to the Redemption Date fixed by the Company (unless a shorter notice shall be satisfactory to the Trustee), notify the Trustee in writing of such Redemption Date and of the principal amount of Securities of such series to be redeemed, and, if applicable, of the tenor of the Securities to be redeemed, and shall deliver to the Trustee such documentation and records as shall enable the Trustee to select the Securities to be redeemed pursuant to Section 1103. In the case of any redemption of Securities of any series prior to the expiration of any restriction on such redemption provided in the terms of such Securities or elsewhere in this Indenture, the Company shall furnish the Trustee with an Officers' Certificate evidencing compliance with such restriction.

**SECTION 1103. Selection by Trustee of Securities to Be Redeemed.**

If less than all the Securities of any series issued on the same day with the same terms are to be redeemed, the particular Securities to be redeemed shall be selected not more than 60 days prior to the Redemption Date by the Trustee, from the Outstanding Securities of such series issued on such date with the same terms not previously called for redemption, by such method as the Trustee shall deem fair and appropriate and otherwise in accordance with the procedures of the Depository; provided that such method complies with the rules of any national securities exchange or quotation system on which the Securities are listed, and may provide for the selection for redemption of portions (equal to the minimum authorized denomination for Securities of that series or any integral multiple thereof) of the principal amount of Securities of such series of a denomination larger than the minimum authorized denomination for Securities of that series; provided, however, that no such partial redemption shall reduce the portion of the principal amount of a Security not redeemed to less than the minimum authorized denomination for Securities of such series.

The Trustee shall promptly notify the Company and the Security Registrar (if other than itself) in writing of the Securities selected for redemption and, in the case of any Securities selected for partial redemption, the principal amount thereof to be redeemed.

For all purposes of this Indenture, unless the context otherwise requires, all provisions relating to the redemption of Securities shall relate, in the case of any Security redeemed or to be redeemed only in part, to the portion of the principal amount of such Security which has been or is to be redeemed.

**SECTION 1104. Notice of Redemption.**

Notice of redemption shall be given in the manner provided in Section 106, not less than 30 days nor more than 60 days prior to the Redemption Date, unless a shorter period is specified by the terms of such series established pursuant to Section 301, to each Holder of Securities to be redeemed, but failure to give such notice in the manner herein provided to the Holder of any Security designated for redemption as a whole or in part, or any defect in the notice to any such Holder, shall not affect the validity of the proceedings for the redemption of any other such Security or portion thereof.

Any notice that is mailed to the Holders of Registered Securities in the manner herein provided shall be conclusively presumed to have been duly given, whether or not the Holder receives the notice.

All notices of redemption shall state:

(1) the Redemption Date,

(2) the Redemption Price and accrued interest, if any, to the Redemption Date payable as provided in Section 1106,

(3) if less than all Outstanding Securities of any series are to be redeemed, the identification (and, in the case of partial redemption, the principal amount) of the particular Security or Securities to be redeemed,

(4) in case any Security is to be redeemed in part only, the notice that relates to such Security shall state that on and after the Redemption Date, upon surrender of such Security, the Holder will receive, without a charge, a new Security or Securities of authorized denominations for the principal amount thereof remaining unredeemed,

(5) that on the Redemption Date, the Redemption Price and accrued interest, if any, to the Redemption Date payable as provided in Section 1106 will become due and payable upon each such Security, or the portion thereof, to be redeemed and, if applicable, that interest thereon shall cease to accrue on and after said date,

(6) the Place or Places of Payment where such Securities, are to be surrendered for payment of the Redemption Price and accrued interest, if any,

(7) that the redemption is for a sinking fund, if such is the case, and

(8) the CUSIP number of such Security, if any.

A notice of redemption published as contemplated by Section 106 need not identify particular Registered Securities to be redeemed. Notice of redemption of Securities to be redeemed shall be given by the Company or, at the Company's request, by the Trustee in the name and at the expense of the Company.

**SECTION 1105. Deposit of Redemption Price.**

On or prior to 10:00 am, New York City time, on any Redemption Date, the Company shall deposit with the Trustee or with a Paying Agent (or, if the Company is acting as its own Paying Agent, which it may not do in the case of a sinking fund payment under Article Twelve, segregate and hold in trust as provided in Section 1003) an amount of money in the Currency in which the Securities of such series are payable (except as otherwise specified pursuant to Section 301 for the Securities of such series and except, if applicable, as provided in Sections 312(b), 312(d) and 312(e)) sufficient to pay on the Redemption Date the Redemption Price of, and (unless otherwise specified pursuant to Section 301) accrued interest on, all the Securities or portions thereof which are to be redeemed on that date.

**SECTION 1106. Securities Payable on Redemption Date.**

Notice of redemption having been given as aforesaid, the Securities so to be redeemed shall, on the Redemption Date, become due and payable at the Redemption Price therein specified in the Currency in which the Securities of such series are payable (except as otherwise specified pursuant to Section 301 for the Securities of such series and except, if applicable, as provided in Sections 312(b), 312(d) and 312(e)) (together with accrued interest, if any, to the Redemption Date), and from and after such date (unless the Company shall default in the payment of the Redemption Price and accrued interest, if any) such Securities shall if the same were interest-bearing cease to bear interest. Upon surrender of any such Security for redemption in accordance with said notice, such Security shall be paid by the Company at the Redemption Price, together with accrued interest, if any, to the Redemption Date; provided, however, that unless otherwise specified as contemplated by Section 301, installments of interest on Registered Securities whose Stated Maturity is on or prior to the Redemption Date shall be payable to the Holders of such Securities, or one or more Predecessor Securities, registered as such at the close of business on the relevant Record Dates according to their terms and the provisions of Section 307.

If any Security called for redemption shall not be so paid upon surrender thereof for redemption, the Redemption Price shall, until paid, bear interest from the Redemption Date at the rate of interest set forth in such Security or, in the case of an Original Issue Discount Security, at the Yield to Maturity of such Security.

**SECTION 1107. Securities Redeemed in Part.**

Any Registered Security that is to be redeemed only in part (pursuant to the provisions of this Article or of Article Twelve) shall be surrendered at a Place of Payment therefor (with, if the Company or the Trustee so requires, due endorsement by, or a written instrument of transfer in form satisfactory to the Company and the Trustee duly executed by, the Holder thereof or such Holder's attorney duly authorized in writing) and the Company shall execute and the Trustee shall authenticate and deliver to the Holder of such Security without service charge a new Security or Securities of the same series and of like tenor, of any authorized denomination as requested by such Holder in aggregate principal amount equal to and in exchange for the unredeemed portion of the principal of the Security so surrendered. If a temporary global Security or permanent global Security is so surrendered, such new Security so issued shall be a new temporary global Security or permanent global Security, respectively. However, if less than all the Securities of any series with differing issue dates, interest rates and stated maturities are to be redeemed, the Company in its sole discretion shall select the particular Securities to be redeemed and shall notify the Trustee in writing thereof at least 45 days prior to the relevant redemption date.

## ARTICLE TWELVE

## SINKING FUNDS

**SECTION 1201. Applicability of Article.**

The provisions of this Article shall be applicable to any sinking fund for the retirement of Securities of a series except as otherwise specified as contemplated by Section 301 for Securities of such series.

The minimum amount of any sinking fund payment provided for by the terms of Securities of any series is herein referred to as a "mandatory sinking fund payment", and any payment in excess of such minimum amount provided for by the terms of such Securities of any series is herein referred to as an "optional sinking fund payment". If provided for by the terms of any Securities of any series, the cash amount of any mandatory sinking fund payment may be subject to reduction as provided in Section 1202. Each sinking fund payment shall be applied to the redemption of Securities of any series as provided for by the terms of Securities of such series.

**SECTION 1202. Satisfaction of Sinking Fund Payments with Securities.**

The Company may, in satisfaction of all or any part of any mandatory sinking fund payment with respect to the Securities of a series, (1) deliver Outstanding Securities of such series (other than any previously called for redemption) and (2) apply as a credit Securities of such series which have been redeemed either at the election of the Company pursuant to the terms of such Securities or through the application of permitted optional sinking fund payments pursuant to the terms of such Securities, as provided for by the terms of such Securities; provided that such Securities so delivered or applied as a credit have not been previously so credited. Such Securities shall be received and credited for such purpose by the Trustee at the applicable Redemption Price specified in such Securities for redemption through operation of the sinking fund and the amount of such mandatory sinking fund payment shall be reduced accordingly.

**SECTION 1203. Redemption of Securities for Sinking Fund.**

Not less than 60 days prior to each sinking fund payment date for Securities of any series, the Company will deliver to the Trustee an Officers' Certificate specifying the amount of the next ensuing mandatory sinking fund payment for that series pursuant to the terms of that series, the portion thereof, if any, which is to be satisfied by payment of cash in the Currency in which the Securities of such series are payable (except as otherwise specified pursuant to Section 301 for the Securities of such series and except, if applicable, as provided in Sections 312(b), 312(d) and 312(e)) and the portion thereof, if any, which is to be satisfied by delivering and crediting Securities of that series pursuant to Section 1202, and the optional amount, if any, to be added in cash to the next ensuing mandatory sinking fund payment, and will also deliver to the Trustee any Securities to be so delivered and credited. If such Officers' Certificate shall specify an optional amount to be added in cash to the next ensuing mandatory sinking fund payment, the Company shall thereupon be obligated to pay the amount therein specified. Not less than 30 days before each such sinking fund payment date the Trustee shall select the Securities to be redeemed upon such sinking fund payment date in the manner specified in Section 1103 and cause notice of the redemption thereof to be given in the name of and at the expense of the Company in the manner provided in Section 1104. Such notice having been duly given, the redemption of such Securities shall be made upon the terms and in the manner stated in Sections 1106 and 1107.

## ARTICLE THIRTEEN

## REPAYMENT AT THE OPTION OF HOLDERS

**SECTION 1301. Applicability of Article.**

Repayment of Securities of any series before their Stated Maturity at the option of Holders thereof shall be made in accordance with the terms of such Securities and (except as otherwise specified by the terms of such series established pursuant to Section 301) in accordance with this Article.

**SECTION 1302. Repayment of Securities.**

Securities of any series subject to repayment in whole or in part at the option of the Holders thereof will, unless otherwise provided in the terms of such Securities, be repaid at the Repayment Price thereof, together with interest, if any, thereon accrued to the Repayment Date specified in or pursuant to the terms of such Securities. The Company covenants that on or before 10:00 am, New York City time, on the Repayment Date it will deposit with the Trustee or with a Paying Agent (or, if the Company is acting as its own Paying Agent, segregate and hold in trust as provided in Section 1003) an amount of money in the Currency in which the Securities of such series are payable (except as otherwise specified pursuant to Section 301 for the Securities of such series and except, if applicable, as provided in Sections 312(b), 312(d) and 312(e)) sufficient to pay the Repayment Price of, and (unless otherwise specified pursuant to Section 301) accrued interest on, all the Securities or portions thereof, as the case may be, to be repaid on such date.

**SECTION 1303. Exercise of Option.**

Securities of any series subject to repayment at the option of the Holders thereof will contain an "Option to Elect Repayment" form on the reverse of such Securities. To be repaid at the option of the Holder, any Security so providing for such repayment, with the "Option to Elect Repayment" form on the reverse of such Security duly completed by the Holder (or by the Holder's attorney duly authorized in writing), must be received by the Company at the Place of Payment therefor specified in the terms of such Security (or at such other place or places of which the Company shall from time to time notify the Holders of such Securities) not earlier than 45 days nor later than 30 days prior to the Repayment Date. If less than the entire Repayment Price of such Security is to be repaid in accordance with the terms of such Security, the portion of the Repayment Price of such Security to be repaid, in increments of the minimum denomination for Securities of such series, and the denomination or denominations of the Security or Securities to be issued to the Holder for the portion of such Security surrendered that is not to be repaid, must be specified. Any Security providing for repayment at the option of the Holder thereof may not be repaid in part if, following such repayment, the unpaid principal amount of such Security would be less than the minimum authorized denomination of Securities of the series of which such Security to be repaid is a part. Except as otherwise may be provided by the terms of any Security providing for repayment at the option of the Holder thereof, exercise of the repayment option by the Holder shall be irrevocable unless waived by the Company.

**SECTION 1304. When Securities Presented for Repayment Become Due and Payable.**

If Securities of any series providing for repayment at the option of the Holders thereof shall have been surrendered as provided in this Article and as provided by or pursuant to the terms of such Securities, such Securities or the portions thereof, as the case may be, to be repaid shall become due and payable and shall be paid by the Company on the Repayment Date therein specified, and on and after such Repayment Date (unless the Company shall default in the payment of such Securities on such Repayment Date) such Securities shall, if the same were interest-bearing, cease to bear interest. Upon surrender of any such Security for repayment in accordance with such provisions, the Repayment Price of such Security so to be repaid shall be paid by the Company, together with accrued interest, if any, to the Repayment Date; provided, however, that installments of interest on Registered Securities, whose Stated Maturity is prior to (or, if specified pursuant to Section 301, on) the Repayment Date shall be payable (but without interest thereon, unless the Company shall default in the payment thereof) to the Holders of such Securities, or one or more Predecessor Securities, registered as such at the close of business on the relevant Record Dates according to their terms and the provisions of Section 307.

If any Security surrendered for repayment shall not be so repaid upon surrender thereof, the Repayment Price shall, until paid, bear interest from the Repayment Date at the rate of interest set forth in such Security or, in the case of an Original Issue Discount Security, at the Yield to Maturity of such Security.

**SECTION 1305. Securities Repaid in Part.**

Upon surrender of any Registered Security that is to be repaid in part only, the Company shall execute and the Trustee shall authenticate and deliver to the Holder of such Security, without service charge and at the expense of the Company, a new Registered Security or Securities of the same series, and of like tenor, of any authorized denomination specified by the Holder, in an aggregate principal amount equal to and in exchange for the portion of the principal of such Security so surrendered that is not to be repaid. If a temporary global Security or permanent global Security is so surrendered, such new Security so issued shall be a new temporary global Security or a new permanent global Security, respectively.

## ARTICLE FOURTEEN

## DEFEASANCE AND COVENANT DEFEASANCE

**SECTION 1401. Applicability of Article; Company's Option to Effect Defeasance or Covenant Defeasance.**

If pursuant to Section 301 provision is made for either or both of (a) defeasance of the Securities of or within a series under Section 1402 or (b) covenant defeasance of the Securities of or within a series under Section 1403, then the provisions of such Section or Sections, as the case may be, together with the other provisions of this Article (with such modifications thereto as may be specified pursuant to Section 301 with respect to any Securities), shall be applicable to such Securities, and the Company may at its option by Board Resolution, at any time, with respect to such Securities, elect to have either Section 1402 (if applicable) or Section 1403 (if applicable) be applied to such Outstanding Securities upon compliance with the conditions set forth below in this Article.

**SECTION 1402. Defeasance and Discharge.**

Upon the Company's exercise of the above option applicable to this Section with respect to any Securities of or within a series, the Company shall be deemed to have been discharged from its obligations with respect to such Outstanding Securities on and after the date the conditions set forth in Section 1404 are satisfied (hereinafter, "defeasance"). For this purpose, such defeasance means that the Company shall be deemed to have paid and discharged the entire indebtedness represented by such Outstanding Securities, which shall thereafter be deemed to be "Outstanding" only for the purposes of Section 1405 and the other Sections of this Indenture referred to in clauses (A) and (B) of this Section, and to have satisfied all its other obligations under such Securities and this Indenture insofar as such Securities are concerned (and the Trustee, at the expense of the Company, shall execute proper instruments acknowledging the same), except for the following which shall survive until otherwise terminated or discharged hereunder: (A) the rights of Holders of such Outstanding Securities to receive, solely from the trust fund described in Section 1404 and as more fully set forth in such Section, payments in respect of the principal of (and premium, if any, on) and interest, if any, on such Securities when such payments are due, (B) the Company's obligations with respect to such Securities under Sections 305, 306, 1002 and 1003 and with respect to the payment of Additional Amounts, if any, on such Securities as contemplated by Section 1004, (C) the rights, powers, trusts, duties and immunities of the Trustee hereunder and (D) this Article. Subject to compliance with this Article Fourteen, the Company may exercise its option under this Section notwithstanding the prior exercise of its option under Section 1403 with respect to such Securities. Following a defeasance, payment of such Securities may not be accelerated because of an Event of Default.

**SECTION 1403. Covenant Defeasance.**

Upon the Company's exercise of the above option applicable to this Section with respect to any Securities of or within a series, if specified pursuant to Section 301, the Company shall be released from its obligations under any covenant, with respect to such Outstanding Securities on and after the date the conditions set forth in Section 1404 are satisfied (hereinafter, "covenant defeasance"), and such Securities shall thereafter be deemed to be not "Outstanding" for the purposes of any direction, waiver, consent or declaration or Act of Holders (and the consequences of any thereof) in connection with such covenant, but shall continue to be deemed "Outstanding" for all other purposes hereunder. For this purpose, such covenant defeasance means that, with respect to such Outstanding Securities, the Company may omit to comply with and shall have no liability in respect of any term, condition or limitation set forth in any such Section or such other covenant, whether directly or indirectly, by reason of any reference elsewhere herein to any such Section or such other covenant or by reason of reference in any such Section or such other covenant to any other provision herein or in any other document and such omission to comply shall not constitute a Default or an Event of Default under Section 501(4) or 501(8) or otherwise, as the case may be, but, except as specified above, the remainder of this Indenture and such Securities shall be unaffected thereby. Following a covenant defeasance, payment of such Securities may not be accelerated because of an Event of Default solely by reference to such Sections specified above in this Section 1403.

**SECTION 1404. Conditions to Defeasance or Covenant Defeasance.**

The following shall be the conditions to application of either Section 1402 or Section 1403 to any Outstanding Securities of or within a series:

(a) The Company shall have irrevocably deposited or caused to be irrevocably deposited with the Trustee (or another trustee satisfying the requirements of Section 607 who shall agree to comply with the provisions of this Article Fourteen applicable to it) as trust funds in trust for the purpose of making the following payments, specifically pledged as security for the benefit of, and dedicated solely to, the Holders of such Securities, (1) an amount (in such Currency in which such Securities are then specified as payable at Stated Maturity), or (2) Government Obligations applicable to such Securities (determined on the basis of the Currency in which such Securities are then specified as payable at Stated Maturity) which through the scheduled payment of principal and interest in respect thereof in accordance with their terms will provide, not later than one day before the due date of any payment of principal of (and premium, if any, on) and interest, if any, on such Securities, money in an amount, or (3) a combination thereof in an amount, sufficient, in the opinion of a nationally recognized firm of independent public accountants expressed in a written certification thereof delivered to the Trustee, to pay and discharge, and which shall be applied by the Trustee (or other qualifying trustee) to pay and discharge, (i) the principal of (and premium, if any, on) and interest, if any, on such Outstanding Securities on the Stated Maturity of such principal or installment of principal or interest and (ii) any mandatory sinking fund payments or analogous payments applicable to such Outstanding Securities on the day on which such payments are due and payable in accordance with the terms of this Indenture and of such Securities.

(b) Such defeasance or covenant defeasance shall not result in a breach or violation of, or constitute a default under, this Indenture or any other material agreement or instrument to which the Company is a party or by which it is bound.

(c) No Default or Event of Default with respect to such Securities shall have occurred and be continuing on the date of such deposit or, insofar as Sections 501(5) and 501(6) are concerned, at any time during the period ending on the 91st day after the date of such deposit (it being understood that this condition shall not be deemed satisfied until the expiration of such period).

(d) In the case of an election under Section 1402, the Company shall have delivered to the Trustee an Opinion of Counsel stating that (i) the Company has received from, or there has been published by, the Internal Revenue Service a ruling, or (ii) since the date of execution of this Indenture, there has been a change in the applicable Federal income tax law, in either case to the effect that, and based thereon such opinion shall confirm that, the Holders of such Outstanding Securities will not recognize income, gain or loss for Federal income tax purposes as a result of such defeasance and will be subject to Federal income tax on the same amounts, in the same manner and at the same times as would have been the case if such defeasance had not occurred.

(e) In the case of an election under Section 1403, the Company shall have delivered to the Trustee an Opinion of Counsel to the effect that the Holders of such Outstanding Securities will not recognize income, gain or loss for Federal income tax purposes as a result of such covenant defeasance and will be subject to Federal income tax on the same amounts, in the same manner and at the same times as would have been the case if such covenant defeasance had not occurred.

