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

Form 10-Q

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QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2013

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TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File No. 814-00735

KCAP Financial, Inc.
(Exact name of Registrant as specified in its charter)

Delaware **(State or other jurisdiction of Incorporation or organization)**	**20-5951150** **(I.R.S. Employer Identification Number)**

295 Madison Avenue, 6th Floor
New York, New York 10017
(Address of principal executive offices)

(212) 455-8300
(Registrant's telephone number, including area code)

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

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

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

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

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

The number of outstanding shares of common stock of the registrant as of August 2, 2013 was 33,314,779.

TABLE OF CONTENTS

KCAP FINANCIAL, INC.
BALANCE SHEETS

	As of June 30, 2013 (unaudited)	As of December 31, 2012
ASSETS		
Investments at fair value:		
Time deposits (cost: 2013 - $0; 2012 - $1,942,834)	$ —	$ 1,942,834
Money market account (cost: 2013 - $67,494,608; 2012 - $30,543,824)	67,494,608	30,543,824
Debt securities (cost: 2013 - $211,661,173; 2012 - $134,377,151)	190,732,894	111,037,882
CLO Fund securities managed by non-affiliates (cost: 2013 - $9,733,633; 2012 - $10,487,023)	1,784,300	3,725,924
CLO Fund securities managed by affiliates (cost: 2013 - $88,175,787; 2012 - $79,659,387)	79,700,585	79,531,583
Equity securities (cost: 2013 - $18,841,238; 2012 - $18,375,587)	9,485,307	8,020,716
Asset manager affiliates (cost: 2013 - $83,234,131; 2012 - $83,161,529)	87,300,000	77,242,000
Total Investments at fair value (cost: 2013 - $479,140,566; 2012 - $358,547,336)	436,497,694	312,044,763
Cash	7,669,782	738,756
Restricted cash	78,985,473	—
Interest receivable	1,164,144	697,349
Receivable for open trades	3,515,052	—
Accounts receivable	3,302,142	2,210,869
Other assets	10,364,201	3,568,736
Total assets	$ 541,498,488	$ 319,260,473
LIABILITIES		
Convertible Notes	$ 51,008,000	$ 60,000,000
Retail Notes	41,400,000	41,400,000
KCAP Senior Funding I, LLC	105,250,000	—
Payable for open trades	66,840,035	—
Accounts payable and accrued expenses	2,692,613	2,581,432
Dividend payable	—	7,403,382
Total liabilities	$ 267,190,648	$ 111,384,814
STOCKHOLDERS' EQUITY		
Common stock, par value $0.01 per share, 100,000,000 common shares authorized; 33,298,674 and 26,470,408 common shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively	$ 330,207	$ 264,382
Capital in excess of par value	370,441,874	310,566,503
Accumulated undistributed net investment income	4,380,234	103,484
Accumulated net realized losses	(57,680,841)	(56,035,375)
Net unrealized depreciation on investments	(43,163,634)	(47,023,335)
Total stockholders' equity	$ 274,307,840	$ 207,875,659
Total liabilities and stockholders' equity	$ 541,498,488	$ 319,260,473
NET ASSET VALUE PER COMMON SHARE	$ 8.24	$ 7.85

See accompanying notes to financial statements.