(f) The Company shall have delivered to the Trustee an Officers' Certificate and an Opinion of Counsel, each stating that all conditions precedent to either the defeasance under Section 1402 or the covenant defeasance under Section 1403 (as the case may be) have been complied with and an Opinion of Counsel to the effect that as a result of a deposit pursuant to subsection (a) above and the related exercise of the Company's option under Section 1402 or Section 1403 (as the case may be), registration is not required under the Investment Company Act of 1940, as amended, by the Company, with respect to the trust funds representing such deposit or by the trustee for such trust funds.

(g) Notwithstanding any other provisions of this Section, such defeasance or covenant defeasance shall be effected in compliance with any additional or substitute terms, conditions or limitations which may be imposed on the Company in connection therewith pursuant to Section 301.

**SECTION 1405. Deposited Money and Government Obligations to Be Held in Trust; Other Miscellaneous Provisions.**

Subject to the provisions of the last paragraph of Section 1003, all money and Government Obligations (or other property as may be provided pursuant to Section 301) (including the proceeds thereof) deposited with the Trustee (or other qualifying trustee, collectively for purposes of this Section 1405, the "Trustee") pursuant to Section 1404 in respect of any Outstanding Securities of any series shall be held in trust and applied by the Trustee, in accordance with the provisions of such Securities and this Indenture, to the payment, either directly or through any Paying Agent (including the Company acting as its own Paying Agent) as the Trustee may determine, to the Holders of such Securities of all sums due and to become due thereon in respect of principal (and premium, if any) and interest, if any, but such money need not be segregated from other funds except to the extent required by law.

Unless otherwise specified with respect to any Security pursuant to Section 301, if, after a deposit referred to in Section 1404(a) has been made, (a) the Holder of a Security in respect of which such deposit was made is entitled to, and does, elect pursuant to Section 312(b) or the terms of such Security to receive payment in a Currency other than that in which the deposit pursuant to Section 1404(a) has been made in respect of such Security, or (b) a Conversion Event occurs as contemplated in Section 312(d) or 312(e) or by the terms of any Security in respect of which the deposit pursuant to Section 1404(a) has been made, the indebtedness represented by such Security shall be deemed to have been, and will be, fully discharged and satisfied through the payment of the principal of (and premium, if any, on) and interest, if any, on such Security as the same becomes due out of the proceeds yielded by converting (from time to time as specified below in the case of any such election) the amount or other property deposited in respect of such Security into the Currency in which such Security becomes payable as a result of such election or Conversion Event based on the applicable Market Exchange Rate for such Currency in effect on the second Business Day prior to each payment date, except, with respect to a Conversion Event, such conversion shall be based on the applicable Market Exchange Rate for such Currency in effect (as nearly as feasible) at the time of the Conversion Event.

The Company shall pay and indemnify the Trustee against any tax, fee or other charge imposed on or assessed against the money or Government Obligations deposited pursuant to Section 1404 or the principal and interest received in respect thereof other than any such tax, fee or other charge which by law is for the account of the Holders of such Outstanding Securities.

Anything in this Article to the contrary notwithstanding, the Trustee shall deliver or pay to the Company from time to time upon Company Request any money or Government Obligations (or other property and any proceeds therefrom) held by it as provided in Section 1404 which, in the opinion of a nationally recognized firm of independent public accountants expressed in a written certification thereof delivered to the Trustee, are in excess of the amount thereof which would then be required to be deposited to effect a defeasance or covenant defeasance, as applicable, in accordance with this Article.

## ARTICLE FIFTEEN

## MEETINGS OF HOLDERS OF SECURITIES

**SECTION 1501. Purposes for Which Meetings May Be Called.**

A meeting of Holders of any series of Securities may be called at any time and from time to time pursuant to this Article to make, give or take any request, demand, authorization, direction, notice, consent, waiver or other action provided by this Indenture to be made, given or taken by Holders of Securities of such series.

**SECTION 1502. Call, Notice and Place of Meetings.**

(a) The Trustee may at any time call a meeting of Holders of Securities of any series for any purpose specified in Section 1501, to be held at such time and at such place in the Borough of Manhattan, The City of New York as the Trustee shall determine. Notice of every meeting of Holders of Securities of any series, setting forth the time and the place of such meeting and in general terms the action proposed to be taken at such meeting, shall be given, in the manner provided in Section 106.

(b) In case at any time the Company, pursuant to a Board Resolution, or the Holders of at least 10% in principal amount of the Outstanding Securities of any series shall have requested the Trustee to call a meeting of the Holders of Securities of such series for any purpose specified in Section 1501, by written request setting forth in reasonable detail the action proposed to be taken at the meeting, and the Trustee shall not have made the first publication or mailing of the notice of such meeting within 21 days after receipt of such request or shall not thereafter proceed to cause the meeting to be held as provided herein, then the Company or the Holders of Securities of such series in the amount above specified, as the case may be, may determine the time and the place in the Borough of Manhattan, The City of New York for such meeting and may call such meeting for such purposes by giving notice thereof as provided in subsection (a) of this Section.

**SECTION 1503. Persons Entitled to Vote at Meetings.**

To be entitled to vote at any meeting of Holders of Securities of any series, a Person shall be (1) a Holder of one or more Outstanding Securities of such series, or (2) a Person appointed by an instrument in writing as proxy for a Holder or Holders of one or more Outstanding Securities of such series by such Holder or Holders. The only Persons who shall be entitled to be present or to speak at any meeting of Holders of Securities of any series shall be the Persons entitled to vote at such meeting and their counsel, any representatives of the Trustee and its counsel and any representatives of the Company and its counsel.

**SECTION 1504. Quorum; Action.**

The Persons entitled to vote a majority in principal amount of the Outstanding Securities of a series shall constitute a quorum for a meeting of Holders of Securities of such series; provided, however, that if any action is to be taken at such meeting with respect to a consent, waiver, request, demand, notice, authorization, direction or other action that this Indenture expressly provides may be made, given or taken by the Holders of not less than a specified percentage in principal amount of the Outstanding Securities of a series, the Persons entitled to vote such specified percentage in principal amount of the Outstanding Securities of such series shall constitute a quorum. In the absence of a quorum within 30 minutes of the time appointed for any such meeting, the meeting shall, if convened at the request of Holders of Securities of such series, be dissolved. In any other case the meeting may be adjourned for a period of not less than 10 days as determined by the chairman of the meeting prior to the adjournment of such meeting. In the absence of a quorum at any such adjourned meeting, such adjourned meeting may be further adjourned for a period of not less than 10 days as determined by the chairman of the meeting prior to the adjournment of such adjourned meeting. Notice of the reconvening of any adjourned meeting shall be given as provided in Section 1502(a), except that such notice need be given only once not less than five days prior to the date on which the meeting is scheduled to be reconvened. Notice of the reconvening of any adjourned meeting shall state expressly the percentage, as provided above, of the principal amount of the Outstanding Securities of such series which shall constitute a quorum.

Except as limited by the proviso to Section 902, any resolution presented to a meeting or adjourned meeting duly reconvened at which a quorum is present as aforesaid may be adopted by the affirmative vote of the Holders of a majority in principal amount of the Outstanding Securities of that series; provided, however, that, except as limited by the proviso to Section 902, any resolution with respect to any consent, waiver, request, demand, notice, authorization, direction or other action which this Indenture expressly provides may be made, given or taken by the Holders of a specified percentage, which is less than a majority, in principal amount of the Outstanding Securities of a series may be adopted at a meeting or an adjourned meeting duly reconvened and at which a quorum is present as aforesaid by the affirmative vote of the Holders of such specified percentage in principal amount of the Outstanding Securities of that series.

Any resolution passed or decision taken at any meeting of Holders of Securities of any series duly held in accordance with this Section shall be binding on all the Holders of Securities of such series, whether or not present or represented at the meeting.

Notwithstanding the foregoing provisions of this Section 1504, if any action is to be taken at a meeting of Holders of Securities of any series with respect to any consent, waiver, request, demand, notice, authorization, direction or other action that this Indenture expressly provides may be made, given or taken by the Holders of a specified percentage in principal amount of all Outstanding Securities affected thereby, or of the Holders of such series and one or more additional series:

(i) there shall be no minimum quorum requirement for such meeting; and

(ii) the principal amount of the Outstanding Securities of such series that vote in favor of such consent, waiver, request, demand, notice, authorization, direction or other action shall be taken into account in determining whether such request, demand, authorization, direction, notice, consent, waiver or other action has been made, given or taken under this Indenture.

**SECTION 1505. Determination of Voting Rights; Conduct and Adjournment of Meetings.**

(a) Notwithstanding any other provisions of this Indenture, the Trustee may make such reasonable regulations as it may deem advisable for any meeting of Holders of Securities of a series in regard to proof of the holding of Securities of such series and of the appointment of proxies and in regard to the appointment and duties of inspectors of votes, the submission and examination of proxies, certificates and other evidence of the right to vote, and such other matters concerning the conduct of the meeting as it shall deem appropriate. Except as otherwise permitted or required by any such regulations, the holding of Securities shall be proved in the manner specified in Section 104 and the appointment of any proxy shall be proved in the manner specified in Section 104. Such regulations may provide that written instruments appointing proxies, regular on their face, may be presumed valid and genuine without the proof specified in Section 104 or other proof.

(b) The Trustee shall, by an instrument in writing appoint a temporary chairman of the meeting, unless the meeting shall have been called by the Company or by Holders of Securities as provided in Section 1502(b), in which case the Company or the Holders of Securities of the series calling the meeting, as the case may be, shall in like manner appoint a temporary chairman. A permanent chairman and a permanent secretary of the meeting shall be elected by vote of the Persons entitled to vote a majority in principal amount of the Outstanding Securities of such series represented at the meeting.

(c) At any meeting of Holders, each Holder of a Security of such series or proxy shall be entitled to one vote for each $1,000 principal amount of the Outstanding Securities of such series held or represented by such Holder; provided, however, that no vote shall be cast or counted at any meeting in respect of any Security challenged as not Outstanding and ruled by the chairman of the meeting to be not Outstanding. The chairman of the meeting shall have no right to vote, except as a Holder of a Security of such series or proxy.

(d) Any meeting of Holders of Securities of any series duly called pursuant to Section 1502 at which a quorum is present may be adjourned from time to time by Persons entitled to vote a majority in principal amount of the Outstanding Securities of such series represented at the meeting, and the meeting may be held as so adjourned without further notice.

**SECTION 1506. Counting Votes and Recording Action of Meetings.**

The vote upon any resolution submitted to any meeting of Holders of Securities of any series shall be by written ballots on which shall be subscribed the signatures of the Holders of Securities of such series or of their representatives by proxy and the principal amounts and serial numbers of the Outstanding Securities of such series held or represented by them. The permanent chairman of the meeting shall appoint two inspectors of votes who shall count all votes cast at the meeting for or against any resolution and who shall make and file with the secretary of the meeting their verified written reports in duplicate of all votes cast at the meeting. A record, at least in duplicate, of the proceedings of each meeting of Holders of Securities of any Series shall be prepared by the secretary of the meeting and there shall be attached to said record the original reports of the inspectors of votes on any vote by ballot taken thereat and affidavits by one or more persons having knowledge of the fact, setting forth a copy of the notice of the meeting and showing that said notice was given as provided in Section 1502 and, if applicable, Section 1504. Each copy shall be signed and verified by the affidavits of the permanent chairman and secretary of the meeting and one such copy shall be delivered to the Company and another to the Trustee to be preserved by the Trustee, the latter to have attached thereto the ballots voted at the meeting. Any record so signed and verified shall be conclusive evidence of the matters therein stated.

## ARTICLE SIXTEEN

## SUBORDINATION OF SECURITIES

**SECTION 1601. Agreement to Subordinate.**

The Company, for itself, its successors and assigns, covenants and agrees, and each Holder of Subordinated Securities by his acceptance thereof, likewise covenants and agrees, that the payment of the principal of (and premium, if any) and interest, if any, on each and all of the Subordinated Securities is hereby expressly subordinated, to the extent and in the manner hereinafter set forth, in right of payment to the prior payment in full of all Senior Indebtedness.

**SECTION 1602. Distribution on Dissolution, Liquidation and Reorganization; Subrogation of Subordinated Securities.**

Upon any distribution of assets of the Company upon any dissolution, winding up, liquidation or reorganization of the Company, whether in bankruptcy, insolvency, reorganization or receivership proceedings or upon an assignment for the benefit of creditors or any other marshalling of the assets and liabilities of the Company or otherwise (subject to the power of a court of competent jurisdiction to make other equitable provision reflecting the rights conferred in this Indenture upon the

Senior Indebtedness and the holders thereof with respect to the Securities and the holders thereof by a lawful plan of reorganization under applicable bankruptcy law):

(a) the holders of all Senior Indebtedness shall be entitled to receive payment in full of the principal thereof (and premium, if any) and interest due thereon (including post-petition interest) before the Holders of the Subordinated Securities are entitled to receive any payment upon the principal (or premium, if any) or interest, if any, on indebtedness evidenced by the Subordinated Securities; and

(b) any payment or distribution of assets of the Company of any kind or character, whether in cash, property or securities, to which the Holders of the Securities or the Trustee would be entitled except for the provisions of this Article Sixteen shall be paid by the liquidating trustee or agent or other person making such payment or distribution, whether a trustee in bankruptcy, a receiver or liquidating trustee or otherwise, directly to the holders of Senior Indebtedness or their representative or representatives or to the trustee or trustees under any indenture under which any instruments evidencing any of such Senior Indebtedness may have been issued, ratably according to the aggregate amounts remaining unpaid on account of the principal of (and premium, if any) and interest on the Senior Indebtedness held or represented by each, to the extent necessary to make payment in full of all Senior Indebtedness remaining unpaid, after giving effect to any concurrent payment or distribution to the holders of such Senior Indebtedness; and

(c) in the event that, notwithstanding the foregoing, any payment or distribution of assets of the Company of any kind or character, whether in cash, property or securities, shall be received by the Trustee or the Holders of the Subordinated Securities before all Senior Indebtedness is paid in full, such payment or distribution shall be paid over, upon written notice to the Trustee, to the holder of such Senior Indebtedness or their representative or representatives or to the trustee or trustees under any indenture under which any instrument evidencing any of such Senior Indebtedness may have been issued, ratably as aforesaid, for application to payment of all Senior Indebtedness remaining unpaid until all such Senior Indebtedness shall have been paid in full, after giving effect to any concurrent payment or distribution to the holders of such Senior Indebtedness.

Subject to the payment in full of all Senior Indebtedness, the Holders of the Subordinated Securities shall be subrogated to the rights of the holders of Senior Indebtedness to receive payments or distributions of cash, property or securities of the Company applicable to Senior Indebtedness until the principal of (and premium, if any, on) and interest, if any, on the Subordinated Securities shall be paid in full and no such payments or distributions to the Holders of the Subordinated Securities of cash, property or securities otherwise distributable to the holders of Senior Indebtedness shall, as between the Company, its creditors other than the holders of Senior Indebtedness, and the Holders of the Subordinated Securities be deemed to be a payment by the Company to or on account of the Subordinated Securities. It is understood that the provisions of this Article Sixteen are and are intended solely for the purpose of defining the relative rights of the Holders of the Subordinated Securities, on the one hand, and the holders of the Senior Indebtedness, on the other hand. Nothing contained in this Article Sixteen or elsewhere in this Indenture or in the Subordinated Securities is intended to or shall impair, as between the Company, its creditors other than the holders of Senior Indebtedness, and the Holders of the Subordinated Securities, the obligation of the Company, which is unconditional and absolute, to pay to the Holders of the Subordinated Securities the principal of (and premium, if any) and interest, if any, on the Subordinated Securities as and when the same shall become due and payable in accordance with their terms, or to affect the relative rights of the Holders of the Subordinated Securities and creditors of the Company other than the holders of Senior Indebtedness, nor shall anything herein or in the Subordinated Securities prevent the Trustee or the Holder of any Subordinated Security from exercising all remedies otherwise permitted by applicable law upon default under this Indenture, subject to the rights, if any, under this Article Sixteen of the holders of Senior Indebtedness in respect of cash, property or securities of the Company received upon the exercise of any such remedy. Upon any payment or distribution of assets of the Company referred to in this Article Sixteen, the Trustee, subject to the provisions of Section 601, shall be entitled to rely upon a certificate of the liquidating trustee or agent or other person making any distribution to the Trustee for the purpose of ascertaining the Persons entitled to participate in such distribution, the holders of Senior Indebtedness and other indebtedness of the Company, the amount thereof or payable thereon, the amount or amounts paid or distributed thereon and all other facts pertinent thereto or to this Article Sixteen.

If the Trustee or any Holder of Subordinated Securities does not file a proper claim or proof of debt in the form required in any proceeding referred to above prior to 30 days before the expiration of the time to file such claim in such proceeding, then the holder of any Senior Indebtedness is hereby authorized, and has the right, to file an appropriate claim or claims for or on behalf of such Holder of Subordinated Securities.

With respect to the holders of Senior Indebtedness, the Trustee undertakes to perform or to observe only such of its covenants or obligations as are specifically set forth in this Article and no implied covenants or obligations with respect to holders of Senior Indebtedness shall be read into this Indenture against the Trustee. The Trustee does not owe any fiduciary duties to the holders of Senior Indebtedness other than Securities issued under this Indenture.

**SECTION 1603. No Payment on Subordinated Securities in Event of Default on Senior Indebtedness.**

No payment by the Company on account of principal (or premium, if any), sinking funds or interest, if any, on the Subordinated Securities shall be made unless full payment of amounts then due for principal (premium, if any), sinking funds and interest on Senior Indebtedness has been made or duly provided for in money or money's worth.

**SECTION 1604. Payments on Subordinated Securities Permitted.**

Nothing contained in this Indenture or in any of the Subordinated Securities shall (a) affect the obligation of the Company to make, or prevent the Company from making, at any time except as provided in Sections 1602 and 1603, payments of principal of (or premium, if any) or interest, if any, on the Subordinated Securities, (b) without limiting clause (c) of this sentence, prevent the application by the Trustee of any moneys deposited with it hereunder to the payment of or on account of the principal of (or premium, if any) or interest, if any, on the Subordinated Securities, unless the Trustee shall have received at its Corporate Trust Office written notice of any event prohibiting the making of such payment more than three Business Days prior to the date fixed for such payment or (c) prevent the application by the Trustee of any moneys or the proceeds of Government Obligations deposited with it pursuant to Section 1404(a) to the payment of or on account of the principal of (or premium, if any, on) or interest, if any, on the Subordinated Securities if all the conditions specified in Section 1404 to the application of Section 1402 or Section 1403, as applicable, have been satisfied prior to the date the Trustee shall have received at its Corporate Trust Office written notice of any event prohibiting the making of such payment.

**SECTION 1605. Authorization of Holders to Trustee to Effect Subordination.**

Each Holder of Subordinated Securities by his acceptance thereof authorizes and directs the Trustee on his behalf to take such action as may be necessary or appropriate to effectuate the subordination as provided in this Article Sixteen and appoints the Trustee his attorney-in-fact for any and all such purposes.

**SECTION 1606. Notices to Trustee.**

Notwithstanding the provisions of this Article or any other provisions of this Indenture, neither the Trustee nor any Paying Agent (other than the Company) shall be charged with knowledge of the existence of any Senior Indebtedness or of any event that would prohibit the making of any payment of moneys to or by the Trustee or such Paying Agent, unless and until the Trustee or such Paying Agent shall have received (in the case of the Trustee, at its Corporate Trust Office) written notice thereof from the Company or from the holder of any Senior Indebtedness or from the trustee for any such holder, together with proof satisfactory to the Trustee of such holding of Senior Indebtedness or of the authority of such trustee; provided, however, that if at least three Business Days prior to the date upon which by the terms hereof any such moneys may become payable for any purpose (including, without limitation, the payment of either the principal (or premium, if any) or interest, if any, on any Subordinated Security) the Trustee shall not have received with respect to such moneys the notice provided for in this Section 1606, then, anything herein contained to the contrary notwithstanding, the Trustee shall have full power and authority to receive such moneys and to apply the same to the purpose for which they were received, and shall not be affected by any notice to the contrary, which may be received by it within three Business Days prior to such date. The Trustee shall be entitled to rely on the delivery to it of a written notice by a Person representing himself to be a holder of Senior Indebtedness (or a trustee on behalf of such holder) to establish that such a notice has been given by a holder of Senior Indebtedness or a trustee on behalf of any such holder. In the event that the Trustee determines in good faith that further evidence is required with respect to the right of any Person as a holder of Senior Indebtedness to participate in any payment or distribution pursuant to this Article Sixteen, the Trustee may request such Person to furnish evidence to the reasonable satisfaction of the Trustee as to the amount of Senior Indebtedness held by such Person, the extent to which such Person is entitled to participate in such payment or distribution and any other facts pertinent to the rights of such Person under this Article Sixteen and, if such evidence is not furnished, the Trustee may defer any payment to such Person pending judicial determination as to the right of such Person to receive such payment.