KCAP FINANCIAL, INC.
STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Investment Income:				
Interest from investments in debt securities	$ 2,997,246	$ 2,671,291	$ 5,475,265	$ 5,172,904
Interest from cash and time deposits	3,026	845	7,738	3,408
Dividends from investments in CLO Fund securities managed by non-affiliates	323,790	458,538	747,664	877,703
Dividends from investments in CLO Fund securities managed by affiliates	4,557,531	5,028,886	10,038,183	8,642,525
Dividends from affiliate asset managers	3,300,000	1,200,000	6,300,000	2,025,000
Capital structuring service fees	52,753	122,044	59,326	161,605
Total investment income	11,234,346	9,481,604	22,628,176	16,883,145
Expenses:				
Interest and amortization of debt issuance costs	2,250,063	1,646,352	4,510,309	3,088,638
Compensation	1,110,409	1,073,975	2,020,122	2,021,710
Professional fees	652,644	245,671	1,294,971	1,162,331
Insurance	126,632	142,676	255,348	272,280
Administrative and other	513,085	369,109	1,019,556	695,085
Total expenses	4,652,833	3,477,783	9,100,306	7,240,044
Net Investment Income	**6,581,513**	**6,003,821**	**13,527,870**	**9,643,101**
Realized And Unrealized Gains (Losses) On Investments:				
Net realized gains (losses) from investment transactions	(1,562,529)	1,688	(1,645,466)	304,421
Net change in unrealized appreciation (depreciation) on:				
Debt securities	124,466	(3,915,572)	2,410,992	(4,998,267)
Equity securities	1,064,379	997,361	998,942	1,678,347
CLO Fund securities managed by affiliates	(3,768,238)	264,851	(8,347,397)	2,631,727
CLO Fund securities managed by non-affiliates	(820,826)	(38,767)	(1,188,235)	(65,611)
Affiliate asset manager investments	6,910,060	(1,695,927)	9,985,399	(6,999,609)
Total net change in unrealized appreciation (depreciation)	3,509,841	(4,388,054)	3,859,701	(7,753,413)
Net realized and unrealized appreciation (depreciation) on investments	1,947,312	(4,386,366)	2,214,235	(7,448,992)
Net Increase In Net Assets Resulting From Operations	$ 8,528,825	$ 1,617,455	$ 15,742,105	$ 2,194,109
Net Increase In Net Assets Resulting from Operations per Common Share:				
Basic:	$ 0.26	$ 0.06	$ 0.51	$ 0.09
Diluted:	$ 0.25	$ 0.06	$ 0.48	$ 0.09
Net Investment Income Per Common Share:				
Basic:	$ 0.20	$ 0.23	$ 0.43	$ 0.38
Diluted:	$ 0.20	$ 0.23	$ 0.42	$ 0.38
Weighted Average Shares of Common Stock Outstanding—Basic	33,040,155	26,633,122	31,163,596	25,451,974
Weighted Average Shares of Common Stock Outstanding—Diluted	39,372,311	26,633,122	37,495,139	25,451,974

See accompanying notes to financial statements.

KCAP FINANCIAL, INC.
STATEMENTS OF CHANGES IN NET ASSETS
(unaudited)

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Operations:		
Net investment income	$ 13,527,870	$ 9,643,101
Net realized gains (losses) from investment transactions	(1,645,466)	304,421
Net change in unrealized appreciation (depreciation) on investments	3,859,701	(7,753,413)
Net increase in net assets resulting from operations	15,742,105	2,194,109
Stockholder distributions:		
Tax return of capital Distributions to stockholders	(9,251,119)	(4,731,232)
Tax return of capital distributions to stockholders	—	(7,308)
Net decrease in net assets resulting from stockholder distributions	(9,251,119)	(4,738,540)
Capital transactions:		
Issuance of common stock for:		
Interest in affiliate asset manager	—	25,560,000
Dividend reinvestment plan	394,275	280,095
Issuance of common stock for public offering	50,404,236	—
Vesting of restricted stock	—	501
Convertible Bonds Conversion	8,992,000	—
Stock based compensation	150,687	338,202
Net increase in net assets resulting from capital transactions	59,941,198	26,178,798
Net assets at beginning of period	207,875,656	180,525,941
Net assets at end of period (including undistributed net investment income of $4,380,234 in 2013 and $5,726,464 in 2012)	$ 274,307,840	$ 204,160,309
Net asset value per common share	$ 8.24	$ 7.66
Common shares outstanding at end of period	33,298,674	26,664,132

See accompanying notes to financial statements.

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

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
OPERATING ACTIVITIES:		
Net increase in net assets resulting from operations	$ 15,742,105	$ 2,194,109
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	1,645,466	(304,421)
Net change in unrealized (appreciation) depreciation on investments	(3,859,701)	7,753,413
Net accretion of discount on securities and loans	496,351	(1,005,102)
Amortization of debt issuance cost	402,169	283,105
Payment-in-kind interest income	—	(96,908)
Stock-based compensation expense	150,687	338,202
Changes in operating assets and liabilities:		
Purchases of investments	(111,594,696)	(70,119,157)
Proceeds from sale and redemption of investments	50,241,800	49,804,938
Increase in interest and dividends receivable	(466,795)	(374,740)
Increase in accounts receivable	(1,091,273)	(1,145,165)
Decrease in time deposits	1,942,834	—
Increase in other assets	(7,197,635)	(247,782)
Decrease in due from affiliates	—	3,126
Decrease in accounts payable and accrued expenses	111,180	(167,548)
Net cash used in by operating activities	(53,477,508)	(13,083,930)
FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	50,404,236	—
Dividends paid in cash	(16,260,229)	(8,537,984)
Proceeds from issuance of debt	105,250,000	22,500,000
Cash paid on repayment of debt	—	(1,000,000)
Increase in restricted cash	(78,985,473)	(815,478)
Net cash provided by (used in) financing activities	60,408,534	12,146,538
CHANGE IN CASH	6,931,026	(937,392)
CASH, BEGINNING OF PERIOD	738,756	2,555,259
CASH, END OF PERIOD	$ 7,669,782	$ 1,617,867
Supplemental Information:		
Interest paid during the period	$ 4,193,151	$ 2,781,731
Dividends paid during the period under the dividend reinvestment plan	$ 393,297	$ 280,596
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, 2013
(Unaudited)

Debt Securities Portfolio

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
Advanced Lighting Technologies, Inc.[10, 12] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	First Lien Bond — 10.5% Cash, Due 6/19	$ 3,000,000	$ 2,932,604	$ 2,550,300
Alaska Communications Systems Holdings, Inc.[10, 12] *Telecommunications*	Senior Secured Loan — Term Loan 6.0% Cash, Due 10/16	2,826,477	2,837,525	2,801,039
Allison Transmission, Inc.[12] *Automobile*	Senior Secured Loan — New Term B-2 Loan 3.2% Cash, Due 8/17	1,970,100	1,963,543	1,979,951
Alpha Topco Limited[3] *Automobile*	Senior Secured Loan — New Facility B (USD) 4.5% Cash, Due 4/19	3,990,000	3,993,741	3,994,988
Apria Healthcare Group Inc.[10, 12] *Healthcare, Education and Childcare*	Senior Secured Loan — Initial Term Loan 6.8% Cash, Due 4/20	3,000,000	3,010,929	3,008,445
Aramark Corporation[10, 12] *Diversified/Conglomerate Service*	Senior Secured Loan — LC-3 Facility 3.8% Cash, Due 7/16	61,707	61,748	61,807
Aramark Corporation[10, 12] *Diversified/Conglomerate Service*	Senior Secured Loan — U.S. Term C Loan 3.8% Cash, Due 7/16	938,293	938,923	939,813
Asurion, LLC (fka Asurion Corporation)[10, 12] *Insurance*	Senior Secured Loan — Incremental Tranche B-1 Term Loan 4.5% Cash, Due 5/19	1,990,000	2,016,406	1,973,831
Avis Budget Car Rental, LLC [12] *Personal Transportation*	Senior Secured Loan — New Tranche B Term Loan (2013) 3.0% Cash, Due 3/19	1,980,045	2,015,845	1,986,975
Bankruptcy Management Solutions, Inc.[10] *Diversified/Conglomerate Service*	Senior Secured Loan — Term B Loan (2013) 7.0% Cash, Due 6/18	727,273	727,273	724,581