**SECTION 1607. Trustee as Holder of Senior Indebtedness.**

The Trustee in its individual capacity shall be entitled to all the rights set forth in this Article Sixteen in respect of any Senior Indebtedness at any time held by it to the same extent as any other holder of Senior Indebtedness and nothing in this Indenture shall be construed to deprive the Trustee of any of its rights as such holder.

Nothing in this Article Sixteen shall apply to claims of, or payments to, the Trustee under or pursuant to Section 606.

**SECTION 1608. Modifications of Terms of Senior Indebtedness.**

Any renewal or extension of the time of payment of any Senior Indebtedness or the exercise by the holders of Senior Indebtedness of any of their rights under any instrument creating or evidencing Senior Indebtedness, including, without limitation, the waiver of default thereunder, may be made or done all without notice to or assent from the Holders of the Subordinated Securities or the Trustee.

No compromise, alteration, amendment, modification, extension, renewal or other change of, or waiver, consent or other action in respect of, any liability or obligation under or in respect of, or of any of the terms, covenants or conditions of any indenture or other instrument under which any Senior Indebtedness is outstanding or of such Senior Indebtedness, whether or not any of the foregoing are in accordance with the provisions of any applicable document, shall in any way alter or affect any of the provisions of this Article Sixteen or of the Subordinated Securities relating to the subordination thereof.

**SECTION 1609. Reliance on Judicial Order or Certificate of Liquidating Agent.**

Upon any payment or distribution of assets of the Company referred to in this Article Sixteen, the Trustee and the Holders of the Securities shall be entitled to rely upon any order or decree entered by any court of competent jurisdiction in which such insolvency, bankruptcy, receivership, liquidation, reorganization, dissolution, winding up or similar case or proceeding is pending, or a certificate of the trustee in bankruptcy, liquidating trustee, custodian, receiver, assignee for the benefit of creditors, agent or other person making such payment or distribution, delivered to the Trustee or to the Holders of Subordinated Securities, for the purpose of ascertaining the persons entitled to participate in such payment or distribution, the holders of Senior Indebtedness and other indebtedness of the Company, the amount thereof or payable thereon, the amount or amounts paid or distributed thereon and all other facts pertinent thereto or to this Article Sixteen.

* * * * *

This Indenture may be executed in any number of counterparts, each of which so executed shall be deemed to be an original, but all such counterparts shall together constitute but one and the same Indenture. The exchange of copies of this Indenture and delivery of signature pages by facsimile, .pdf transmission, e-mail or other electronic means shall constitute effective execution and delivery of this Indenture for all purposes. Signatures of the parties hereto transmitted by facsimile, .pdf transmission, e-mail or other electronic means shall be deemed to be their original signatures for all purposes.

IN WITNESS WHEREOF, the parties hereto have caused this Indenture to be duly executed, as of the day and year first above written.

KCAP FINANCIAL, INC.

By: _____
Name:
Title:

U.S. Bank National Association,
as Trustee

By: _____
Name:
Title:

[Signature Page to Indenture]

**Exhibit d.4**

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

# FORM T-1

## STATEMENT OF ELIGIBILITY UNDER THE TRUST INDENTURE ACT OF 1939 OF A CORPORATION DESIGNATED TO ACT AS TRUSTEE

Check if an Application to Determine Eligibility of
a Trustee Pursuant to Section 305(b)(2)

## U.S. BANK NATIONAL ASSOCIATION

(Exact name of Trustee as specified in its charter)

**31-0841368**
I.R.S. Employer Identification No.

| 800 Nicollet Mall<br>Minneapolis, Minnesota | 55402 |
|---|---|
| (Address of principal executive offices) | (Zip Code) |

Eric J. Donaghey
U.S. Bank National Association
1 Federal Street – 10th Floor
Boston, MA
(617)603-6549
(Name, address and telephone number of agent for service)

## KCAP FINANCIAL, INC.

(Issuer with respect to the Securities)

| Delaware | 20-5951150 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 295 Madison Avenue, 6th Floor<br>New York, New York | 10017 |
| (Address of Principal Executive Offices) | (Zip Code) |

**% Senior Notes due**
**(Title of the Indenture Securities)**

**FORM T-1**

**Item 1.** **GENERAL INFORMATION.** Furnish the following information as to the Trustee.

a) *Name and address of each examining or supervising authority to which it is subject.*
Comptroller of the Currency
Washington, D.C.

b) *Whether it is authorized to exercise corporate trust powers.*
Yes

**Item 2.** **AFFILIATIONS WITH OBLIGOR.** *If the obligor is an affiliate of the Trustee, describe each such affiliation.*
None

**Items 3-15** *Items 3-15 are not applicable because to the best of the Trustee's knowledge, the obligor is not in default under any Indenture for which the Trustee acts as Trustee.*

**Item 16.** **LIST OF EXHIBITS:** *List below all exhibits filed as a part of this statement of eligibility and qualification.*

1. A copy of the Articles of Association of the Trustee.*
2. A copy of the certificate of authority of the Trustee to commence business, attached as Exhibit 2.
3. A copy of the certificate of authority of the Trustee to exercise corporate trust powers, attached as Exhibit 3.
4. A copy of the existing bylaws of the Trustee.**
5. A copy of each Indenture referred to in Item 4. Not applicable.
6. The consent of the Trustee required by Section 321(b) of the Trust Indenture Act of 1939, attached as Exhibit 6.
7. Report of Condition of the Trustee as of June 30, 2012 published pursuant to law or the requirements of its supervising or examining authority, attached as Exhibit 7.

* Incorporated by reference to Exhibit 25.1 to Amendment No. 2 to registration statement on S-4, Registration Number 333-128217 filed on November 15, 2005.
** Incorporated by reference to Exhibit 25.1 to registration statement on S-4, Registration Number 333-166527 filed on May 5, 2010.

**SIGNATURE**

Pursuant to the requirements of the Trust Indenture Act of 1939, as amended, the Trustee, U.S. BANK NATIONAL ASSOCIATION, a national banking association organized and existing under the laws of the United States of America, has duly caused this statement of eligibility and qualification to be signed on its behalf by the undersigned, thereunto duly authorized, all in the City of Boston, Commonwealth of Massachusetts on the 31st of August, 2012.

By: /s/ Eric J. Donaghey
Eric J. Donaghey
Vice President

**Exhibit 2**

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

## CERTIFICATE OF CORPORATE EXISTENCE

I, Thomas J. Curry, Comptroller of the Currency, do hereby certify that:

1. The Comptroller of the Currency, pursuant to Revised Statutes 324, et seq, as amended, and 12 USC 1, et seq, as amended, has possession, custody, and control of all records pertaining to the chartering, regulation, and supervision of all national banking associations.

2. "U.S. Bank National Association," Cincinnati, Ohio (Charter No. 24), is a national banking association formed under the laws of the United States and is authorized thereunder to transact the business of banking on the date of this certificate.

IN TESTIMONY WHEREOF, today, May 9, 2012, I have hereunto subscribed my name and caused my seal of office to be affixed to these presents at the U.S. Department of the Treasury, in the City of Washington, District of Columbia.

Comptroller of the Currency

**Exhibit 3**

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

CERTIFICATE OF FIDUCIARY POWERS

I, John Walsh, Acting Comptroller of the Currency, do hereby certify that:

1. The Comptroller of the Currency, pursuant to Revised Statutes 324, et seq., as amended, 12 U.S.C. 1, et seq., as amended, has possession, custody and control of all records pertaining to the chartering, regulation and supervision of all National Banking Associations.

2. "U.S. Bank National Association," Cincinnati, Ohio, (Charter No. 24), was granted, under the hand and seal of the Comptroller, the right to act in all fiduciary capacities authorized under the provisions of the Act of Congress approved September 28, 1962, 76 Stat.668, 12 U.S.C. 92 a, and that the authority so granted remains in full force and effect on the date of this Certificate.

IN TESTIMONY WHERE OF, I have hereunto subscribed my name and caused my seal of office to be affixed to these presents at the Treasury Department, in the City of Washington and District of Columbia, this September 9, 2010.

John Walsh

Acting Comptroller of the Currency

**Exhibit 6**

**CONSENT**

In accordance with Section 321(b) of the Trust Indenture Act of 1939, the undersigned, U.S. BANK NATIONAL ASSOCIATION hereby consents that reports of examination of the undersigned by Federal, State, Territorial or District authorities may be furnished by such authorities to the Securities and Exchange Commission upon its request therefor.

Dated: August 31, 2012

By: /s/ Eric J. Donaghey
Eric J. Donaghey
Vice President

**Exhibit 7**
**U.S. Bank National Association**
**Statement of Financial Condition**
**As of 6/30/2012**

**($000's)**

| | 6/30/2012 |
|---|---|
| **Assets** | |
| Cash and Balances Due From Depository Institutions | $ 15,399,893 |
| Securities | 72,720,824 |
| Federal Funds | 75,584 |
| Loans & Lease Financing Receivables | 211,830,660 |
| Fixed Assets | 5,286,747 |
| Intangible Assets | 12,383,063 |
| Other Assets | 25,125,941 |
| **Total Assets** | **$ 342,822,712** |
| | |
| **Liabilities** | |
| Deposits | $ 245,043,009 |
| Fed Funds | 6,587,299 |
| Treasury Demand Notes | 0 |
| Trading Liabilities | 937,898 |
| Other Borrowed Money | 35,563,317 |
| Acceptances | 0 |
| Subordinated Notes and Debentures | 5,829,815 |
| Other Liabilities | 11,359,611 |
| **Total Liabilities** | **$ 305,320,949** |
| | |
| **Equity** | |
| Minority Interest in Subsidiaries | $ 2,015,054 |
| Common and Preferred Stock | 18,200 |
| Surplus | 14,133,323 |
| Undivided Profits | 21,335,186 |
| **Total Equity Capital** | **$ 37,501,763** |
| | |
| **Total Liabilities and Equity Capital** | **$ 342,822,712** |

**Exhibit d.5**

**FIRST SUPPLEMENTAL INDENTURE**

**between**

**KCAP FINANCIAL, INC.**

**and**

**U.S. BANK NATIONAL ASSOCIATION,**

**as Trustee**

**Dated as of October [__], 2012**

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## FIRST SUPPLEMENTAL INDENTURE

THIS FIRST SUPPLEMENTAL INDENTURE (this "First Supplemental Indenture"), dated as of October [__], 2012, is between KCAP Financial, Inc., a Delaware corporation (the "Company"), and U.S. Bank National Association, as trustee (the "Trustee"). All capitalized terms used herein shall have the meaning set forth in the Base Indenture (as defined below).

## RECITALS OF THE COMPANY

The Company and the Trustee executed and delivered an Indenture, dated as of October [__], 2012 (the "Base Indenture" and, as supplemented by this First Supplemental Indenture, the "Indenture"), to provide for the issuance by the Company from time to time of the Company's unsecured debentures, notes or other evidences of indebtedness (the "Securities"), to be issued in one or more series as provided in the Indenture.

The Company desires to issue and sell up to $34,500,000 aggregate principal amount of the Company's [___]% Senior Notes due 2019 (the "Notes").

Sections 901(4) and 901(6) of the Base Indenture provide that without the consent of Holders of the Securities of any series issued under the Indenture, the Company, when authorized by or pursuant to a Board Resolution, and the Trustee, at any time and from time to time, may enter into one or more indentures supplemental to the Base Indenture to (i) change or eliminate any of the provisions of the Indenture when there is no Security Outstanding of any series created prior to the execution of the supplemental indenture that is entitled to the benefit of such provision and (ii) establish the form or terms of Securities of any series as permitted by Section 201 and Section 301 of the Base Indenture.

The Company desires to establish the form and terms of the Notes and to modify, alter, supplement and change certain provisions of the Base Indenture for the benefit of the Holders of the Notes (except as may be provided in a future supplemental indenture to the Indenture ("Future Supplemental Indenture")).

---

The Company has duly authorized the execution and delivery of this First Supplemental Indenture to provide for the issuance of the Notes and all acts and things necessary to make this First Supplemental Indenture a valid, binding, and legal obligation of the Company and to constitute a valid agreement of the Company, in accordance with its terms, have been done and performed.

NOW, THEREFORE, for and in consideration of the premises and the purchase of the Notes by the Holders thereof, it is mutually agreed, for the equal and proportionate benefit of all Holders of the Notes, as follows:

## ARTICLE I
## TERMS OF THE NOTES

**Section 1.01** **Terms of the Notes.** The following terms relating to the Notes are hereby established:

(a) The Notes shall constitute a series of Senior Securities having the title "[___]% Senior Notes due 2019." The Notes shall bear a CUSIP number of [_____] and an ISIN number of [_____].

(b) The aggregate principal amount of the Notes that may be initially authenticated and delivered under the Indenture (except for Notes authenticated and delivered upon registration of, transfer of, or in exchange for, or in lieu of, other Notes pursuant to Sections 304, 305, 306, 906, 1107 or 1305 of the Base Indenture, and except for any Securities that, pursuant to Section 303 of the Base Indenture, are deemed never to have been authenticated and delivered under the Indenture) shall be up to $34,500,000. Under a Board Resolution, Officers' Certificate pursuant to Board Resolutions or an indenture supplement, the Company may from time to time, without the consent of the Holders of Notes, issue additional Notes (in any such case "Additional Notes") having the same ranking and the same interest rate, maturity and other terms as the Notes. Any Additional Notes and the existing Notes will constitute a single series under the Indenture and all references to the relevant Notes herein shall include the Additional Notes unless the context otherwise requires.

(c) The entire outstanding principal of the Notes shall be payable on September 30, 2019.

(d) The rate at which the Notes shall bear interest shall be [___]% per annum (the "Applicable Interest Rate"). The date from which interest shall accrue on the Notes shall be October [__], 2012, or the most recent Interest Payment Date to which interest has been paid or provided for; the Interest Payment Dates for the Notes shall be March 30, June 30, September 30 and December 30 of each year, commencing December 30, 2012 (if an Interest Payment Date falls on a day that is not a Business Day, then the applicable interest payment will be made on the next succeeding Business Day and no additional interest will accrue as a result of such delayed payment); the initial interest period will be the period from and including October [__], 2012, to, but excluding, the initial Interest Payment Date, and the subsequent interest periods will be the periods from and including an Interest Payment Date to, but excluding, the next Interest Payment Date or the Stated Maturity, as the case may be; the interest so payable, and punctually paid or duly provided for, on any Interest Payment Date, will be paid to the Person in whose name the Note (or one or more Predecessor Securities) is registered at the close of business on the Regular Record Date for such interest, which shall be March 15, June 15, September 15 and December 15 (whether or not a Business Day), as the case may be, next preceding such Interest Payment Date. Payment of principal of (and premium, if any, on) and any such interest on the Notes will be made at the office of the Trustee located at 100 Wall Street, Suite 1600, New York, New York, 10005, Attention: KCAP Financial, Inc. ([____]% Senior Notes Due 2019) and at such other address as designated by the Trustee, in such coin or currency of the United States of America as at the time of payment is legal tender for payment of public and private debts; *provided, however*, that at the option of the Company payment of interest may be made by check mailed to the address of the Person entitled thereto as such address shall appear in the Security Register; *provided, further, however*, that so long as the Notes are registered to Cede & Co., such payment will be made by wire transfer in accordance with the procedures established by The Depository Trust Company and the Trustee. Interest on the Notes will be computed on the basis of a 360-day year of twelve 30-day months.

(e) The Notes shall be initially issuable in global form (each such Note, a "Global Note"). The Global Notes and the Trustee's certificate of authentication thereon shall be substantially in the form of Exhibit A to this First Supplemental Indenture. Each Global Note shall represent the outstanding Notes as shall be specified therein and each shall provide that it shall represent the aggregate amount of outstanding Notes from time to time endorsed thereon and that the aggregate amount of outstanding Notes represented thereby may from time to time be reduced or increased, as appropriate, to reflect exchanges and redemptions. Any endorsement of a Global Note to reflect the amount of any increase or decrease in the amount of outstanding Notes represented thereby shall be made by the Trustee or the Security Registrar, in accordance with Sections 203 and 305 of the Base Indenture.

(f) The depositary for such Global Notes (the "Depositary") shall be The Depository Trust Company, New York, New York. The Security Registrar with respect to the Global Notes shall be the Trustee.

(g) The Notes shall be defeasible pursuant to Section 1402 or Section 1403 of the Base Indenture. Covenant defeasance contained in Section 1403 of the Base Indenture shall apply to the covenants contained in Sections 1006, 1008 and 1010 of the Indenture.

(h) The Notes shall be redeemable pursuant to Section 1101 of the Base Indenture and as follows:

(i) The Notes will be redeemable in whole or in part at any time or from time to time, at the option of the Company, on or after September 30, 2015, at a redemption price equal to 100% of the outstanding principal amount thereof, plus accrued and unpaid interest payments otherwise payable for the then-current quarterly interest period accrued to, but excluding, the date fixed for redemption.

(ii) Notice of redemption shall be given in writing and mailed, first-class postage prepaid or by overnight courier guaranteeing next-day delivery, to each Holder of the Notes to be redeemed, not less than thirty (30) nor more than sixty (60) days prior to the Redemption Date, at the Holder's address appearing in the Security Register. All notices of redemption shall contain the information set forth in Section 1104 of the Base Indenture.

(iii) Any exercise of the Company's option to redeem the Notes will be done in compliance with the Investment Company Act, to the extent applicable.

(iv) If the Company elects to redeem only a portion of the Notes, the Trustee will determine the method for selecting the particular Notes to be redeemed, in accordance with Section 1103 of the Base Indenture and the Investment Company Act, to the extent applicable.

(v) Unless the Company defaults in payment of the Redemption Price, on and after the Redemption Date, interest will cease to accrue on the Notes called for redemption hereunder.

(i) The Notes shall not be subject to any sinking fund pursuant to Section 1201 of the Base Indenture.

(j) The Notes shall be issuable in denominations of $25 and integral multiples of $25 in excess thereof.

(k) Holders of the Notes will not have the option to have the Notes repaid prior to the Stated Maturity.

(l) The Notes are hereby designated as "Senior Securities" under the Indenture.

## ARTICLE II
## DEFINITIONS AND OTHER PROVISIONS OF GENERAL APPLICATION

**Section 2.01** Except as may be provided in a Future Supplemental Indenture, for the benefit of the Holders of the Notes but no other series of Securities under the Indenture, whether now or hereafter issued and Outstanding, Article I of the Base Indenture shall be amended by adding the following defined terms to Section 101 in appropriate alphabetical sequence, as follows:

"'Exchange Act' means the Securities Exchange Act of 1934, as amended, and any statute successor thereto."

"'GAAP' means generally accepted accounting principles in the United States set forth in the opinions and pronouncements of the Accounting Principles Board of the American Institute of Certified Public Accountants, the opinions and pronouncements of the Public Company Accounting Oversight Board and the statements and pronouncements of the Financial Accounting Standards Board or in such other statements by such other entity as have been approved by a significant segment of the accounting profession in the United States, which are in effect from time to time."

"'Investment Company Act' means the Investment Company act of 1940, as amended, and the rules, regulations and interpretations promulgated thereunder, to the extent applicable, and any statute successor thereto."

**ARTICLE III**
**REMEDIES**

**Section 3.01** Except as may be provided in a Future Supplemental Indenture, for the benefit of the Holders of the Notes but no other series of Securities under the Indenture, whether now or hereafter issued and Outstanding, Section 501 of the Base Indenture shall be amended by adding the following new clauses (9) and (10) thereto, each as set forth below:

"(9) default by the Company or any Significant Subsidiary of the Company with respect to any mortgage, agreement or other instrument under which there may be outstanding, or by which there may be secured or evidenced, any indebtedness for money borrowed in excess of $10 million in the aggregate of the Company and/or any such Significant Subsidiary, whether such indebtedness now exists or shall hereafter be created (i) resulting in such indebtedness becoming or being declared due and payable or (ii) constituting a failure to pay the principal or interest of any such debt when due and payable at its stated maturity, upon required repurchase, upon declaration of acceleration or otherwise, and, in each of case (i) and (ii), such default is not cured within 30 days;"

"(10) a final judgment for the payment of $15 million or more (excluding any amounts covered by insurance) rendered against the Company or any Significant Subsidiary of the Company, which judgment is not discharged or stayed within 60 days after (i) the date on which the right to appeal such final judgment has expired if no such appeal has commenced or (ii) the date on which all rights to appeal have ben extinguished."