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
BBB Industries, LLC[10, 12] *Automobile*	Senior Secured Loan — Term Loan B 6.5% Cash, Due 3/19	$ 2,962,500	$ 2,947,596	$ 2,962,500
Berry Plastics Corporation [12] *Containers, Packaging and Glass*	Senior Secured Loan — Term C Loan 2.2% Cash, Due 4/15	1,968,504	1,949,168	1,969,183
Blue Coat Systems, Inc.[10, 12] *Electronics*	Senior Secured Loan — New Term Loan 4.5% Cash, Due 5/19	4,000,000	4,015,000	3,988,320
Burger King Corporation[12] *Personal, Food and Miscellaneous Services*	Senior Secured Loan — Tranche B Term Loan (2012) 3.8% Cash, Due 9/19	1,637,625	1,637,968	1,650,193
Caribe Media Inc. (fka Caribe Information Investments[10] Incorporated) *Printing and Publishing*	Senior Secured Loan — Loan 10.0% Cash, Due 11/14	511,876	511,876	509,623
Catalent Pharma Solutions, Inc. (f/k/a Cardinal Health 409[10], Inc.) *Healthcare, Education and Childcare*	Senior Secured Loan — Refinancing Dollar Term-2 (2017) 4.3% Cash, Due 9/17	3,994,987	3,992,500	3,992,590
Catalina Marketing Corporation[10, 12] *Diversified/Conglomerate Service*	Senior Secured Loan — 2017 Term Loan 5.7% Cash, Due 9/17	1,704,212	1,679,331	1,716,994
Chrysler Group LLC[10, 12] *Automobile*	Senior Secured Loan — Term Loan B 4.3% Cash, Due 5/17	1,969,849	1,974,724	1,980,319
Clover Technologies Group, LLC (Clover Holdings Inc.)[10, 12] *Personal and Non Durable Consumer Products (Mfg. Only)*	Senior Secured Loan — Term Loan 7.8% Cash, Due 5/18	2,961,343	3,002,884	2,961,342
CoActive Technologies LLC (fka CoActive Technologies, Inc.)[8, 10] *Machinery (Non-Agriculture, Non-Construction, Non-Electronic)*	Junior Secured Loan — Term Loan (Second Lien) 11.9% PIK, Due 1/15	2,063,007	1,987,358	1,355,188
Del Monte Foods Company[10, 12] *Beverage, Food and Tobacco*	Senior Secured Loan — Initial Term Loan 4.0% Cash, Due 3/18	2,789,388	2,777,759	2,784,744
eInstruction Corporation[8,10] *Healthcare, Education and Childcare*	Junior Secured Loan — Term Loan (Second Lien) 11.5% Cash, Due 7/14	10,000,000	10,000,000	1,000

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
ELO Touch Solutions, Inc.[10, 12] *Electronics*	Senior Secured Loan — Term Loan (First Lien) 8.0% Cash, Due 6/18	$ 1,980,000	$ 1,917,333	$ 1,881,000
Fender Musical Instruments Corporation[10, 12] *Hotels, Motels, Inns, and Gaming*	Senior Secured Loan — Initial Loan 5.8% Cash, Due 4/19	2,701,865	2,713,392	2,711,416
First American Payment Systems, L.P. [10] *Finance*	Junior Secured Loan — Term Loan (Second Lien) 10.8% Cash, Due 4/19	3,000,000	2,946,512	3,001,200
First Data Corporation[10, 12] *Finance*	Senior Secured Loan — 2018 Dollar Term Loan 4.2% Cash, Due 3/18	2,000,000	1,827,483	1,954,720
Flexera Software LLC (fka Flexera Software, Inc.)[10, 12] *Electronics*	Senior Secured Loan — Term Loan 5.0% Cash, Due 3/19	2,992,500	3,001,228	3,005,667
Fram Group Holdings Inc./Prestone Holdings Inc.[10, 12] *Automobile*	Senior Secured Loan — Term Loan (First Lien) 6.5% Cash, Due 7/17	966,900	975,151	960,258
Freescale Semiconductor, Inc. *Electronics*	Senior Subordinated Bond — 10.125% - 12/2016 10.1% Cash, Due 12/16	1,036,000	1,037,899	1,064,490
Getty Images, Inc.[10, 12] *Printing and Publishing*	Senior Secured Loan — Initial Term Loan 4.8% Cash, Due 10/19	3,730,003	3,724,741	3,694,251
Ginn LA Conduit Lender, Inc.[8, 10] *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	50,286
Ginn LA Conduit Lender, Inc.[8, 10] *Buildings and Real Estate*[4]	Senior Secured Loan — First Lien Tranche B Term Loan 11.8% Cash, Due 6/11	2,694,857	2,624,028	107,794
Ginn LA Conduit Lender, Inc.[8, 10] *Buildings and Real Estate*[4]	Junior Secured Loan — Loan (Second Lien) 7.8% Cash, Due 6/12	3,000,000	2,715,997	30,015
Global Tel*Link Corporation[10] *Telecommunications*	Junior Secured Loan — Term Loan (Second Lien) 9.0% Cash, Due 11/20	4,000,000	3,920,000	3,933,320