**Section 3.02** Except as may be provided in a Future Supplemental Indenture, for the benefit of the Holders of the Notes but no other series of Securities under the Indenture, whether now or hereafter issued and Outstanding, Section 502 of the Base Indenture shall be amended by replacing the first paragraph thereof with the following:

"If an Event of Default (other than an Event of Default under Section 501(5) or Section 501(6)) with respect to the Notes at the time Outstanding occurs and is continuing, then and in every case the Trustee or the Holders of not less than 25% in principal amount of the Outstanding Notes may (and the Trustee shall at the request of such Holders) declare the principal of all the Notes to be due and payable immediately, by a notice in writing to the Company (and to the Trustee if given by the Holders), and upon any such declaration such principal or specified portion thereof shall become immediately due and payable. If an Event of Default under Section 501(5) or Section 501(6) occurs, the entire principal amount of all the Notes will automatically become due and immediately payable."

**ARTICLE IV**
**COVENANTS**

**Section 4.01** Except as may be provided in a Future Supplemental Indenture, for the benefit of the Holders of the Notes but no other series of Securities under the Indenture, whether now or hereafter issued and Outstanding, Article X of the Base Indenture shall be amended by adding the following new Sections 1008, 1009 and 1010 thereto, each as set forth below:

"Section 1008. Section 18(a)(1)(A) of the Investment Company Act.

The Company hereby agrees that for the period of time during which Notes are Outstanding, the Company will not violate (whether or not it is subject to) Section 18(a)(1)(A) as modified by Section 61(a)(1) of the Investment Company Act or any successor provisions thereto of the Investment Company Act, giving effect to any exemptive relief granted to the Company by the Commission (even if the Company is no longer subject to such provisions of the Investment Company Act)."

"Section 1009. Section 18(a)(1)(B) of the Investment Company Act.

The Company hereby agrees that for the period of time during which Notes are Outstanding, pursuant to Section 18(a)(1)(B) as modified by Section 61(a)(1) of the Investment Company Act or any successor provisions thereto of the Investment Company Act, the Company will not declare any dividend (except a dividend payable in stock of the issuer), or declare any other distribution, upon a class of the capital stock of the Company, or purchase any such capital stock, unless, in every such case, at the time of the declaration of any such dividend or distribution, or at the time of any such purchase, the Company has an asset coverage (as defined in the Investment Company Act) of at least 200 per centum after deducting the amount of such dividend, distribution or purchase price, as the case may be, giving effect to any exemptive relief granted to the Company by the Commission."

"Section 1010. Commission Reports and Reports to Holders.

If, at any time, the Company is not subject to the reporting requirements of Sections 13 or 15(d) of the Exchange Act to file any periodic reports with the Securities and Exchange Commission, the Company agrees to furnish to the Holders of Notes and the Trustee for the period of time during which the Notes are Outstanding: (i) within 90 days after the end of the each fiscal year of the Company, audited annual consolidated financial statements of the Company and (ii) within 45 days after the end of each fiscal quarter of the Company (other than the Company's fourth fiscal quarter), unaudited interim consolidated financial statements of the Company. All such financial statements shall be prepared, in all material respects, in accordance with GAAP."

## ARTICLE V
## MEETINGS OF HOLDERS OF SECURITIES

**Section 5.01** Except as may be provided in a Future Supplemental Indenture, for the benefit of the Holders of the Notes but no other series of Securities under the Indenture, whether now or hereafter issued and Outstanding, Section 1505 of the Base Indenture shall be amended by replacing clause (c) thereof with the following:

"(c) At any meeting of Holders, each Holder of a Security of such series or proxy shall be entitled to one vote for each $25.00 principal amount of the Outstanding Securities of such series held or represented by such Holder; provided, however, that no vote shall be cast or counted at any meeting in respect of any Security challenged as not Outstanding and ruled by the chairman of the meeting to be not Outstanding. The chairman of the meeting shall have no right to vote, except as a Holder of a Security of such series or proxy."

## ARTICLE VI
## MISCELLANEOUS

**Section 6.01** This First Supplemental Indenture and the Notes shall be governed by and construed in accordance with the law of the State of New York, without regard to principles of conflicts of laws. This First Supplemental Indenture is subject to the provisions of the Trust Indenture Act that are required to be part of the Indenture and shall, to the extent applicable, be governed by such provisions.

**Section 6.02** In case any provision in this First Supplemental Indenture or in the Notes shall be invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby.

**Section 6.03** This First Supplemental Indenture may be executed in counterparts, each of which will be an original, but such counterparts will together constitute but one and the same First Supplemental Indenture. The exchange of copies of this First Supplemental Indenture and of signature pages by facsimile, .pdf transmission, email or other electronic means shall constitute effective execution and delivery of this First Supplemental Indenture for all purposes. Signatures of the parties hereto transmitted by facsimile, .pdf transmission, email or other electronic means shall be deemed to be their original signatures for all purposes.

**Section 6.04** The Base Indenture, as supplemented and amended by this First Supplemental Indenture, is in all respects ratified and confirmed, and the Base Indenture and this First Supplemental Indenture shall be read, taken and construed as one and the same instrument with respect to the Notes. All provisions included in this First Supplemental Indenture supersede any conflicting provisions included in the Base Indenture with respect to the Notes, unless not permitted by law. The Trustee accepts the trusts created by the Base Indenture, as supplemented by this First Supplemental Indenture, and agrees to perform the same upon the terms and conditions of the Base Indenture, as supplemented by this First Supplemental Indenture.

**Section 6.05** The provisions of this First Supplemental Indenture shall become effective as of the date hereof.

**Section 6.06** Notwithstanding anything else to the contrary herein, the terms and provisions of this First Supplemental Indenture shall apply only to the Notes and shall not apply to any other series of Securities under the Indenture and this First Supplemental Indenture shall not and does not otherwise affect, modify, alter, supplement or change the terms and provisions of any other series of Securities under the Indenture, whether now or hereafter issued and Outstanding.

**Section 6.07** The recitals contained herein and in the Notes shall be taken as the statements of the Company, and the Trustee assumes no responsibility for their correctness. The Trustee makes no representations as to the validity or sufficiency of this First Supplemental Indenture, the Notes or any Additional Notes, except that the Trustee represents that it is duly authorized to execute and deliver this First Supplemental Indenture, authenticate the Notes and any Additional Notes and perform its obligations hereunder. The Trustee shall not be accountable for the use or application by the Company of the Notes or any Additional Notes or the proceeds thereof.

IN WITNESS WHEREOF, the parties hereto have caused this First Supplemental Indenture to be duly executed as of the date first above written.

KCAP FINANCIAL, INC.

By: _____
Name:
Title:

U.S. BANK NATIONAL ASSOCIATION, as Trustee

By: _____
Name:
Title:

*[Signature page to First Supplemental Indenture]*

**Exhibit A – Form of Global Note**

**This Security is a Global Note within the meaning of the Indenture hereinafter referred to and is registered in the name of The Depository Trust Company or a nominee thereof. This Security may not be exchanged in whole or in part for a Security registered, and no transfer of this Security in whole or in part may be registered, in the name of any Person other than The Depository Trust Company or a nominee thereof, except in the limited circumstances described in the Indenture.**

**Unless this certificate is presented by an authorized representative of The Depository Trust Company to the issuer or its agent for registration of transfer, exchange or payment and such certificate issued in exchange for this certificate is registered in the name of Cede & Co., or such other name as requested by an authorized representative of The Depository Trust Company, any transfer, pledge or other use hereof for value or otherwise by or to any person is wrongful, as the registered owner hereof, Cede & Co., has an interest herein.**

**KCAP Financial, Inc.**

No.

$
CUSIP No. [_____]
ISIN No. [_____]

[___]% Senior Notes due 2019

KCAP Financial, Inc., a corporation duly organized and existing under the laws of Delaware (herein called the "Company", which term includes any successor Person under the Indenture hereinafter referred to), for value received, hereby promises to pay to Cede & Co., or registered assigns, the principal sum of [_____] U.S. DOLLARS (U.S.$[ ]) on September 30, 2019 and to pay interest thereon from October [__], 2012 or from the most recent Interest Payment Date to which interest has been paid or duly provided for, quarterly on March 30, June 30, September 30 and December 30 in each year, commencing December 30, 2012, at the rate of [___]% per annum, until the principal hereof is paid or made available for payment. The interest so payable, and punctually paid or duly provided for, on any Interest Payment Date will, as provided in such Indenture, be paid to the Person in whose name this Security is registered at the close of business on the Regular Record Date for such interest, which shall be March 15, June 15, September 15 and December 15 (whether or not a Business Day), as the case may be, next preceding such Interest Payment Date. Any such interest not so punctually paid or duly provided for will forthwith cease to be payable to the Holder on such Regular Record Date and may either be paid to the Person in whose name this Security is registered at the close of business on a Special Record Date for the payment of such Defaulted Interest to be fixed by the Trustee, notice whereof shall be given to Holders of Securities of this series not less than 10 days prior to such Special Record Date, or be paid at any time in any other lawful manner not inconsistent with the requirements of any securities exchange on which the Securities of this series may be listed, and upon such notice as may be required by such exchange, all as more fully provided in said Indenture. This Security may be issued as part of a series.

Payment of the principal of (and premium, if any, on) and any such interest on this Security will be made at the office of the Trustee located at 100 Wall Street, Suite 1600, New York, New York, 10005, Attention: KCAP Financial, Inc. ([___]% Senior Notes Due 2019) and at such other address as designated by the Trustee, in such coin or currency of the United States of America as at the time of payment is legal tender for payment of public and private debts; *provided*, *however*, that at the option of the Company payment of interest may be made by check mailed to the address of the Person entitled thereto as such address shall appear in the Security Register; *provided, further, however*, that so long as this Security is registered to Cede & Co., such payment will be made by wire transfer in accordance with the procedures established by The Depository Trust Company and the Trustee.

Reference is hereby made to the further provisions of this Security set forth on the reverse hereof, which further provisions shall for all purposes have the same effect as if set forth at this place.

Unless the certificate of authentication hereon has been executed by the Trustee referred to on the reverse hereof by manual signature, this Security shall not be entitled to any benefit under the Indenture or be valid or obligatory for any purpose.

IN WITNESS WHEREOF, the Company has caused this instrument to be duly executed.

Dated:

KCAP FINANCIAL, INC.

By: _____
Name:
Title:

Attest

By: _____
Name:
Title:

This is one of the Securities of the series designated therein referred to in the within-mentioned Indenture.

Dated:

U.S. BANK NATIONAL ASSOCIATION
as Trustee

By: _____
Authorized Signatory

**KCAP Financial, Inc.**
[___]% Senior Notes due 2019

This Security is one of a duly authorized issue of Senior Securities of the Company (herein called the "Securities"), issued and to be issued in one or more series under an Indenture, dated as of October [__], 2012 (herein called the "Base Indenture", which term shall have the meaning assigned to it in such instrument), between the Company and U.S. Bank National Association, as Trustee (herein called the "Trustee", which term includes any successor trustee under the Base Indenture), and reference is hereby made to the Base Indenture for a statement of the respective rights, limitations of rights, duties and immunities thereunder of the Company, the Trustee, and the Holders of the Securities and of the terms upon which the Securities are, and are to be, authenticated and delivered, as supplemented by the First Supplemental Indenture relating to the Securities, dated October [__], 2012, by and between the Company and the Trustee (herein called the "First Supplemental Indenture", the First Supplemental Indenture and the Base Indenture collectively are herein called the "Indenture"). In the event of any conflict between the Base Indenture and the First Supplemental Indenture, the First Supplemental Indenture shall govern and control.

This Security is one of the series designated on the face hereof, initially limited in aggregate principal amount to $34,500,000. Under a Board Resolution, Officers' Certificate pursuant to Board Resolutions or an indenture supplement, the Company may from time to time, without the consent of the Holders of Securities, issue additional Securities of this series (in any such case "Additional Securities") having the same ranking and the same interest rate, maturity and other terms as the Securities. Any Additional Securities and the existing Securities will constitute a single series under the Indenture and all references to the relevant Securities herein shall include the Additional Securities unless the context otherwise requires. The aggregate amount of outstanding Securities represented hereby may from time to time be reduced or increased, as appropriate, to reflect exchanges and redemptions.

The Securities of this series are subject to redemption in whole or in part at any time or from time to time, at the option of the Company, on or after September 30, 2015, at a redemption price per security equal to 100% of the outstanding principal amount theref plus accrued and unpaid interest payments otherwise payable for the then-current quarterly interest period accrued to the date fixed for redemption.

Notice of redemption shall be given in writing and mailed, first-class postage prepaid or by overnight courier guaranteeing next-day delivery, to each Holder of the Securities to be redeemed, not less than thirty (30) nor more than sixty (60) days prior to the Redemption Date, at the Holder's address appearing in the Security Register. All notices of redemption shall contain the information set forth in Section 1104 of the Base Indenture.

Any exercise of the Company's option to redeem the Securities will be done in compliance with the Investment Company Act, to the extent applicable.

If the Company elects to redeem only a portion of the Securities, the Trustee or the Depositary, as applicable, will determine the method for selecting the particular Securities to be redeemed, in accordance with their standard operating procedures and the Investment Company Act, to the extent applicable. In the event of redemption of this Security in part only, a new Security or Securities of this series and of like tenor for the unredeemed portion hereof will be issued in the name of the Holder hereof upon the cancellation hereof.

Unless the Company defaults in payment of the Redemption Price, on and after the Redemption Date, interest will cease to accrue on the Notes called for redemption.

Holders of Securities do not have the option to have the Securities repaid prior to September 30, 2019.

The Indenture contains provisions for defeasance at any time of the entire indebtedness of this Security or certain restrictive covenants and Events of Default with respect to this Security, in each case upon compliance with certain conditions set forth in the Indenture.

If an Event of Default with respect to Securities of this series shall occur and be continuing, the principal of the Securities of this series may be declared due and payable in the manner and with the effect provided in the Indenture.

The Indenture permits, with certain exceptions as therein provided, the amendment thereof and the modification of the rights and obligations of the Company and the rights of the Holders of the Securities of each series to be affected under the Indenture at any time by the Company and the Trustee with the consent of the Holders of not less than a majority in principal amount of the Securities at the time Outstanding of each series to be affected. The Indenture also contains provisions permitting the Holders of specified percentages in principal amount of the Securities of each series at the time Outstanding, on behalf of the Holders of all Securities of such series, to waive compliance by the Company with certain provisions of the Indenture and certain past defaults under the Indenture and their consequences. Any such consent or waiver by the Holder of this Security shall be conclusive and binding upon such Holder and upon all future Holders of this Security and of any Security issued upon the registration of transfer hereof or in exchange herefor or in lieu hereof, whether or not notation of such consent or waiver is made upon this Security.

As provided in and subject to the provisions of the Indenture, the Holder of this Security shall not have the right to institute any proceeding with respect to the Indenture or for the appointment of a receiver or trustee or for any other remedy thereunder, unless such Holder shall have previously given the Trustee written notice of a continuing Event of Default (other than an Event of Default under Section 501(5) or Section 501(6) of the Indenture) with respect to the Securities of this series, the Holders of not less than 25% in principal amount of the Securities of this series at the time Outstanding shall have made written request to the Trustee to institute proceedings in respect of such Event of Default as Trustee and offered the Trustee indemnity reasonably satisfactory to the Trustee against the costs, expenses and liabilities to be incurred in compliance with such request, and the Trustee shall not have received from the Holders of a majority in principal amount of Securities of this series at the time Outstanding a direction inconsistent with such request, and shall have failed to institute any such proceeding, for sixty (60) days after receipt of such notice, request and offer of indemnity. The foregoing shall not apply to any suit instituted by the Holder of this Security for the enforcement of any payment of principal hereof or any premium or interest hereon on or after the respective due dates expressed herein. If an Event of Default under Section 501(5) or Section 5010(6) of the Indenture occurs the entire principal amount of the Securities of this series will automatically become due and immediately payable.

No reference herein to the Indenture and no provision of this Security or of the Indenture shall alter or impair the obligation of the Company, which is absolute and unconditional, to pay the principal of and any premium and interest on this Security at the times, place and rate, and in the coin or currency, herein prescribed.

As provided in the Indenture and subject to certain limitations therein set forth, the transfer of this Security is registrable in the Security Register, upon surrender of this Security for registration of transfer at the office or agency of the Company in any place where the principal of and any premium and interest on this Security are payable, duly endorsed by, or accompanied by a written instrument of transfer in form satisfactory to the Company and the Security Registrar duly executed by, the Holder hereof or his attorney duly authorized in writing, and thereupon one or more new Securities of this series and of like tenor, of authorized denominations and for the same aggregate principal amount, will be issued to the designated transferee or transferees.

The Securities of this series are issuable only in registered form without coupons in denominations of $25 and any integral multiples of $25 in excess thereof. As provided in the Indenture and subject to certain limitations therein set forth, Securities of this series are exchangeable for a like aggregate principal amount of Securities of this series and of like tenor of a different authorized denomination, as requested by the Holder surrendering the same.

No service charge shall be made for any such registration of transfer or exchange, but the Company or Trustee may require payment of a sum sufficient to cover any tax or other governmental charge payable in connection therewith.

Prior to due presentment of this Security for registration of transfer, the Company, the Trustee and any agent of the Company or the Trustee may treat the Person in whose name this Security is registered as the owner hereof for all purposes, whether or not this Security be overdue, and neither the Company, the Trustee nor any such agent shall be affected by notice to the contrary.

All terms used in this Security which are defined in the Indenture shall have the meanings assigned to them in the Indenture.

The Indenture and this Security shall be governed by and construed in accordance with the laws of the State of New York, without regard to principles of conflicts of laws.

**Exhibit h.1**

$[ ] Aggregate Principal Amount Senior Notes due 20[ ]

UNDERWRITING AGREEMENT

New York, New York

[ ], 2012

Stifel, Nicolaus & Company, Incorporated
As Representative of the several Underwriters

c/o Stifel, Nicolaus & Company, Incorporated
501 N. Broadway
St. Louis, Missouri 63102

Ladies and Gentlemen:

KCAP Financial, Inc., a Delaware corporation (the "Company"), confirms its agreement with Stifel, Nicolaus & Company, Incorporated and each of the other Underwriters named in Schedule A hereto (collectively, the "Underwriters", which term shall also include any underwriter substituted as hereinafter provided in Section 9 hereof), for whom Stifel, Nicolaus & Company, Incorporated is acting as representative (in such capacity, the "Representative"), with respect to the issue and sale by the Company and the purchase by the Underwriters, acting severally and not jointly, of $[ ] aggregate principal amount of senior notes due 20[ ] (the "Securities") of the Company, and with respect to the grant by the Company to the Underwriters, acting severally and not jointly, of the option described in Section 2(b) hereof to purchase additional Securities (as hereinafter defined). The Securities will be issued under an indenture dated as of [ ], 2012, between the Company and U.S. Bank National Association, as trustee (the "Trustee"), as supplemented by a Supplemental Indenture, dated as of [ ], 2012 (collectively, the "Indenture") between the Company and the Trustee. The aforesaid Securities (the "Initial Securities") to be purchased by the Underwriters and all or any part of the Securities subject to the option described in Section 2(b) hereof (the "Option Securities") are hereinafter called, collectively, the "Underwritten Securities". Securities issued in book-entry form will be issued to Cede & Co. as nominee of the Depository Trust Company ("DTC") pursuant to a blanket letter of representations, to be dated on or prior to the Initial Delivery Date (as defined below) (the "DTC Agreement"), between the Company and DTC.

The Company understands that the Underwriters propose to make a public offering of the Underwritten Securities as soon as the Representative deems advisable after this Agreement has been executed and delivered.

The Company has filed with the Securities and Exchange Commission (the "Commission") a registration statement on Form N-2 (File No. 333-183032), covering the registration of the Underwritten Securities under the Securities Act of 1933, as amended (the "Securities Act"), which registration statement has been declared effective by the Commission (the date and time as of which the Registration Statement was declared effective by the Commission, the "Effective Date"). The Indenture has been qualified under the Trust Indenture Act of 1939, as amended (the "Trust Indenture Act"). The Company's preliminary prospectus, subject to completion, dated October [ ], 2012, relating to the Underwritten Securities, that was used after the Effective Date and prior to the execution and delivery of this Agreement is referred to herein as the "Preliminary Prospectus." Promptly after execution and delivery of this Agreement, the Company will prepare and file a prospectus in accordance with the provisions of Rule 430A ("Rule 430A") of the rules and regulations of the Commission under the Securities Act (the "Securities Act Rules and Regulations") and Rule 497 of the Securities Act Rules and Regulations. The information included in such prospectus that was omitted from such registration statement at the time it became effective but that is deemed to be part of such registration statement pursuant to Rule 430A of the Securities Act Rules and Regulations is referred to as "Rule 430A Information." Unless the context otherwise requires, such registration statement, including all documents filed as a part thereof, and including any Rule 430A Information contained in a prospectus subsequently filed with the Commission pursuant to Rule 497 of the Securities Act Rules and Regulations and deemed to be part of the registration statement and also including any registration statement filed pursuant to Rule 462(b) of the Securities Act Rules and Regulations (the "Rule 462(b) Registration Statement"), is herein called the "Registration Statement." The final prospectus in the form filed by the Company with the Commission pursuant to Rule 497 of the Securities Act Rules and Regulations on or before the second business day after the date hereof (or such earlier time as may be required under the Securities Act), is herein called the "Prospectus." For purposes of this Agreement, all references to the Registration Statement, the Preliminary Prospectus, the Prospectus or any amendment or supplement to any of the foregoing shall be deemed to include the copy filed with the Commission pursuant to its Electronic Data Gathering, Analysis and Retrieval system ("EDGAR").

A Form N-54A Notification of Election to be Subject to Sections 55 through 65 of the Investment Company Act of 1940 filed Pursuant to Section 54(a) of the Investment Company Act (File No. 814-00735) (the "Notification of Election") was filed by the Company with the Commission on December 5, 2006 under the Investment Company Act of 1940, as amended, and the rules and regulations thereunder (collectively, the "Investment Company Act").

1. Representations and Warranties

(a) The Company represents and warrants to each Underwriter as of the date hereof, as of the Applicable Time referred to in Section 1(a)(i) hereof and as of each Delivery Date referred to in Section 4(b) hereof, and agrees with each Underwriter, as follows:

(i) The Company is eligible to use Form N-2. The Registration Statement (and the Registration Statement as amended by any post-effective amendment if the Company shall have made any amendments thereto after the effective date of the Registration Statement) has become effective under the Securities Act and no stop order suspending the effectiveness of the Registration Statement (and the Registration Statement as amended by any post-effective amendment if the Company shall have made any amendments thereto after the effective date of the Registration Statement) has been issued under the Securities Act and no proceedings for that purpose have been instituted or are pending or, to the knowledge of the Company, have been threatened by the Commission, and any request on the part of the Commission for additional information has been complied with. At the respective times the Registration Statement, the Rule 462(b) Registration Statement, if any, and any post-effective amendments thereto became effective, at the Applicable Time and at each applicable Delivery Date, the Registration Statement complied and will comply in all material respects with the requirements of the Securities Act, the Securities Act Rules and Regulations and the Investment Company Act and did not and will not contain an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein not misleading. Neither the Prospectus nor any amendments or supplements thereto (including any prospectus wrapper), at the time the Prospectus or any such amendment or supplement was issued, and at each applicable Delivery Date, included or will include an untrue statement of a material fact or omitted or will omit to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading. The Prospectus and the Preliminary Prospectus complied when so filed in all material respects with the Securities Act, the Securities Act Rules and Regulations and the Investment Company Act except for any corrections to the Preliminary Prospectus that are made in the Prospectus and the Preliminary Prospectus and the Prospectus delivered to the Underwriters for use in connection with this offering was identical to the electronically transmitted copies thereof filed with the Commission pursuant to EDGAR, except to the extent permitted by Regulation S-T. As of the Applicable Time, the Preliminary Prospectus, together with the information included on Schedule B hereto (which information the Representative has informed the Company is being conveyed orally by the Underwriters to prospective purchasers at or prior to the Underwriters' confirmation of sales of Underwritten Securities in the offering), all considered together (collectively, the "General Disclosure Package"), did not include any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading. As used in this subsection and elsewhere in this Agreement, "Applicable Time" means [ ] (Eastern time) on [ ], 2012 or such other time as agreed by the Company and the Representative. The representations and warranties in this subsection shall not apply to statements in or omissions from the Registration Statement, the Preliminary Prospectus, the part of the Registration Statement that constitutes the Statement of Eligibility and Qualification under the Trustee Indenture Act (Form T-1) of the Trustee under the Indenture (the "Trustee Eligibility Statement"), the Prospectus (or any amendment or supplement thereto) or the General Disclosure Package made in reliance upon and in conformity with written information furnished to the Company by any Underwriter through the Representative expressly for use in the Registration Statement (or any amendment thereto), the Preliminary Prospectus, the Prospectus (or any amendment or supplement thereto), the Trustee Eligibility Statement (or any amendment or supplement thereto) or the General Disclosure Package.

(ii) Any written materials provided to investors by, or with the prior written approval of, the Company specifically for use in any roadshow or investor presentations made to investors by the Company in connection with the marketing of the offering of the Underwritten Securities (whether in person or electronically) (collectively, the "Marketing Materials"), considered together with the General Disclosure Package, do not contain an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading. All Marketing Materials complied and will comply in all material respects with the applicable requirements of the Securities Act, the Securities Act Rules and Regulations, the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the rules and regulations of the Commission under the Exchange Act (the "Exchange Act Rules and Regulations"; the Exchange Act Rules and Regulations and the Securities Act Rules and Regulations, collectively, the "Rules and Regulations"), the Investment Company Act and the rules and interpretations of the Financial Industry Regulatory Authority (the "FINRA").

(iii) The Commission has not issued any order preventing or suspending the use of the Preliminary Prospectus or the Prospectus or suspended the effectiveness of the Registration Statement, and no proceeding or examination for such purpose has been instituted or, to the knowledge of the Company, threatened by the Commission.

(iv) [Reserved].

(v) The Company has been duly organized, is validly existing and is in good standing as a corporation in the State of Delaware and is duly qualified to do business and in good standing as a foreign corporation in each jurisdiction in which its ownership or lease of property or the conduct of its businesses requires such qualification, except where the failure to be so qualified or in good standing would not, in the aggregate, reasonably be expected to have a material adverse effect on the condition (financial or otherwise), results of operations, stockholders' equity, prospects, properties or business of the Company (a "Material Adverse Effect"); the Company has all corporate power and authority necessary to own or hold its properties and to conduct the businesses in which it is engaged.

(vi) The Company's only subsidiaries and/or wholly-owned portfolio companies are listed on Exhibit I hereto (each, a "Subsidiary" and collectively, the "Subsidiaries"). Each of the Subsidiaries has been duly organized, is validly existing in good standing under the laws of the jurisdiction of its incorporation or organization and is duly qualified to do business and in good standing as a foreign corporation in each jurisdiction in which its ownership or lease of property or the conduct of its businesses requires such qualification, except where the failure to be so qualified or in good standing would not, in the aggregate, reasonably be expected to have a Material Adverse Effect; the Subsidiaries the power and authority, corporate or otherwise, necessary to own or hold their properties and to conduct the businesses in which they are engaged.

(vii) The Company has an authorized capitalization as set forth in the Registration Statement, the General Disclosure Package and the Prospectus under the caption "Capitalization," and all of the issued shares of capital stock of the Company have been duly authorized and validly issued, are fully paid and non-assessable, and were issued in compliance with federal and state securities laws and not in violation of any preemptive right, resale right, right of first refusal or similar right. All of the capital stock or limited liability company interests of the Subsidiaries have been duly authorized and validly issued, are fully paid and non-assessable and are owned directly or indirectly by the Company, free and clear of all liens, encumbrances, equities or claims, except for such liens, encumbrances, equities or claims as would not, in the aggregate, reasonably be expected to have a Material Adverse Effect.

(viii) The Underwritten Securities being sold pursuant to this Agreement have been duly authorized for issuance and sale to the Underwriters pursuant to this agreement (this "Agreement") and, when duly executed, issued, authenticated and delivered, against payment of the consideration therefor in accordance with this Agreement, will be valid and legally binding obligations of the Company enforceable in accordance with their terms (subject, as to the enforcement of remedies, to applicable bankruptcy, reorganization, insolvency, moratorium or other laws affecting creditors' rights generally from time to time in effect and to general principles of equity regardless of whether in a proceeding at equity or at law), and will be entitled to the benefits of the Indenture; and the Underwritten Securities and the Indenture conform in all material respects to the statements relating thereto contained in the General Disclosure Package and the Prospectus.

(ix) The Company has all requisite corporate power and authority to execute, deliver and perform its obligations under this Agreement, the Indenture, the Underwritten Securities and the DTC Agreement.

(x) (A) This Agreement has been duly authorized, executed and delivered by the Company and constitutes a legal, valid, binding and enforceable instrument of the Company (subject, as to the enforcement of remedies, to applicable bankruptcy, reorganization, insolvency, moratorium or other laws affecting creditors' rights generally from time to time in effect and to general principles of equity regardless of whether in a proceeding at equity or at law). (B) The Indenture has been duly authorized, will be executed and delivered by the Company on the Initial Delivery Date (as defined below) and, when executed and delivered by the Trustee, will constitute a valid and binding obligation of the Company, enforceable against the Company in accordance with its terms (subject, as to the enforcement of remedies, to applicable bankruptcy, reorganization, insolvency, moratorium or other laws affecting creditors' rights generally from time to time in effect and to general principles of equity regardless of whether in a proceeding at equity or at law). (C) The DTC Agreement has been duly authorized, executed and delivered by the Company and constitutes a valid and binding obligation of the Company, enforceable against the Company in accordance with its terms (subject, as to the enforcement of remedies, to applicable bankruptcy, reorganization, insolvency, moratorium or other laws affecting creditors' rights generally from time to time in effect and to general principles of equity regardless of whether in a proceeding at equity or at law).

(xi) The execution, delivery and performance of this Agreement, the Indenture, the Underwritten Securities and the DTC Agreement by the Company, the consummation of the transactions contemplated hereby and thereby and the application of the proceeds from the sale of the Underwritten Securities as described under "Use of Proceeds" in the Registration Statement and the Prospectus will not (A) conflict with or result in a breach or violation of any of the terms or provisions of, impose any lien, charge or encumbrance upon any property or assets of the Company or any of its Subsidiaries, or constitute a default or Repayment Event (as defined below) under, any indenture, mortgage, deed of trust, loan agreement, license or other agreement or instrument to which the Company or its Subsidiaries is a party or by which the Company or its Subsidiaries is bound or to which any of the property or assets of the Company or its Subsidiaries is subject, except for such conflicts, breaches or violations that would not, in the aggregate, reasonably be expected to result in a Material Adverse Effect; (B) result in any violation of the provisions of the charter or bylaws or other organizational documents of the Company or its Subsidiaries; or (C) to the knowledge of the Company, result in any violation of any statute or any order, rule or regulation of any court or governmental agency or body having jurisdiction over the Company or its Subsidiaries or any of their properties or assets. As used herein, a "Repayment Event" means any event or condition which gives the holder of any note, debenture or other evidence of indebtedness (or any person acting on such holder's behalf) the right to require the repurchase, redemption or repayment of all or a portion of such indebtedness by the Company or any of the Subsidiaries.

(xii) No consent, approval, authorization or order of, or filing or registration with, any court or governmental agency or body having jurisdiction over the Company or its Subsidiaries or any of their properties or assets is required to be obtained by the Company for the execution, delivery and performance of this Agreement, the Indenture, the Securities and the DTC Agreement by the Company, the consummation of the transactions contemplated hereby and thereby and the application of the proceeds from the sale of the Underwritten Securities as described under "Use of Proceeds" in the Registration Statement and the Prospectus, except for the registration of the Underwritten Securities under the Securities Act and such consents, approvals, authorizations, registrations or qualifications as may be required under the Exchange Act and applicable state securities laws in connection with the sale of the Underwritten Securities and in connection with the listing of the Underwritten Securities on the New York Stock Exchange (the "NYSE").

(xiii) Except as identified in the Registration Statement and the Prospectus, there are no contracts, agreements or understandings between the Company and any person granting such person the right to require the Company to file a registration statement under the Securities Act with respect to any securities of the Company owned or to be owned by such person or to require the Company to include such securities in the securities registered pursuant to the Registration Statement.

(xiv) The Company has not sold or issued any securities that would be required to be integrated with the sale and delivery of the Underwritten Securities contemplated by this Agreement pursuant to the Securities Act or the Securities Act Rules and Regulations.

(xv) Since June 30, 2012, except as disclosed in the Registration Statement, the General Disclosure Package and the Prospectus, there has not been any material change in the capital stock or short term or long term debt of the Company or its Subsidiaries or any material adverse change, or, to the Company's knowledge, any development involving a prospective material adverse change, in or affecting the condition (financial or otherwise), results of operations, stockholders' equity, prospects, properties, management or business of the Company and its Subsidiaries taken as a whole, in each case except as would not, in the aggregate, reasonably be expected to have a Material Adverse Effect.

(xvi) Since the date as of which information is given in the General Disclosure Package and the Prospectus and except as may otherwise be described in the General Disclosure Package and the Prospectus, the Company has not (A) incurred any material liability or obligation, direct or contingent, other than liabilities and obligations that were incurred in the ordinary course of business; (B) entered into any material transaction not in the ordinary course of business; or (C) declared or paid any dividend on its capital stock.

(xvii) The financial statements (including the related notes and supporting schedules) included in the Registration Statement, the General Disclosure Package and the Prospectus comply as to form in all material respects with the requirements of Regulation S-X under the Securities Act and present fairly the financial condition, results of operations and cash flows of Company at the dates and for the periods indicated and have been prepared in conformity with accounting principles generally accepted in the United States applied on a consistent basis throughout the periods involved. The selected financial information and data included in the Registration Statement, the General Disclosure Package and the Prospectus have been prepared on a basis consistent with that of the books and records of the Company, Katonah Debt Advisors, L.L.C. ("KDA") and Trimaran Advisors, L.L.C. ("Trimaran") , as applicable.

(xviii) Grant Thornton LLP, who has audited certain financial statements of the Company, KDA and Trimaran, whose reports appear in the Registration Statement, the General Disclosure Package and the Prospectus and who have delivered their letter referred to in Section 6(e) hereof, (A) with respect to the Company, are independent public accountants as required by the Securities Act, the Investment Company Act, the Rules and Regulations and the rules of the Public Company Accounting Oversight Board, and (B) with respect to KDA and Trimaran, are independent certified public accountants within the meaning of Rule 101 of the American Institute of Certified Public Accountants' Code of Professional Conduct, and its interpretations and rulings.

(xix) The Company and its Subsidiaries have good and marketable title in fee simple to all real property, have valid rights to lease or otherwise use and have good and marketable title to all personal property owned by them, material to the respective businesses of each of the Company and its Subsidiaries, in each case free and clear of all liens, encumbrances and defects, except such as (A) are described in the Registration Statement and the Prospectus; (B) do not materially interfere with the use made and proposed to be made of such property by the Company and its Subsidiaries; or (C) would not, individually or in the aggregate, reasonably be expected to have a Material Adverse Effect; and all assets held under lease by the Company and its Subsidiaries are held by them under valid, subsisting and enforceable leases, with such exceptions as do not materially interfere with the use made and proposed to be made of such assets by the Company and its Subsidiaries.

(xx) Any statistical and market related data included in the Registration Statement, the General Disclosure Package and the Prospectus are based on or derived from sources that the Company believes to be reliable and accurate.

(xxi) Neither the Company nor any Subsidiary is and, after giving effect to the offering and sale of the Underwritten Securities and the application of the proceeds therefrom as described under "Use of Proceeds" in the Registration Statement and the Prospectus, will be, required to register as a "registered management investment company" under the Investment Company Act.

(xxii) (A) The Company has duly elected to be regulated by the Commission as a business development company ("BDC") under the Investment Company Act and has not withdrawn that election, and no order of suspension or revocation has been issued or proceedings therefor initiated or, to the knowledge of the Company, threatened by the Commission. Subject to the filing of the Registration Statement and the Prospectus, all required action has been taken by the Company under the Securities Act and the Investment Company Act to make the public offering and consummate the sale of the Underwritten Securities as provided in this Agreement; (B) the provisions of the Company's charter and bylaws and the investment objective, policies and restrictions described in the Registration Statement and the Prospectus, assuming they are implemented as described, comply in all material respects with the requirements of the Investment Company Act; and (C) the operations of the Company are in compliance in all material respects with the provisions of the Investment Company Act applicable to BDCs.

(xxiii) When the Notification of Election was filed with the Commission, it (A) contained all statements required to be stated therein in accordance with, and complied in all material respects with the requirements of the Investment Company Act and (B) did not include any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading.

(xxiv) There are no legal or governmental action, suit or proceedings pending to which the Company or its consolidated Subsidiaries is a party or of which any property or assets of the Company or its Subsidiaries is the subject that would be required to be described in the General Disclosure Package or the Prospectus and is not so described or that would, in the aggregate, reasonably be expected to have an adverse effect on the performance of this Agreement, the Indenture or the consummation of the transactions contemplated hereby or thereby; and to the Company's knowledge, no such actions, suits or proceedings are threatened by governmental authorities or others.

(xxv) There are no contracts or other documents of a character required to be described in the Registration Statement, the General Disclosure Package or the Prospectus or to be filed as exhibits to the Registration Statement that are not described and filed as required; and that statements made in the Registration Statement and the Prospectus under the captions "Regulation," "Certain United States Federal Income Tax Considerations" and "Description of the Notes," insofar as they purport to constitute summaries of the terms of statutes, rules or regulations, legal or governmental proceedings or contracts and other documents, constitute accurate summaries of the terms of such statutes, rules and regulations, legal and governmental proceedings and contracts and other documents in all material respects.

(xxvi) Except as described in the Registration Statement, the General Disclosure Package and the Prospectus, no relationship, direct or indirect, exists between or among the Company, on the one hand, and the directors, officers or stockholders of the Company, on the other hand, that is required to be described in the Registration Statement, the General Disclosure Package or the Prospectus which is not so described.

(xxvii) No labor disturbance by the employees of the Company or its Subsidiaries exists or, to the knowledge of the Company, is threatened that would reasonably be expected to have a Material Adverse Effect.

(xxviii) (A) Each "employee benefit plan" (within the meaning of Section 3(3) of the Employee Retirement Security Act of 1974, as amended ("ERISA")) for which the Company or any member of its "Controlled Group" (defined as any organization which is a member of a controlled group of corporations within the meaning of Section 414 of the Internal Revenue Code of 1986, as amended (the "Code"), would have any liability (each a "Plan"), has been maintained in compliance with its terms and with the requirements of all applicable statutes, rules and regulations including ERISA and the Code except where failure to so comply would not reasonably be expected to have Material Adverse Effect; (B) with respect to each Plan subject to Title IV of ERISA (1) no "reportable event" (within the meaning of Section 4043(c) of ERISA) has occurred or is reasonably expected to occur, (2) no "accumulated funding deficiency" (within the meaning of Section 302 of ERISA or Section 412 of the Code), whether or not waived, has occurred or is reasonably expected to occur, (3) the fair market value of the assets under each Plan exceeds the present value of all benefits accrued under such Plan (determined based on those assumptions used to fund such Plan) and (4) neither the Company nor any member of its Controlled Group has incurred, or reasonably expects to incur, any liability under Title IV of ERISA (other than contributions to the Plan or premiums to the Pension Benefit Guaranty Corporation in the ordinary course and without default) in respect of a Plan (including a "multiemployer plan" within the meaning of Section 4001(c)(3) of ERISA)); and (C) each Plan that is intended to be qualified under Section 401(a) of the Code has received a prototype determination or opinion letter to the effect that the form of such Plan is so qualified and the Company and, as to the form of such Plan, the Plan may rely on such letter or opinion (without an individual application) under applicable the rules of the Internal Revenue Service, and, to the knowledge of the Company nothing has occurred, whether by action or by failure to act, which would reasonably be expected to cause the loss of such qualification.

(xxix) The Company and its Subsidiaries have (A) filed all Federal, state, local and foreign tax returns required to be filed through the date hereof, subject to permitted extensions, and all such tax returns are true, complete and correct in all material respects; and (B) paid all material taxes required to be paid, and no tax deficiency has been determined adversely to the Company or its Subsidiaries, nor does the Company or its Subsidiaries have any knowledge of any tax deficiencies that would, in the aggregate, reasonably be expected to have a Material Adverse Effect.

(xxx) Commencing with its short taxable year ended December 31, 2006, the Company has qualified as a regulated investment company ("RIC") (within the meaning of Section 851(a) of the Code) and the Company intends to continue to operate so as to qualify as a RIC.

(xxxi) Neither the Company nor its Subsidiaries (A) is in violation of its charter, bylaws or other organizational documents; (B) is in default, and no event has occurred that, with notice or lapse of time or both, would constitute such a default, in the due performance or observance of any term, covenant or condition contained in any indenture, mortgage, deed of trust, loan agreement, license or other agreement or instrument to which it is a party or by which it is bound or to which any of its properties or assets is subject; or (C) is in violation of any statute or any order, rule or regulation of any court or governmental agency or body having jurisdiction over it or its property or assets or has failed to obtain any license, permit, certificate, franchise or other governmental authorization or permit necessary to the ownership of its property or to the conduct of its business, except in the case of clauses (B) and (C), to the extent any such conflict, breach, violation or default would not, in the aggregate, reasonably be expected to have a Material Adverse Effect.