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
Grande Communications Networks LLC[10, 12] *Telecommunications*	Senior Secured Loan — Initial Term Loan 4.5% Cash, Due 5/20	$ 4,000,000	$ 4,004,949	$ 3,987,500
Grupo HIMA San Pablo, Inc.[10] *Healthcare, Education and Childcare*	Senior Secured Loan — Term B Loan (First Lien) 8.5% Cash, Due 1/18	2,992,500	2,937,569	3,052,350
Grupo HIMA San Pablo, Inc. [10] *Healthcare, Education and Childcare*	Junior Secured Loan — Term Loan (Second Lien) 13.8% Cash, Due 7/18	5,000,000	4,768,694	5,200,000
Gymboree Corporation., The[10, 12] *Retail Stores*	Senior Secured Loan — Term Loan 5.0% Cash, Due 2/18	1,421,105	1,364,947	1,372,695
Hargray Acquisition Co.,/DPC Acquisition LLC/HCP Acquisition LLC,[10, 12] *Broadcasting and Entertainment*	Senior Secured Loan — Initial Term Loan 4.8% Cash, Due 6/19	3,000,000	2,970,000	2,970,000
Harland Clarke Holdings Corp. (fka Clarke American Corp.)[10, 12] *Printing and Publishing*	Senior Secured Loan — Tranche B-3 Term Loan 7.0% Cash, Due 5/18	3,500,000	3,465,767	3,374,385
Hunter Defense Technologies, Inc.[10] *Aerospace and Defense*	Junior Secured Loan — Term Loan (Second Lien) 7.0% Cash, Due 2/15	4,074,074	4,038,681	3,829,630
Iasis Healthcare LLC[10] *Healthcare, Education and Childcare*	Senior Unsecured Bond — 8.375% - 05/2019 8.4% Cash, Due 5/19	3,000,000	2,884,958	3,067,500
International Architectural Products, Inc.[8, 10] *Mining, Steel, Iron and Non-Precious Metals*	Senior Secured Loan — Term Loan 12.0% Cash, 3.3% PIK, Due 5/15	255,127	228,563	995
Jones Stephens Corp.[10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Senior Secured Loan — Term Loan 7.0% Cash, Due 9/15	1,234,775	1,234,775	1,234,775
Jones Stephens Corp.[10, 12] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Senior Secured Loan — Term Loan 7.0% Cash, Due 9/15	2,975,207	2,975,207	2,975,207
Key Safety Systems, Inc.[10, 12] *Automobile*	Senior Secured Loan — Initial Term Loan 4.8% Cash, Due 5/18	2,692,152	2,678,691	2,708,978