(xxxii) The Company makes and keeps accurate books and records and the Company maintains effective internal control over financial reporting as defined in Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and a system of internal accounting controls sufficient to provide reasonable assurance that (A) transactions are executed in accordance with management's general or specific authorization; (B) transactions are recorded as necessary to permit preparation of the Company's financial statements in conformity with accounting principles generally accepted in the United States and to maintain accountability for its assets; (C) access to the Company's assets is permitted only in accordance with management's general or specific authorization; and (D) the recorded accountability for the Company's assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to any differences. Since the Company's most recent audited fiscal year, there have been, to the Company's knowledge, no changes in the Company's internal control over financial reporting that could significantly affect internal control over financial reporting, including any corrective actions with regard to significant deficiencies and material weaknesses.

(xxxiii) (A) The Company has established and maintains disclosure controls and procedures (as such term is defined in Rule 13a-15 under the Exchange Act); (B) such disclosure controls and procedures are designed to ensure that the information required to be disclosed by the Company in the reports it will file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms, and is accumulated and communicated to management of the Company, including its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure to be made; and (C) such disclosure controls and procedures are effective in all material respects to perform the functions for which they were established.

(xxxiv) There is and has been no failure on the part of the Company and any of the Company's directors or officers, in their capacities as such, to comply with the applicable provisions of the Sarbanes Oxley Act of 2002 (the "Sarbanes Oxley Act") and the rules and regulations promulgated thereunder.

(xxxv) The Company and each of its Subsidiaries have such permits, licenses, patents, franchises, certificates of need and other approvals or authorizations of governmental or regulatory authorities ("Permits") as are necessary under applicable law to own their properties and conduct their businesses in the manner described in the Registration Statement, the General Disclosure Package and the Prospectus, except for any of the foregoing that would not, in the aggregate, reasonably be expected to have a Material Adverse Effect; the Company and each of its Subsidiaries has fulfilled and performed all of its obligations with respect to the Permits, and no event has occurred that allows, or after notice or lapse of time would allow, revocation or termination thereof or results in any other impairment of the rights of the holder or any such Permits, except for any of the foregoing that would not reasonably be expected to have a Material Adverse Effect.

(xxxvi) The Company and its Subsidiaries own or possess adequate rights to use all material patents, patent applications, trademarks, service marks, trade names, trademark registrations, service mark registrations, copyrights, licenses, know how, software, systems and technology (including trade secrets and other unpatented and/or unpatentable proprietary or confidential information, systems or procedures) necessary for the conduct of their respective businesses and have no reason to believe that the conduct of their respective businesses will conflict with, and have not received any notice of any claim of conflict with, any such rights of others.

(xxxvii) Neither the Company nor any of its Subsidiaries is in violation of or has received notice of any violation with respect to any federal or state law relating to discrimination in the hiring, promotion or pay of employees, nor any applicable federal or state wage and hour laws, nor any state law precluding the denial of credit due to the neighborhood in which a property is situated, the violation of any of which would reasonably be expected to have a Material Adverse Affect.

(xxxviii) There are no material restrictions, limitations or regulations with respect to the ability of the Company to invest its assets as described in the Registration Statement, the General Disclosure Package or the Prospectus, other than as described therein. Each Subsidiary is not currently prohibited, directly or indirectly, under any agreement or other instrument to which it is a party or is subject, from paying any dividends to the Company, from making any other distribution on its limited liability company interests, from repaying to the Company any loans or advances to it from the Company or from transferring any of its property or assets to the Company, except as described in or contemplated in the Registration Statement, the General Disclosure Package and the Prospectus.

(xxxix) Neither the Company nor any of its Subsidiaries, nor, to the knowledge of the Company, any director, officer, agent, employee or other person acting on behalf of the Company or its Subsidiaries, has (A) used any corporate funds for any unlawful contribution, gift, entertainment or other unlawful expense relating to political activity; (B) made any direct or indirect unlawful payment to any foreign or domestic government official or employee from corporate funds; (C) violated or is in violation of any provision of the U.S. Foreign Corrupt Practices Act of 1977; or (D) made any bribe, rebate, payoff, influence payment, kickback or other unlawful payment.

(xl) The operations of the Company and its Subsidiaries are and have been conducted at all times in compliance with applicable financial recordkeeping and reporting requirements of the Currency and Foreign Transactions Reporting Act of 1970, as amended, the money laundering statutes of all jurisdictions, the rules and regulations thereunder and any related or similar rules, regulations or guidelines, issued, administered or enforced by any governmental agency (collectively, the "Money Laundering Laws") and no action, suit or proceeding by or before any court or governmental agency, authority or body or any arbitrator involving the Company or its Subsidiaries with respect to the Money Laundering Laws is pending or, to the knowledge of the Company, threatened, except, in each case, as would not reasonably be expected to have a Material Adverse Effect.

(xli) Neither the Company nor its Subsidiaries nor, to the knowledge of the Company, any director, officer, agent, or employee of the Company or its Subsidiaries is currently subject to any U.S. sanctions administered by the Office of Foreign Assets Control of the U.S. Treasury Department ("OFAC"); and the Company will not directly or indirectly knowingly use the proceeds of the offering, or lend, contribute or otherwise knowingly make available such proceeds to any subsidiary, joint venture partner or other person or entity, for the purpose of financing the activities of any person currently subject to any U.S. sanctions administered by OFAC.

(xlii) The Company has not distributed and, prior to the completion of the distribution of the Underwritten Securities, will not distribute any offering material in connection with the offering and sale of the Underwritten Securities other than the Preliminary Prospectus, the Prospectus or any statement made in accordance with Rule 482 of the Securities Act Rules and Regulations (a "Rule 482 Statement") to which the Representative has consented.

(xliii) The Company (A) has not taken, directly or indirectly, any action designed to cause or to result in, or that has constituted or which might reasonably be expected to constitute, the stabilization or manipulation of the price of any security of the Company to facilitate the sale of the Underwritten Securities; (B) has not since the filing of the Registration Statement sold, bid for or purchased, or paid anyone any compensation for soliciting purchases of, the Underwritten Securities; and (C) will not, until the completion of the distribution (within the meaning of the anti-manipulation rules under the Exchange Act) of the Underwritten Securities, sell, bid for or purchase, pay or agree to pay to any person any compensation for soliciting another to purchase any other securities of the Company.

(xliv) The Company will use its best efforts to have the NYSE has approve the Underwritten Securities for listing within thirty (30) days of the date of the Prospectus.

(b) Any certificate signed by any officer of the Company and delivered to the Underwriters in connection with the offering and sale of the Underwritten Securities shall be deemed a representation and warranty by the Company as to matters covered thereby to such Underwriters.

2. Purchase of the Underwritten Securities by the Underwriters.

(a) On the basis of the representations and warranties contained in, and subject to the terms and conditions of, this Agreement, the Company agrees to sell the Initial Securities to the several Underwriters, and each of the Underwriters, severally and not jointly, agrees to purchase the aggregate principal amount of the Initial Securities set forth opposite that Underwriter's name in Schedule A hereto.

(b) In addition, the Company grants to the Underwriters an option to purchase up to $[ ] additional aggregate principal amount of Option Securities (without giving effect to any accrued interest from the Initial Delivery Date to the Option Securities Delivery Date, as defined below). The Option Securities may be purchased as provided in Section 4 hereof. Each Underwriter agrees, severally and not jointly, to purchase the aggregate principal amount of Option Securities that bears the same proportion to the aggregate principal amount of Option Securities to be sold on such Delivery Date as the aggregate principal amount of Initial Securities set forth in Schedule A hereto opposite the name of such Underwriter bears to the aggregate principal amount of Initial Securities.

(c) The price of both the Initial Securities and any Option Securities purchased by the Underwriters shall be [ ]% of the aggregate principal amount. The Company shall not be obligated to deliver any of the Initial Securities or Option Securities to be delivered on the applicable Delivery Date, except upon payment for all such Underwritten Securities to be purchased on such Delivery Date as provided herein.

3. Offering of Securities by the Underwriters. Upon authorization by the Representative of the release of the Initial Securities, the several Underwriters propose to offer the Initial Securities for sale upon the terms and conditions to be set forth in the Prospectus.

4. Delivery of and Payment for the Underwritten Securities.

(a) Delivery of and payment for the Initial Securities shall be made at 10:00 A.M., New York City time, on the fifth full business day following the date of this Agreement or at such other date or place as shall be determined by agreement between the Representative and the Company. This date and time are sometimes referred to as the "Initial Delivery Date." Delivery of the Initial Securities shall be made to the Representative for the account of each Underwriter against payment by the several Underwriters through the Representative of the aggregate purchase price of the Initial Securities being sold by the Company to or upon the order of the Company by wire transfer in immediately available funds to the accounts specified by the Company. Time shall be of the essence, and delivery at the time and place specified pursuant to this Agreement is a further condition of the obligation of each Underwriter hereunder. The Company shall deliver the Initial Securities through the facilities of DTC unless the Representative shall otherwise instruct.

(b) The option granted in Section 2 will expire 30 days after the date of this Agreement and may be exercised in whole or in part on not more than one occasion by written notice being given to the Company by the Representative; provided that if such date falls on a day that is not a business day, the option granted in Section 2 will expire on the next succeeding business day. Such notice shall set forth the aggregate principal amount of Option Securities as to which the option is being exercised, the names in which the Option Securities are to be registered, the denominations in which the Option Securities are to be issued and the date and time, as determined by the Representative, when the Option Securities are to be delivered; provided, however, that this date and time shall not be earlier than the Initial Delivery Date nor earlier than the first business day after the date on which the option shall have been exercised nor later than the fifth business day after the date on which the option shall have been exercised. The date and time the Option Securities are delivered is sometimes referred to as an "Option Securities Delivery Date," and the Initial Delivery Date and any Option Securities Delivery Date are sometimes each referred to as a "Delivery Date."

(c) Delivery of the Option Securities by the Company and payment for the Option Securities by the several Underwriters through the Representative shall be made at 10:00 A.M., New York City time, on the date specified in the corresponding notice described in the preceding paragraph or at such other date or place as shall be determined by agreement between the Representative and the Company. On the Option Securities Delivery Date, the Company shall deliver or cause to be delivered the Option Securities to the Representative for the account of each Underwriter against payment by the several Underwriters through the Representative and of the aggregate purchase price of the Option Securities being sold by the Company to or upon the order of the Company of the purchase price by wire transfer in immediately available funds to the accounts specified by the Company. Time shall be of the essence, and delivery at the time and place specified pursuant to this Agreement is a further condition of the obligation of each Underwriter hereunder. The Company shall deliver the Option Securities through the facilities of DTC unless the Representative shall otherwise instruct.

5. Further Agreements of the Company and the Underwriters.

(a) The Company agrees:

(i) During any period that a prospectus relating to the Underwritten Securities is required to be delivered under the Securities Act (but in any event through the applicable Delivery Date), (A) to comply with the requirements of Rule 415, Rule 430A and Rule 497 of the Securities Act Rules and Regulations; (B) to prepare the Prospectus in a form approved by the Representative and to file such Prospectus pursuant to Rule 497 of the Securities Act Rules and Regulations not later than the Commission's close of business on the second business day following the execution and delivery of this Agreement; (C) to make no further amendment or any supplement to the Registration Statement or the Prospectus which shall be disapproved by the Representative promptly after reasonable notice thereof (unless in the reasonable determination of the Company such amendment or supplement is required by applicable law); (D) to advise the Representative, promptly after it receives notice thereof, of the time when any or amendment or supplement to the Registration Statement (including any filing pursuant to Rule 462(b) of the Securities Act Rules and Regulations) or the Prospectus has been filed and to furnish the Representative with copies thereof; and (E) to advise the Representative, promptly after it receives notice thereof of (i) the time when any post-effective amendment to the Registration Statement shall become effective; (ii) the receipt of any comments from the Commission; (iii) the request by the Commission for any amendment to the Registration Statement; (iv) the issuance by the Commission of any stop order or of any order preventing or suspending the use of the Prospectus; (v) the suspension of the qualification of the Underwritten Securities for offering or sale in any jurisdiction (vi) the initiation or threatening of any proceeding or examination for any such purpose; or (vii) any request by the Commission for the amending or supplementing of the Registration Statement, the Prospectus or for additional information related to the Registration Statement or the offering contemplated thereby; and, in the event of the issuance of any stop order or of any order preventing or suspending the use of the Prospectus suspending any such qualification, to use promptly its commercially reasonable best efforts to obtain its withdrawal;

(ii) To furnish promptly to the Representative and to counsel for the Underwriters a signed copy of the Registration Statement as originally filed with the Commission, and each amendment thereto filed with the Commission, including all consents and exhibits filed therewith;

(iii) To deliver promptly and without charge to the Representative such number of the following documents as the Representative shall reasonably request: (A) conformed copies of the Registration Statement as originally filed with the Commission and each amendment thereto (in each case excluding exhibits other than this Agreement), (B) the Preliminary Prospectus, the Prospectus and any amended or supplemented Prospectus, (C) any Rule 482 Statement and (D) if the delivery of a Prospectus is required at any time after the date hereof in connection with the offering or sale of the Underwritten Securities or any other securities relating thereto and if at such time any events shall have occurred as a result of which the Prospectus as then amended or supplemented would include an untrue statement of a material fact or omit to state any material fact necessary in order to make the statements therein, in light of the circumstances under which they were made when such Prospectus is delivered, not misleading, or, if for any other reason it shall be necessary to amend or supplement the Prospectus in order to comply with the Securities Act, to notify the Representative and, upon its request, to file such document and to prepare and furnish without charge to each Underwriter and to any dealer in securities as many copies as the Representative may from time to time reasonably request of an amended or supplemented Prospectus that will correct such statement or omission or effect such compliance. The copies of the Registration Statement, the Preliminary Prospectus, the Prospectus or amendment or supplement thereto furnished to the Underwriters will be identical to the electronically transmitted copies thereof filed with the Commission pursuant to EDGAR, expect to the extent permitted by Regulation S-T;

(iv) To file promptly with the Commission any amendment or supplement to the Registration Statement or the Prospectus that may, in the reasonable judgment of the Company or the Representative, be required by the Securities Act or requested by the Commission; prior to filing with the Commission any amendment or supplement to the Registration Statement or to the Prospectus, to furnish a copy thereof to the Representative and counsel for the Underwriters;

(v) To use its commercially reasonable best efforts to comply with the Securities Act and the Rules and Regulations so as to permit the completion of the distribution of the Underwritten Securities as contemplated in this Agreement and in the Prospectus. If any time when a Prospectus is required by the Securities Act to be delivered in connection with the sale of the Underwritten Securities, any event shall occur or condition exist as a result of which it is necessary, in the opinion of counsel for the Underwriters or for the Company, to amend the Registration Statement or amend or supplement the Prospectus in order that the Prospectus will not include an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements therein not misleading in light of the circumstances existing at the time it is delivered to the purchaser, or if it shall be necessary, in the opinion of such counsel, at any such time to amend the Registration Statement or amend or supplement the Prospectus in order to comply with the Securities Act or the Rules and Regulations, the Company will promptly prepare and file with the Commission, subject to 5(iv), such amendment or supplement as may be necessary to correct such statement or omission or to make the Registration Statement or the Prospectus comply with such requirements, and the Company will furnish to the Underwriters such number of copies of such amendment or supplement as the Underwriters may reasonably request;

(vi) If there occurs an event or development prior to the Initial Delivery Date as a result of which the General Disclosure Package would include an untrue statement of a material fact or would omit to state a material fact necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading, to promptly notify the Underwriters so that any use of the General Disclosure Package may cease until it is amended or supplemented if needed (at the sole cost to the Company);

(vii) As soon as reasonably practicable after the Effective Date (it being understood that the Company shall have until at least [ ] days or, if the fourth quarter following the fiscal quarter that includes the Effective Date is the last fiscal quarter of the Company's fiscal year, at least [ ] days after the end of the Company's current fiscal quarter), to make generally available to the Company's security holders and to deliver to the Representative an earnings statement of the Company and, to the extent required by the Commission, of KDA and Trimaran (which need not be audited) complying with Section 11(a) of the Securities Act and the Rules and Regulations (including, at the option of the Company, Rule 158 of the Securities Act Rules and Regulations);

(viii) During the period during which the Prospectus is required to be delivered under the Securities Act, to file all documents required to be filed with the Commission pursuant to the Exchange Act within the time period required by the Exchange Act and the rules and regulations of the Commission thereunder;

(ix) Promptly from time to time to take such action as the Representative may reasonably request to qualify the Underwritten Securities for offering and sale under the securities laws of such jurisdictions as the Representative may request and to comply with such laws so as to permit the continuance of sales and dealings therein in such jurisdictions for as long as may be necessary to complete the distribution of the Underwritten Securities; provided that in connection therewith the Company shall not be required to (i) qualify as a foreign corporation in any jurisdiction in which it would not otherwise be required to so qualify, (ii) file a general consent to service of process in any such jurisdiction or (iii) subject itself to taxation in any jurisdiction in which it would not otherwise be subject;

(x) Intentionally omitted.

(xi) For a period commencing on the date hereof and ending on the 90th day after the date of the Prospectus (the "Lock Up Period"), not to, directly or indirectly, (1) offer for sale, sell, pledge or otherwise dispose of (or enter into any transaction or device that is designed to, or could be expected to, result in the disposition by the Company at any time during such 90-day period) any debt securities issued or guaranteed by the Company or any securities convertible into or exercisable or exchangeable for debt securities issued or guaranteed by the Company, (2) file or cause to be filed a registration statement, including any amendments, with respect to the registration of any debt securities issued or guaranteed by the Company or any securities convertible into or exercisable or exchangeable for debt securities issued or guaranteed by the Company, or (3) publicly disclose the intention to do any of the foregoing, in each case without the prior written consent of the Representative on behalf of the Underwriters; notwithstanding the foregoing, if (1) during the last 17 days of the Lock Up Period, the Company issues an earnings release or material news or a material event relating to the Company occurs or (2) prior to the expiration of the Lock Up Period, the Company announces that it will release earnings results during the 16-day period beginning on the last day of the Lock Up Period, then the restrictions imposed in the preceding paragraph shall continue to apply until the expiration of the 18-day period beginning on the issuance of the earnings release or the announcement of the material news or the occurrence of the material event, unless the Representative, on behalf of the Underwriters, waives such extension in writing;

(xii) To apply the net proceeds from the sale of the Underwritten Securities being sold by the Company as set forth in the Prospectus and the General Disclosure Package under "Use of Proceeds";

(xiii) To use its commercially reasonable efforts to effect, within 30 days of the Initial Delivery Date, the listing of the Underwritten Securities on the NYSE;

(xiv) When and to the extent required by law, comply in all material respects with all applicable securities and other laws, rules and regulations, including without limitation, the Sarbanes Oxley Act, and will use its best efforts to cause its officers, directors and employees, in their capacities as such, to comply in all material respects with such laws, rules and regulations, including without limitation, the Sarbanes Oxley Act;

(xv) To use its best efforts to maintain its status as a BDC under the Investment Company Act; provided, however, the Company may cease to be, or withdraw its election as a BDC under the Investment Company Act, with the approval of its board of directors and a vote of its stockholders as required by Section 58 of the Investment Company Act, or a successor provision;

(xvi) To use its best efforts to maintain its qualification as a RIC under the Code for each taxable year during which it is a BDC under the Investment Company Act;

(xvii) To cooperate with the Representative and use its commercially reasonable efforts to permit the Underwritten Securities to be eligible for clearance and settlement through the facilities of DTC; and

(xviii) Except for the authorization of actions permitted to be taken by the Underwriters as contemplated by the Underwriters herein or in the Prospectus, not to take, directly or indirectly, within 30 days of the date of the Prospectus, any action designed to cause or to result in, or which might reasonably be expected to constitute, the stabilization or manipulation of the price of any security of the Company to facility the issuance of the sale or resale of the Underwritten Securities.