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
LBREP/L-Suncal Master I LLC[8, 10] *Buildings and Real Estate*[4]	Senior Secured Loan — Term Loan (First Lien) 7.5% Cash, Due 1/10	$ 3,345,759	$ 3,345,759	$ 303,460
LTS Buyer LLC (Sidera Networks, Inc.)[10] *Telecommunications*	Senior Secured Loan — Term B Loan (First Lien) 4.5% Cash, Due 4/20	4,000,000	3,993,750	3,992,400
MB Aerospace ACP Holdings III Corp.[10] *Aerospace and Defense*	Senior Secured Loan — Term Loan 6.0% Cash , Due 5/19	4,000,000	3,960,480	4,017,520
Michael Foods Group, Inc. (f/k/a M-Foods Holdings, Inc.)[10, 12] *Beverage, Food and Tobacco*	Senior Secured Loan — Term B Facility 4.3% Cash, Due 2/18	1,801,784	1,808,862	1,814,919
Mill US Acquisition[10] *Beverage, Food and Tobacco*	Junior Secured Loan — Term Loan (Second Lien) 8.5% Cash, Due 5/20	3,000,000	3,020,000	2,985,000
Mill US Acquisition[10, 12] *Beverage, Food and Tobacco*	Senior Secured Loan — Term Loan (First Lien) 4.8% Cash, Due 5/20	3,666,667	3,665,000	3,641,477
Neiman Marcus Group Inc., The[10, 12] *Retail Stores*	Senior Secured Loan — Term Loan 4.0% Cash, Due 5/18	2,000,000	1,991,986	1,996,770
Ozburn-Hessey Holding Company LLC[10, 12] *Cargo Transport*	Senior Secured Loan — Term Loan 6.8% Cash, Due 5/19	3,565,914	3,550,969	3,551,437
Pegasus Solutions, Inc.[10] *Leisure, Amusement, Motion Pictures, Entertainment*	Senior Subordinated Bond — Senior Subordinated Second Lien PIK Notes 13.0% PIK, Due 4/14	1,800,922	1,800,922	953,408
Perseus Holding Corp.[10] *Leisure, Amusement, Motion Pictures, Entertainment*	Preferred Stock — Preferred Stock 14.0% Cash	400,000	400,000	1,000
PetCo Animal Supplies, Inc.[10, 12] *Retail Stores*	Senior Secured Loan — New Loans 4.0% Cash, Due 11/17	1,989,796	1,994,574	1,992,293
Pinnacle Foods Finance LLC [12] *Beverage, Food and Tobacco*	Senior Secured Loan — New Term Loan G 3.3% Cash, Due 4/20	2,992,500	2,985,046	2,979,034

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
SGF Produce Holding Corp.(Frozsun, Inc.)[10] *Beverage, Food and Tobacco*	Senior Secured Loan — Term Loan 6.8% Cash, Due 3/19	$ 2,224,569	$ 2,203,021	$ 2,224,569
SGF Produce Holding Corp.(Frozsun, Inc.)[10, 12] *Beverage, Food and Tobacco*	Senior Secured Loan — Term Loan 6.8% Cash, Due 3/19	3,492,781	3,458,692	3,492,781
Spin Holdco Inc.[10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Senior Secured Loan — Initial Term Loan (First Lien) 4.3% Cash, Due 11/19	1,250,000	1,248,438	1,248,438
Spin Holdco Inc.[10, 12] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Senior Secured Loan — Initial Term Loan (First Lien) 4.3% Cash, Due 11/19	2,750,000	2,749,063	2,746,563
Stafford Logistics, Inc.(dba Custom Ecology, Inc.)[10, 12] *Ecological*	Senior Secured Loan — Term Loan 6.8% Cash, Due 6/19	3,000,000	2,970,000	2,970,000
Sun Products Corporation, The (fka Huish Detergents Inc.)[10, 12] *Personal and Non Durable Consumer Products (Mfg. Only)*	Senior Secured Loan — Tranche B Term Loan 5.5% Cash, Due 3/20	3,990,000	3,960,075	3,960,075
TriZetto Group, Inc. (TZ Merger Sub, Inc.)[10, 12] *Electronics*	Senior Secured Loan — Term Loan 4.8% Cash, Due 5/18	3,695,459	3,700,920	3,688,530
TRSO I, Inc.[10] *Oil and Gas*	Junior Secured Loan — Term Loan (Second Lien) 11.0% Cash, Due 12/17	10,400,000	10,213,564	10,400,000
TUI University, LLC[10] *Healthcare, Education and Childcare*	Senior Secured Loan — Term Loan (First Lien) 7.3% Cash, Due 10/14	1,885,017	1,866,953	1,772,105
TWCC Holding Corp.[10] *Broadcasting and Entertainment*	Junior Secured Loan — Term Loan (Second Lien) 7.0% Cash, Due 12/20	1,000,000	1,005,007	1,010,000
TWCC Holding Corp.[10, 12] *Broadcasting and Entertainment*	Senior Secured Loan — Term Loan 3.5% Cash, Due 2/17	1,966,350	1,984,912	1,973,016

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
Univar Inc.[10, 12] *Chemicals, Plastics and Rubber*	Senior Secured Loan — Term B Loan 5.0% Cash, Due 6/17	$ 2,939,724	$ 2,939,892	$ 2,875,624
US Foods, Inc. (aka U.S. Foodservice, Inc.)[10] *Personal, Food and Miscellaneous Services*	Senior Secured Loan — Incremental Term Loan 4.5% Cash, Due 3/19	3,000,000	2,985,000	2,975,250
Vertafore, Inc.[10, 12] *Electronics*	Senior Secured Loan — Term Loan (2013) 4.3% Cash, Due 10/19	1,231,141	1,228,949	1,236,374
Vestcom International, Inc. (fka Vector Investment Holdings, Inc.)[10, 12] *Printing and Publishing*	Senior Secured Loan — Term Loan 8.0% Cash, Due 12/18	2,992,500	2,935,923	2,993,697
Wholesome Sweeteners, Inc.[10] *Beverage, Food and Tobacco*	Junior Secured Loan — Subordinated Note (Second Lien) 14.0% Cash, 2.0% PIK, , Due 10/17	6,648,596	6,610,305	6,648,596
WireCo WorldGroup Inc.[10] *Machinery (Non-Agriculture, Non-Construction, Non-Electronic)*	Senior Unsecured Bond — 11.8% Cash, Due 5/17	5,000,000	4,837,744	5,141,500
WireCo WorldGroup Inc.[10, 12] *Machinery (Non-Agriculture, Non-Construction, Non-Electronic)*	Senior Unsecured Bond — 11.8% Cash, Due 5/17	3,000,000	3,090,000	3,084,900
Total Investment in Debt Securities (70% of net asset value at fair value)		$ 213,580,873	$ 211,661,173	$ 190,732,894

Equity Securities Portfolio

Portfolio Company / Principal Business	Investment	Percentage Interest/Shares	Cost	Value[2]
Aerostructures Holdings L.P.[6, 10] *Aerospace and Defense*	Partnership Interests	1.2%	$ 1,000,000	$ 1,000
Aerostructures Holdings L.P.[6, 10] *Aerospace and Defense*	Series A Preferred Interests	1.2%	250,961	70,341
Bankruptcy Management Solutions, Inc.[6, 10] *Diversified/Conglomerate Service*	Class A Warrants	1.7%	-	-
Bankruptcy Management Solutions, Inc.[6, 10] *Diversified/Conglomerate Service*	Class B Warrants	1.7%	-	-
Bankruptcy Management Solutions, Inc.[6, 10] *Diversified/Conglomerate Service*	Class C Warrants	1.7%	-	-
Bankruptcy Management Solutions, Inc.[6, 10] *Diversified/Conglomerate Service*	Common Stock	0.8%	314,325	314,325
Caribe Media Inc. (fka Caribe Information Investments Incorporated)[6, 10] *Printing and Publishing*	Common Stock	1.3%	359,765	612,842
Coastal Concrete Holding II, LLC[6, 10] *Buildings and Real Estate*[4]	Class A Units	10.8%	8,625,626	1,000
eInstruction Acquisition, LLC[6, 10] *Healthcare, Education and Childcare*	Membership Units	1.1%	1,079,617	1,000
FP WRCA Coinvestment Fund VII, Ltd.[3, 6] *Machinery (Non-Agriculture, Non-Construction, Non-Electronic)*	Class A Shares	1,500	1,500,000	1,839,049
International Architectural Products, Inc.[6, 10] *Mining, Steel, Iron and Non-Precious Metals*	Common Stock	2.5%	292,851	1,000