6. Expenses. The Company agrees, whether or not the transactions contemplated by this Agreement are consummated or this Agreement is terminated, to pay all costs, expenses, fees and taxes incident to and in connection with its obligations under this Agreement, including: (a) the authorization, issuance, sale and delivery of the Underwritten Securities, involving any stamp or transfer taxes in connection with the original issuance and sale of the Underwritten Securities, and the preparation and printing of certificates for the foregoing; (b) the preparation, printing and filing under the Securities Act of the Registration Statement (including any exhibits thereto), the Preliminary Prospectus, the Prospectus and any amendment or supplement thereto; (c) the distribution of the Registration Statement (including any exhibits thereto), the Preliminary Prospectus, the Prospectus and any amendment or supplement thereto, all as provided in this Agreement; (d) the production and distribution of this Agreement, any supplemental agreement among Underwriters, the Indenture, any other related documents in connection with the offering, purchase, sale and delivery of the Underwritten Securities; (e) any required review by the FINRA of the terms of sale of the Underwritten Securities (including related fees and expenses of counsel to the Underwriters not to exceed $10,000 in the aggregate); (f) the inclusion of the Underwritten Securities on the NYSE; (g) the qualification of the Underwritten Securities under the securities laws of the several jurisdictions as provided in Section 5(ix) and the preparation, printing and distribution of a blue sky memorandum (including related fees and expenses of counsel to the Underwriters); (h) the fees and disbursements of the Company's counsel, accountants and other advisors, (i) the investor presentations on any "road show" undertaken in connection with the marketing of the Underwritten Securities, including, without limitation, expenses associated with any electronic roadshow, travel and lodging expenses of the officers of the Company and the cost of any aircraft chartered by the Company in connection with the road show; (j) the fees and expenses of the Trustee and any transfer agent, registrar or depositary in connection with the issuance of the Underwritten Securities; and (k) all other costs and expenses incident to the performance of the obligations of the Company under this Agreement and any transfer taxes payable in connection with its sales of Underwritten Securities to the Underwriters, provided that, except as provided in this Section 6 and Section 11, the Underwriters shall pay their own costs and expenses, including the costs and expenses of their counsel, any transfer taxes on the Underwritten Securities which they may sell and the expenses of advertising any such offering of the Underwritten Securities made by the Underwriters, and the travel and lodging expenses of the Underwriters in connection with the road show or otherwise relating to the subject matter of this Agreement.

7. Conditions of Underwriters' Obligations. The respective obligations of the Underwriters hereunder are subject to the accuracy, when made and on each Delivery Date, of the representations and warranties of the Company contained herein, to the accuracy of the statements of the Company's officers made in each certificate furnished pursuant to the provisions hereof, to the performance by the Company of its obligations hereunder, and to each of the following additional terms and conditions:

(a) The Prospectus shall have been timely filed with the Commission in accordance with Section 5(a)(i). The Registration Statement (including any filing pursuant to Rule 462(b) of the Securities Act Rules and Regulations), has become effective; no stop order suspending the effectiveness of the Registration Statement or preventing or suspending the use of the Prospectus shall have been issued and no proceeding or examination for such purpose shall have been initiated or threatened by the Commission; and any request of the Commission for inclusion of additional information in the Registration Statement or the Prospectus or otherwise shall have been complied with. A prospectus containing the Rule 430A Information shall have been filed with the Commission in accordance with Rule 497 of the Securities Act Rules and Regulations.

(b) No Underwriter shall have discovered and disclosed to the Company on or prior to such Delivery Date that the Registration Statement, the Prospectus or the General Disclosure Package, or any amendment or supplement thereto, contains an untrue statement of a fact which, in the Representative's sole discretion, is material or omits to state a fact which, in the opinion of such counsel, is material and is required to be stated therein or is necessary to make the statements therein not misleading.

(c) All corporate proceedings and other legal matters incident to the authorization, form and validity of this Agreement, the Underwritten Securities, the Registration Statement, the General Disclosure Package and the Prospectus, and all other legal matters relating to this Agreement and the transactions contemplated hereby shall be reasonably satisfactory in all material respects to counsel for the Underwriters, and the Company shall have furnished to such counsel all documents and information that they may reasonably request to enable them to pass upon such matters.

(d) Sutherland Asbill & Brennan LLP shall have furnished to the Representative its written opinion, as counsel to the Company, addressed to the Underwriters and dated such Delivery Date, in form and substance reasonably satisfactory to the Representative, and covering the matters substantially in the form attached hereto as Exhibit B-1, along with its negative assurance letter substantially in the form attached hereto as Exhibit B-2.

(e) The Representative shall have received from Fried, Frank, Harris, Shriver & Jacobson LLP, counsel for the Underwriters, such opinion or opinions, dated such Delivery Date, with respect to the issuance and sale of the Underwritten Securities, the Registration Statement, the Prospectus and the General Disclosure Package and other related matters as the Representative may reasonably require, and the Company shall have furnished to such counsel such documents as they reasonably request for the purpose of enabling them to pass upon such matters.

(f) At the time of execution of this Agreement, the Representative shall have received from Grant Thornton LLP a letter, in form and substance satisfactory to the Representative, with respect to the Company, KDA and Trimaran, addressed to the Underwriters and dated the date hereof (i) confirming that they are independent public accountants within the meaning of the Securities Act and the applicable rules and regulations adopted by the Commission and the Public Accounting Oversight Board and are in compliance with the applicable requirements relating to the qualification of accountants under Rule 2-01 of Regulation S-X of the Commission and (ii) stating, as of the date hereof (or, with respect to matters involving changes or developments since the respective dates as of which specified financial information is given in the Preliminary Prospectus, as of a date not more than three days prior to the date hereof), the conclusions and findings of such firm with respect to the financial information and other matters ordinarily covered by accountants' "comfort letters" to underwriters in connection with registered public offerings.

(g) With respect to the letter of Grant Thornton LLP referred to in the preceding paragraph and delivered to the Representative concurrently with the execution of this Agreement (the "initial letter"), the Company shall have caused Grant Thornton LLP to furnish to the Representative a letter (the "bring down letter") of such accountants, addressed to the Underwriters and dated such Delivery Date (i) confirming that they are independent public accountants within the meaning of the Securities Act and are in compliance with the applicable requirements relating to the qualification of accountants under Rule 2-01 of Regulation S-X of the Commission, (ii) stating, as of the date of the bring down letter (or, with respect to matters involving changes or developments since the respective dates as of which specified financial information is given in the Prospectus, as of a date not more than three days prior to the date of the bring down letter), the conclusions and findings of such firm with respect to the financial information and other matters covered by the initial letter and (iii) confirming in all material respects the conclusions and findings set forth in the initial letter.

(h) The Company shall have furnished to the Representative a certificate, dated such Delivery Date, executed on its behalf by its (a) Chief Executive Officer or President or equivalent officer and (b) its Chief Financial Officer or equivalent officer stating that:

(i) The representations, warranties and agreements of the Company in Section 1 are true and correct on and as of such Delivery Date, except for any such representation or warranty that speaks only as of an earlier date or time, which is true and correct as of such earlier specified date and time, and the Company has complied in all material respects with all its agreements contained herein and satisfied all the conditions on its part to be performed or satisfied hereunder at or prior to such Delivery Date;

(ii) No stop order suspending the effectiveness of the Registration Statement has been issued; and no proceedings or examination for that purpose have been instituted or, to the knowledge of such officers, threatened; and

(iii) They have reviewed the Registration Statement, the Prospectus and the General Disclosure Package, and, in their opinion, (A) (1) the Registration Statement, as of the Effective Date, (2) the Prospectus, as of its date and on the applicable Delivery Date, or (3) the General Disclosure Package, as of the Applicable Time, did not and do not contain any untrue statement of a material fact and did not and do not omit to state a material fact required to be stated therein or necessary to make the statements therein (except in the case of the Registration Statement, in light of the circumstances under which they were made) not misleading and (B) since the Effective Date, no event has occurred that is required to be set forth and which has not been set forth in a supplement or amendment to the Registration Statement or the Prospectus;

(i) Prior to such Delivery Date, the Company and its Subsidiaries shall have furnished to the Representative such further information, certificates and documents as the Representative may reasonably request.

(j) (A) Neither the Company nor any of its Subsidiaries shall have sustained since December 31, 2011, any loss or interference with its business from fire, explosion, flood or other calamity, whether or not covered by insurance, or from any labor dispute or court or governmental action, order or decree or (B) since such date there shall not have been any change in the capital stock (except as otherwise disclosed in the Preliminary Prospectus and the Prospectus) or long term debt of the Company or any of its Subsidiaries or any change, or any development involving a prospective change, in or affecting the condition (financial or otherwise), results of operations, stockholders' equity, properties, management, business or prospects of the Company and its Subsidiaries, taken as a whole, the effect of which, in any such case described in clause (A) or (B), is, in the judgment of the Representative, so material and adverse as to make it impracticable or inadvisable to proceed with the public offering or the delivery of the Underwritten Securities being delivered on such Delivery Date on the terms and in the manner contemplated in the General Disclosure Package and the Prospectus.

(k) Subsequent to the execution and delivery of this Agreement there shall not have occurred any of the following: (i) trading in securities generally on the New York Stock Exchange, The NASDAQ Global Select Market or the American Stock Exchange, or trading in any securities of the Company on any exchange, shall have been suspended or materially limited or the settlement of such trading generally shall have been materially disrupted or minimum prices shall have been established on any such exchange by the Commission, by such exchange or by any other regulatory body or governmental authority having jurisdiction, (ii) a banking moratorium shall have been declared by United States Federal or state authorities, (iii) the United States shall have become engaged in hostilities, there shall have been an escalation in hostilities involving the United States or there shall have been a declaration of a national emergency or war by the United States or (iv) there shall have occurred such a material adverse change in general economic, political or financial conditions, including, without limitation, as a result of terrorist activities after the date hereof (or the effect of international conditions on the financial markets in the United States shall be such), as to make it, in the judgment of the Representative, impracticable or inadvisable to proceed with the public offering or delivery of the Underwritten Securities being delivered on such Delivery Date on the terms and in the manner contemplated in the Prospectus.

(l) At or prior to the Initial Delivery Date, the Company and the Trustee shall have executed and delivered the Indenture.

All opinions, letters, evidence and certificates mentioned above or elsewhere in this Agreement shall be deemed to be in compliance with the provisions hereof only if they are in form and substance reasonably satisfactory to counsel for the Underwriters.

8. Indemnification and Contribution.

(a) The Company shall indemnify and hold harmless each Underwriter, its directors, officers, employees, agents, affiliates and each person, if any, who controls any Underwriter within the meaning of Section 15 of the Securities Act or Section 20 of the Exchange Act, from and against any loss, claim, damage or liability, joint or several, or any action in respect thereof (including, but not limited to, any loss, claim, damage, liability or action relating to purchases and sales of Underwritten Securities), to which that Underwriter, director, officer, employee, agent, affiliate or controlling person may become subject, under the Securities Act, the Exchange Act or otherwise, insofar as such loss, claim, damage, liability or action arises out of, or is based upon, (i) any untrue statement or alleged untrue statement of a material fact contained in (A) the Preliminary Prospectus, the Registration Statement, the Prospectus or in any amendment or supplement thereto, including the Rule 430A Information (including the information on Schedule B hereto), or the General Disclosure Package; (B) any Rule 482 Statement; (C) any Marketing Materials or (D) any Blue Sky application or other document prepared or executed by the Company (or based upon any written information furnished by the Company for use therein) specifically for the purpose of qualifying any or all of the Underwritten Securities under the securities laws of any state or other jurisdiction (any such application, document or information being hereinafter called a "Blue Sky Application"), (ii) the omission or alleged omission to state in the Preliminary Prospectus, the Registration Statement, the Prospectus or in any amendment or supplement thereto, including the Rule 430A Information (including the information on Schedule B hereto), the General Disclosure Package, any Rule 482 Statement, any Marketing Materials or any Blue Sky Application, any material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made in the case of the Preliminary Prospectus or Rule 482 Statement, or any amendment or supplement thereto, not misleading or (iii) any act or failure to act or any alleged act or failure to act by any Underwriter in connection with, or relating in any manner to, the Underwritten Securities or the offering contemplated hereby, and which is included as part of or referred to in any loss, claim, damage, liability or action arising out of or based upon matters covered by clause (i) or (ii) above (provided that the Company shall not be liable under this clause (iii) to the extent that it is determined in a final judgment by a court of competent jurisdiction that such loss, claim, damage, liability or action resulted directly from any such acts or failures to act undertaken or omitted to be taken by such Underwriter through its gross negligence or willful misconduct), and shall reimburse each Underwriter and each such director, officer, employee, agent, affiliate or controlling person promptly upon demand for any legal or other expenses reasonably incurred by that Underwriter, director, officer, employee, agent, affiliate or controlling person in connection with investigating or defending or preparing to defend against any such loss, claim, damage, liability or action as such expenses are incurred; provided, however, that the Company shall not be liable in any such case to the extent that any such loss, claim, damage, liability or action arises out of, or is based upon, any untrue statement or alleged untrue statement or omission or alleged omission made in the Preliminary Prospectus, the Registration Statement, the Prospectus, or in any such amendment or supplement thereto, including the Rule 430A Information (including the information on Schedule B hereto), the General Disclosure Package, any Rule 482 Statement, any Marketing Materials or any Blue Sky Application, in reliance upon and in conformity with written information furnished to the Company through the Representative by or on behalf of any Underwriter specifically for inclusion therein, which information is limited to the information set forth in Section 8(e). The foregoing indemnity agreement is in addition to any liability which the Company may otherwise have to any Underwriter or to any director, officer, employee or controlling person of that Underwriter.

(b) Each Underwriter, severally and not jointly, shall indemnify and hold harmless the Company, its directors (including any person who, with his or her consent, is named in the Registration Statement as about to become a director of the Company), officers and employees, and each person, if any, who controls the Company within the meaning of Section 15 of the Securities Act or Section 20 of the Exchange Act, from and against any loss, claim, damage or liability, joint or several, or any action in respect thereof, to which the Company or any such director, officer, employee or controlling person may become subject, under the Securities Act, the Exchange Act or otherwise, insofar as such loss, claim, damage, liability or action arises out of, or is based upon, (i) any untrue statement or alleged untrue statement of a material fact contained in any Preliminary Prospectus, the Registration Statement, the Prospectus, or in any amendment or supplement thereto, including the Rule 430A Information (including the information on Schedule B hereto), the General Disclosure Package, any Rule 482 Statement, any Marketing Materials or Blue Sky Application, or (ii) the omission or alleged omission to state in any Preliminary Prospectus, the Registration Statement, the Prospectus, or in any amendment or supplement thereto, the Rule 430A Information (including the information on Schedule B hereto), the General Disclosure Package, any Rule 482 Statement, any Marketing Materials or Blue Sky Application, any material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made in the case of any Preliminary Prospectus or Rule 482 Statement, or any amendment or supplement thereto, not misleading, but in each case only to the extent that the untrue statement or alleged untrue statement or omission or alleged omission was made in reliance upon and in conformity with written information concerning such Underwriter furnished to the Company through the Representative by or on behalf of that Underwriter specifically for inclusion therein, which information is limited to the information set forth in Section 8(e). The foregoing indemnity agreement is in addition to any liability that any Underwriter may otherwise have to the Company or any such director, officer, employee or controlling person.

(c) Promptly after receipt by an indemnified party under this Section 8 of notice of any claim or the commencement of any action, the indemnified party shall, if a claim in respect thereof is to be made against the indemnifying party under this Section 8, notify the indemnifying party in writing of the claim or the commencement of that action; provided, however, that the failure to notify the indemnifying party shall not relieve it from any liability which it may have under this Section 8 except to the extent it has been materially prejudiced by such failure and, provided, further, that the failure to notify the indemnifying party shall not relieve it from any liability which it may have to an indemnified party otherwise than under this Section 8. If any such claim or action shall be brought against an indemnified party, and it shall notify the indemnifying party thereof, the indemnifying party shall be entitled to participate therein and, to the extent that it wishes, jointly with any other similarly notified indemnifying party, to assume the defense thereof with counsel reasonably satisfactory to the indemnified party. After notice from the indemnifying party to the indemnified party of its election to assume the defense of such claim or action, the indemnifying party shall not be liable to the indemnified party under this Section 8 for any legal or other expenses subsequently incurred by the indemnified party in connection with the defense thereof other than reasonable costs of investigation; provided, however, that the Representative shall have the right to employ counsel to represent jointly the Representative and those other Underwriters and their respective directors, officers, employees and controlling persons who may be subject to liability arising out of any claim in respect of which indemnity may be sought by the Underwriters against the Company under this Section 8 if (i) the Company and the Underwriters shall have so mutually agreed; (ii) the Company has failed within a reasonable time to retain counsel reasonably satisfactory to the Underwriters; (iii) the Underwriters and their respective directors, officers, employees and controlling persons shall have reasonably concluded based upon the advice of counsel that there may be legal defenses available to them that are different from or in addition to those available to the Company; or (iv) the named parties in any such proceeding (including any impleaded parties) include both the Underwriters or their respective directors, officers, employees or controlling persons, on the one hand, and the Company, on the other hand, and representation of both sets of parties by the same counsel would be inappropriate due to actual or potential differing interests between them, and in any such event the fees and expenses of such separate counsel shall be paid by the Company. No indemnifying party shall (i) without the prior written consent of the indemnified parties (which consent shall not be unreasonably withheld), settle or compromise or consent to the entry of any judgment with respect to any pending or threatened claim, action, suit or proceeding in respect of which indemnification or contribution may be sought hereunder (whether or not the indemnified parties are actual or potential parties to such claim or action) unless such settlement, compromise or consent includes an unconditional release of each indemnified party from all liability arising out of such claim, action, suit or proceeding and does not include any findings of fact or admissions of fault or culpability as to the indemnified party or (ii) be liable for any settlement of any such action effected without its written consent (which consent shall not be unreasonably withheld), but if settled with the consent of the indemnifying party or if there be a final judgment for the plaintiff in any such action, the indemnifying party agrees to indemnify and hold harmless any indemnified party from and against any loss or liability by reason of such settlement or judgment.

(d) If the indemnification provided for in this Section 8 shall for any reason be unavailable or insufficient to hold harmless an indemnified party under Section 8(a) or 8(b) in respect of any loss, claim, damage or liability, or any action in respect thereof, referred to therein, then each indemnifying party shall, in lieu of indemnifying such indemnified party, contribute to the amount paid or payable by such indemnified party as a result of such loss, claim, damage liability or action in respect thereof, (i) in such proportion as shall be appropriate to reflect the relative benefits received by the Company, on the one hand, and the Underwriters, on the other, from the offering of the Underwritten Securities or (ii) if the allocation provided by clause (i) above is not permitted by applicable law, in such proportion as is appropriate to reflect not only the relative benefits referred to in clause (i) above but also the relative fault of the Company, on the one hand, and the Underwriters, on the other, with respect to the statements or omissions that resulted in such loss, claim, damage, liability or action in respect thereof, as well as any other relevant equitable considerations. The relative benefits received by the Company, on the one hand, and the Underwriters, on the other, with respect to such offering shall be deemed to be in the same proportion as the total net proceeds from the offering of the Underwritten Securities purchased under this Agreement (before deducting expenses) received by the Company, as set forth in the table on the cover page of the Prospectus, on the one hand, and the total underwriting discounts and commissions received by the Underwriters with respect to the Underwritten Securities purchased under this Agreement, as set forth in the table on the cover page of the Prospectus, on the other hand. The relative fault shall be determined by reference to whether the untrue or alleged untrue statement of a material fact or omission or alleged omission to state a material fact relates to information supplied by the Company or the Underwriters, the intent of the parties and their relative knowledge, access to information and opportunity to correct or prevent such statement or omission. The Company and the Underwriters agree that it would not be just and equitable if contributions pursuant to this Section 8(d) were to be determined by pro rata allocation (even if the Underwriters were treated as one entity for such purpose) or by any other method of allocation that does not take into account the equitable considerations referred to herein. The amount paid or payable by an indemnified party as a result of the loss, claim, damage liability or action in respect thereof, referred to above in this Section 8(d) shall be deemed to include, for purposes of this Section 8(d), any legal or other expenses reasonably incurred by such indemnified party in connection with investigating or defending any such action or claim. Notwithstanding the provisions of this Section 8(d), no Underwriter shall be required to contribute any amount in excess of the amount by which the underwriting commissions from the sale of the Underwritten Securities underwritten by it exceeds the amount of any damages that such Underwriter has otherwise paid or become liable to pay by reason of any untrue or alleged untrue statement or omission or alleged omission. No person guilty of fraudulent misrepresentation (within the meaning of Section 11(f) of the Securities Act) shall be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation. The Underwriters' obligations to contribute as provided in this Section 8(d) are several in proportion to their respective underwriting obligations and not joint.

(e) The Underwriters severally confirm and the Company acknowledges and agrees that (i) the statements regarding the concession and reallowance figures by the Underwriters, (ii) the first paragraph appearing under the heading "Underwriting—Stabilization" and (iii) the paragraph appearing under the heading "Underwriting—Electronic Distribution" in the Preliminary Prospectus and the Prospectus are correct and constitute the only information concerning such Underwriters furnished in writing to the Company by or on behalf of the Underwriters specifically for inclusion in the Preliminary Prospectus, the Registration Statement, the General Disclosure Package, the Prospectus or in any amendment or supplement thereto, including the Rule 430A Information, any Rule 482 Statement, any Marketing Materials or Blue Sky Application.

(f) Notwithstanding any other provision of this Section 8, no party shall be entitled to indemnification and contribution under this Agreement in violation of Section 17(i) of the Investment Company Act.

9. Defaulting Underwriters. If, on any Delivery Date, any Underwriter defaults in the performance of its obligations under this Agreement, the remaining non defaulting Underwriters shall be obligated to purchase the Underwritten Securities as to which such defaulting Underwriter failed to deliver payment on such Delivery Date in the respective proportions which the aggregate principal amount of the Initial Securities set forth opposite the name of each remaining non defaulting Underwriter in Schedule A hereto bears to the aggregate principal amount of the Initial Securities set forth opposite the names of all the remaining non defaulting Underwriters in Schedule A hereto; provided, however, that the remaining non defaulting Underwriters shall not be obligated to purchase any of the Underwritten Securities on such Delivery Date if the aggregate principal amount of the Underwritten Securities as to which the defaulting Underwriter failed to deliver payment on such date exceeds 10% of the aggregate principal amount of the Underwritten Securities to be delivered on such Delivery Date, and any remaining non defaulting Underwriter shall not be obligated to purchase more than 10% of the aggregate principal amount of the Underwritten Securities that it agreed to purchase on such Delivery Date pursuant to the terms of Section 2. If the foregoing maximums are exceeded, the remaining non defaulting Underwriters, or those other underwriters satisfactory to the Representative who so agree, shall have the right, but shall not be obligated, to purchase, in such proportion as may be agreed upon among them, all the Underwritten Securities to be purchased on such Delivery Date. If the remaining Underwriters or other underwriters satisfactory to the Representative do not elect to purchase the Underwritten Securities as to which the defaulting Underwriter or Underwriters agreed but failed to deliver payment on such Delivery Date, this Agreement (or, with respect to any Option Securities Delivery Date, the obligation of the Underwriters to purchase, and of the Company to sell, the Option Securities) shall terminate without liability on the part of any non defaulting Underwriter or the Company, except that the Company will continue to be liable for the payment of expenses to the extent set forth in Sections 6 and 11. As used in this Agreement, the term "Underwriter" includes, for all purposes of this Agreement unless the context requires otherwise, any party not listed in Schedule A hereto that, pursuant to this Section 9, purchases Underwritten Securities that a defaulting Underwriter agreed but failed to purchase. Nothing contained herein shall relieve a defaulting Underwriter of any liability it may have to the Company for damages caused by its default. If other Underwriters are obligated or agree to purchase the Underwritten Securities of a defaulting or withdrawing Underwriter, either the Representative or the Company may postpone the Delivery Date for up to seven full business days in order to effect any changes that in the opinion of counsel for the Company or counsel for the Underwriters may be necessary in the Registration Statement, the Prospectus or in any other document or arrangement.

10. Termination. The obligations of the Underwriters hereunder may be terminated by the Representative by notice given to and received by the Company prior to delivery of and payment for the Initial Securities if, prior to that time, any of the events described in Sections 7(j) and 7(k) shall have occurred or if the Underwriters shall decline to purchase the Underwritten Securities for any reason permitted under this Agreement.

11. Reimbursement of Underwriters' Expenses. If (a) the Company shall fail to tender the Underwritten Securities for delivery to the Underwriters by reason of any failure, refusal or inability on the part of the Company to perform any agreement on its part to be performed, or because any other condition to the Underwriters' obligations hereunder required to be fulfilled by the Company is not fulfilled for any reason or (b) the Underwriters shall decline to purchase the Underwritten Securities for any reason permitted under this Agreement, the Company will reimburse the Underwriters for all reasonable out of pocket expenses (including fees and disbursements of counsel) incurred by the Underwriters in connection with this Agreement and the proposed purchase of the Underwritten Securities, and upon demand the Company shall pay the full amount thereof to the Representative. If this Agreement is terminated pursuant to Section 9 by reason of the default of one or more Underwriters, the Company shall not be obligated to reimburse any defaulting Underwriter on account of those expenses.

12. Research Analyst Independence. The Company acknowledges that the Underwriters' research analysts and research departments are required to be independent from their respective investment banking divisions and are subject to certain regulations and internal policies, and that such Underwriters' research analysts may hold views and make statements or investment recommendations and/or publish research reports with respect to the Company and/or the offering that differ from the views of their respective investment banking divisions. The Company hereby waives and releases, to the fullest extent permitted by law, any claims that the Company may have against the Underwriters with respect to any conflict of interest that may arise from the fact that the views expressed by their independent research analysts and research departments may be different from or inconsistent with the views or advice communicated to the Company by such Underwriters' investment banking divisions. The Company acknowledges that each of the Underwriters is a full service securities firm and as such from time to time, subject to applicable securities laws, may effect transactions for its own account or the account of its customers and hold long or short positions in debt or equity securities of the companies that may be the subject of the transactions contemplated by this Agreement.

13. No Fiduciary Duty. The Company acknowledges and agrees that in connection with this offering, sale of the Underwritten Securities or any other services the Underwriters may be deemed to be providing hereunder, notwithstanding any preexisting relationship, advisory or otherwise, between the parties or any oral representations or assurances previously or subsequently made by the Underwriters: (i) no fiduciary or agency relationship between the Company and any other person, on the one hand, and the Underwriters, on the other, exists; (ii) the Underwriters are not acting as advisors, expert or otherwise, to the Company, including, without limitation, with respect to the determination of the public offering price of the Underwritten Securities, and such relationship between the Company, on the one hand, and the Underwriters, on the other, is entirely and solely commercial, based on arms length negotiations; (iii) any duties and obligations that the Underwriters may have to the Company shall be limited to those duties and obligations specifically stated herein; and (iv) the Underwriters and their respective affiliates may have interests that differ from those of the Company. The Company hereby waives any claims that the Company may have against the Underwriters with respect to any breach of fiduciary duty in connection with this offering.

14. Notices. All statements, requests, notices and agreements hereunder shall be in writing, and:

(a) if to the Underwriters, shall be delivered or sent by mail or facsimile transmission to:

Stifel, Nicolaus & Company Incorporated

[ ]

With a copy (for informational purposes only) to:

Fried, Frank, Harris, Shriver & Jacobson LLP
One New York Plaza
New York, New York 10004
Attention: Stuart Gelfond, Esq.
Facsimile: (212) 859-4000

And in the case of any notice pursuant to Section 7(d), a copy to:

(b) if to the Company, shall be delivered or sent by mail or facisimile transmission to:

KCAP Financial, Inc.
295 Madison Avenue, 6th Floor
New York, New York 10017
Attention: Dayl W. Pearson
Facsimile: (212) 455-8300
With a copy (for informational purposes only) to:
Sutherland Asbill & Brennan LLP
1275 Pennsylvania Avenue NW
Washington, DC 20004
Attention: Harry Pangas, Esq.
Facsimile: (202) 637-3593

Any such statements, requests, notices or agreements shall take effect at the time of receipt thereof. The Company shall be entitled to act and rely upon any request, consent, notice or agreement given or made on behalf of the Underwriters by the Representative.

15. Persons Entitled to Benefit of Agreement. This Agreement shall inure to the benefit of and be binding upon the Underwriters, the Company, and their respective successors. This Agreement and the terms and provisions hereof are for the sole benefit of only those persons, except that (A) the representations, warranties, indemnities and agreements of the Company contained in this Agreement shall also be deemed to be for the benefit of the directors, officers, employees, agents and affiliates of the Underwriters and each person or persons, if any, who control any Underwriter within the meaning of Section 15 of the Securities Act and Section 20 of the Exchange Act and (B) the indemnity agreement of the Underwriters contained in Section 8(b) of this Agreement shall be deemed to be for the benefit of the directors of the Company, the officers of the Company who have signed the Registration Statement and any person controlling the Company within the meaning of Section 15 of the Securities Act and Section 20 of the Exchange Act. Nothing in this Agreement is intended or shall be construed to give any person, other than the persons referred to in this Section 15, any legal or equitable right, remedy or claim under or in respect of this Agreement or any provision contained herein.

16. Survival. The respective indemnities, representations, warranties and agreements of the Company and the Underwriters contained in this Agreement or made by or on behalf of them, respectively, pursuant to this Agreement, shall survive the delivery of and payment for the Underwritten Securities and shall remain in full force and effect, regardless of any investigation made by or on behalf of any of them or any person controlling any of them.

17. Definition of the Terms "Business Day". For purposes of this Agreement, "business day" means each Monday, Tuesday, Wednesday, Thursday or Friday that is not a day on which banking institutions in New York are generally authorized or obligated by law or executive order to close.

18. Governing Law. **This Agreement and any claim, counterclaim or dispute of any kind or nature whatsoever arising out of or in any way relating to this Agreement (a "Claim"), directly or indirectly, shall be governed by and construed in accordance with the laws of the State of New York, without regard to the conflict of law provisions thereof to the extent such principles or rules would require or permit the application of the laws of another jurisdiction.**

19. Submission to Jurisdiction. Except as set forth below, no Claim may be commenced, prosecuted or continued in any court other than the courts of the State of New York located in the City and County of New York or in the United States District Court for the Southern District of New York, which courts shall have jurisdiction over the adjudication of such matters, and the Company consents to the jurisdiction of such courts and personal service with respect thereto. The Company hereby consents to personal jurisdiction, service and venue in any court in which any Claim arising out of or in any way relating to this Agreement is brought by any third party against the Underwriter or any indemnified party. Each of the Underwriters and the Company (on its behalf and, to the extent permitted by applicable law, on behalf of its stockholders and affiliates) waives all right to trial by jury in any action, proceeding or counterclaim (whether based upon contract, tort or otherwise) in any way arising out of or relating to this Agreement. The Company agrees that a final judgment in any such action, proceeding or counterclaim brought in any such court shall be conclusive and binding upon the Company and may be enforced in any other courts to the jurisdiction of which the Company is or may be subject, by suit upon such judgment.

20. Counterparts. This Agreement may be executed in one or more counterparts and, if executed in more than one counterpart, the executed counterparts shall each be deemed to be an original but all such counterparts shall together constitute one and the same instrument.

21. Headings. The headings herein are inserted for convenience of reference only and are not intended to be part of, or to affect the meaning or interpretation of, this Agreement.

[*Remainder of Page Intentionally Left Blank*.]

If the foregoing correctly sets forth the agreement between the Company and the Underwriters, please indicate your acceptance in the space provided for that purpose below.

Very truly yours,

KCAP FINANCIAL, INC.

By:_____

Name: Dayl W. Pearson
Title: President and Chief Executive Officer

Accepted:

For itself and as a Representative of the several Underwriters named in Schedule A hereto

By: _____
*Authorized Representative*

SCHEDULE A

| Underwriter | Aggregate Principal Amount of Securities to be Purchased |
|---|---|
| Stifel, Nicolaus & Company, Incorporated | $ [ ] |
| Barclays Capital Inc. | [ ] |
| Janney Montgomery Scott LLC | [ ] |
| JMP Securities LLC | [ ] |
| Ladenburg Thalmann & Co. Inc. | [ ] |
| Sandler O'Neill & Partners, L.P. | [ ] |
| Wunderlich Securities, Inc. | [ ] |
| Total: | $ [ ] |

SCHEDULE B

$[ ]

KCAP FINANCIAL, INC.

[ ]% Senior Notes due 20[ ]

1. The aggregate principal amount of the Initial Securities is $[ ].

2. The purchase price for the Initial Securities shall be [100]% of the aggregate principal amount thereof plus accrued interest, if any, from the date of issuance.

3. The purchase price for the Initial Securities to be paid by the several Underwriters shall be [ ]% of the aggregate principal amount thereof.

4. The interest rate is [ ]%.

EXHIBIT I

KCAP Funding
Katonah Debt Advisors, L.L.C.
Katonah Management Holdings LLC
Katonah X Management LLC
Katonah 2007-I Management LLC
Katonah 2008-II Management LLC
Commodore Holdings, LLC
Trimaran Advisors, L.L.C.

**Exhibit (l)**

[Letterhead of Sutherland Asbill & Brennan LLP]

October 3, 2012

KCAP Financial, Inc.
295 Madison Avenue, 6th Floor
New York, New York 10017

Ladies and Gentlemen:

We have acted as counsel to KCAP Financial, Inc., a Delaware corporation (the "***Company***"), in connection with the registration statement on Form N-2 (File No. 333-183032) (the "***Registration Statement***") filed by the Company with the Securities and Exchange Commission (the "***Commission***") under the Securities Act of 1933, as amended (the "***Securities Act***"), in connection with the registration, issuance and sale under the Securities Act of $30,000,000 in aggregate principal amount of the Company's Senior Notes (the "***Notes***"), together with any additional Notes that may be issued by the Company pursuant to Rule 462(b) under the Securities Act (as prescribed by the Commission pursuant to the Securities Act) in connection with the offering described in the Registration Statement.

The Notes will be issued pursuant to an indenture, substantially in the form filed as an exhibit to the Registration Statement, to be entered into between the Company and U.S. Bank National Association, as trustee (the "***Trustee***"), as supplemented by a first supplemental indenture, substantially in the form filed as an exhibit to the Registration Statement, to be entered into between the Company and the Trustee (collectively, the "***Indenture***").

As counsel to the Company, we have participated in the preparation of the Registration Statement and have examined originals or copies of the following:

(i) the Certificate of Incorporation of the Company, as amended, certified as of the date of this opinion letter by an officer of the Company;

(ii) the Bylaws of the Company, certified as of the date hereof by an officer of the Company;

(iii) a Certificate of Good Standing, dated October [•], 2012, with respect to the Company issued by the Delaware Secretary of State; and

(iv) resolutions of the Board of Directors of the Company relating to, among other things, (a) the authorization and approval of the preparation and filing of the Registration Statement and (b) the authorization, execution and delivery of the Indenture;

(v) the Indenture; and

(vi) a specimen copy of the form of the Notes to be issued pursuant to the Indenture in the form attached to the Indenture.

With respect to such examination and our opinion expressed herein, we have assumed, without any independent investigation or verification, (i) the genuineness of all signatures on all documents submitted to us for examination, (ii) the legal capacity of all natural persons, (iii) the authenticity of all documents submitted to us as originals, (iv) the conformity to original documents of all documents submitted to us as conformed or reproduced copies and the authenticity of the originals of such copied documents, and (v) that all certificates issued by public officials have been properly issued. We also have assumed without independent investigation or verification (i) the accuracy and completeness of all corporate records made available to us by the Company and (ii) that the Indenture will be a valid and legally binding obligation of the parties thereto (other than the Company).

Where factual matters material to this opinion letter were not independently established, we have relied upon certificates and/or representations of officers of the Company. We have also relied on certificates of public officials. Except as otherwise stated herein, we have not independently established the facts, or in the case of certificates of public officials, the other statements, so relied upon.

This opinion is limited to the General Corporation Law of the Delaware and the contract laws of the State of New York, in each case, as in effect on the date hereof, and we express no opinion with respect to any other laws of the State of Delaware or the State of New York or the laws of any other jurisdiction. Without limiting the preceding sentence, we express no opinion as to any state securities or broker-dealer laws or regulations thereunder relating to the offer, issuance or sale of the Notes. This opinion letter has been prepared, and should be interpreted, in accordance with customary practice followed in the preparation of opinion letters by lawyers who regularly give, and such customary practice followed by lawyers who on behalf of their clients regularly advise opinion recipients regarding, opinion letters of this kind.

Based upon and subject to the limitations, exceptions, qualifications and assumptions set forth in this opinion letter, we are of the opinion that, when the Notes are duly executed and delivered by duly authorized officers of the Company and duly authenticated by the Trustee, all in accordance with the provisions of the Indenture, and delivered to the purchasers thereof against payment of the agreed consideration therefor, the Notes will constitute valid and legally binding obligations of the Company, enforceable against the Company in accordance with their terms.

The opinion expressed in this opinion letter is subject, as to enforcement, to (i) any applicable bankruptcy, insolvency, reorganization, moratorium, fraudulent transfer or conveyance or other laws of general applicability relating to or affecting creditors' rights generally and (ii) general principles of equity (regardless of whether enforceability is considered in a proceeding in equity or at law) and the discretion of the court before which any proceeding therefor may be brought.

The opinions expressed in this opinion letter (a) are strictly limited to the matters stated in this opinion letter, and without limiting the foregoing, no other opinions are to be implied and (b) are only as of the date of this opinion letter, and we are under no obligation, and do not undertake, to advise the addressee of this opinion letter or any other person or entity either of any change of law or fact that occurs, or of any fact that comes to our attention, after the date of this opinion letter, even though such change or such fact may affect the legal analysis or a legal conclusion in this opinion letter.

We hereby consent to the filing of this opinion as an exhibit to the Registration Statement and to the reference to our firm in the "Legal Matters" section in the Registration Statement. We do not admit by giving this consent that we are in the category of persons whose consent is required under Section 7 of the Securities Act.

Very truly yours,

/s/ Sutherland Asbill & Brennan LLP

**Exhibit n.1**

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We have issued our reports dated March 15, 2012, with respect to the financial statements and financial highlights and internal control over financial reporting contained in the Registration Statement and Prospectus and our report dated August 2, 2012, with respect to the debt obligations and indebtedness incorporated by reference in the Registration Statement and Prospectus of KCAP Financial, Inc. (formerly, Kohlberg Capital Corporation). We consent to the use of the aforementioned reports in the Registration Statement and Prospectus, and to the use of our name as it appears under the caption "Independent Registered Public Accounting Firm."

/s/ GRANT THORNTON LLP

New York, New York
October 2, 2012

**Exhibit n.2**

**CONSENT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS**

We have issued our report dated March 15, 2012, with respect to the combined financial statements of Katonah Debt Advisors, L.L.C. and affiliates as of December 31, 2011 and 2010, and the related combined statements of operations, cash flows, and members' equity for the years then ended, contained in the Registration Statement and Prospectus of KCAP Financial, Inc. We hereby consent to the inclusion of said report in the Registration Statement and Prospectus of KCAP Financial, Inc.

/s/ GRANT THORNTON LLP

New York, New York
October 2, 2012

**Exhibit n.3**

**CONSENT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS**

We have issued our report dated May 14, 2012, with respect to the consolidated financial statements of Trimaran Advisors, L.L.C. and affiliates as of December 31, 2011 and 2010, and the related consolidated statements of operations, cash flows, and members' equity for each of the three years ended December 31, 2011, contained in the Registration Statement and Prospectus of KCAP Financial, Inc. We hereby consent to the inclusion of said report in the Registration Statement and Prospectus of KCAP Financial, Inc.

/s/ GRANT THORNTON LLP

New York, New York
October 2, 2012

**Exhibit 99.1**

## Computation of Ratios of Earnings to Fixed Charges

| | Six Months Ended June 30, 2012 | Year Ended December 31, 2011 | Year Ended December 31, 2010 | Year Ended December 31, 2009 | Year Ended December 31, 2008 | Year Ended December 31, 2007 |
|---|---|---|---|---|---|---|
| **Earnings:** | | | | | | |
| Net increase in net assets from operations | $ 2,194,109 | $ 7,649,544 | $ (14,288,678) | $ 34,428,269 | $ (63,283,409) | $ 26,141,985 |
| Income tax expense, including excise tax | - | - | - | (25,000) | - | - |
| Total Earnings before taxes | $ 2,194,109 | $ 7,649,544 | $ (14,288,678) | $ 34,403,269 | $ (63,283,409) | $ 26,141,985 |
| | | | | | | |
| **Fixed Charges:** | | | | | | |
| Interest expense | $ 3,088,638 | $ 4,588,465 | $ 6,921,159 | $ 9,059,334 | $ 10,758,821 | $ 7,127,433 |
| Total fixed charges | $ 3,088,638 | $ 4,588,465 | $ 6,921,159 | $ 9,059,334 | $ 10,758,821 | $ 7,127,433 |
| | | | | | | |
| Earnings available to cover fixed charges | $ 5,282,747 | $ 12,238,009 | $ (7,367,520) | $ 43,462,603 | $ (52,524,588) | $ 33,269,418 |
| | | | | | | |
| Ratio of earnings to fixed charges | 1.71 | 2.67 | (1.06) | 4.80 | (4.88) | 4.67 |