Portfolio Company / Principal Business	Investment	Percentage Interest/Shares		Cost		Value[2]
Perseus Holding Corp.[6, 10] *Leisure, Amusement, Motion Pictures, Entertainment*	Common Stock	0.2%	$	400,000	$	1,000
Plumbing Holdings Corporation[6, 10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Preferred Stock	4.6%		801,475		902,209
Plumbing Holdings Corporation[6, 10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Common Stock	7.8%		-		688,152
Plumbing Holdings Corporation[6, 10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Preferred Stock	15.5%		2,716,618		3,063,295
TRSO II, Inc.[6, 10] *Oil and Gas*	Common Stock	5.4%		1,500,000		1,990,094
Total Investment in Equity Securities (3% of net asset value at fair value)			$	18,841,238	$	9,485,307

CLO Fund Securities

CLO Equity Investments

Portfolio Company	Investment	Percentage Interest		Cost		Value[2]
Grant Grove CLO, Ltd.[3]	Subordinated Securities	22.2%	$	4,774,950	$	1,508,300
Katonah III, Ltd.[3, 11]	Preferred Shares	23.1%		1,638,683		275,000
Katonah V, Ltd.[3, 11]	Preferred Shares	16.4%		3,320,000		1,000
Katonah VII CLO Ltd.[3, 7]	Subordinated Securities	10.3%		4,506,993		1,794,645
Katonah VIII CLO Ltd[3, 7]	Subordinated Securities	6.9%		3,402,805		1,693,953
Katonah IX CLO Ltd[3, 7]	Preferred Shares	26.7%		2,048,387		1,152,825
Katonah X CLO Ltd [3, 7]	Subordinated Securities	33.3%		11,808,757		7,248,469
Katonah 2007-I CLO Ltd.[3, 7]	Preferred Shares	100.0%		31,086,319		28,839,886
Trimaran CLO IV, Ltd.[3, 7]	Preferred Shares	19.0%		3,564,300		2,720,782
Trimaran CLO V, Ltd.[3, 7]	Subordinate Notes	20.8%		2,725,500		2,285,013
Trimaran CLO VI, Ltd.[3, 7]	Income Notes	16.2%		2,822,200		2,100,121
Trimaran CLO VII, Ltd.[3, 7]	Income Notes	10.5%		3,135,000		2,665,891
Catamaran CLO 2012-1 Ltd.[3, 7]	Subordinated Notes	24.9%		8,991,591		7,599,000
Catamaran CLO 2013-1 Ltd.[3, 7]	Subordinated Notes	23.3%		9,008,400		8,280,000
Total Investment in CLO Equity Securities			$	92,833,885	$	68,164,885

CLO Rated-Note Investment

Portfolio Company	Investment	Percentage Interest	Cost	Value[2]
Katonah 2007-I CLO Ltd.[3, 7]	Class B2L Notes Par Value of $10,500,000 Due 4/22	100%	$ 1,271,689	$ 9,300,000
Catamaran CLO 2012-1 Ltd.[3, 7]	Class F Notes Par Value of $4,500,000 Due 12/23	42.9%	3,803,846	4,020,000
Total Investment in CLO Rated-Note			$ 5,075,535	$ 13,320,000
Total Investment in CLO Fund Securities (30% of net asset value at fair value)			$ 97,909,420	$ 81,484,885

Asset Manager Affiliates

Portfolio Company / Principal Business	Investment	Percentage Interest	Cost	Value[2]
Asset Manager Affiliates[10]	Asset Management Company	100.0%	$ 83,234,131	$ 87,300,000
Total Investment in Asset Manager Affiliates (32% of net asset value at fair value)			$ 83,234,131	$ 87,300,000

Time Deposits and Money Market Account

Time Deposit and Money Market Accounts	Investment	Yield	Par / Cost	Value[2]
JP Morgan Business Money Market Account[10]	Money Market Account	0.15%	$ 245,882	$ 245,882
US Bank Money Market Account[9, 10]	Money Market Account	0.40%	67,248,726	67,248,726
Total Investment in Time Deposit and Money Market Accounts (25% of net asset value at fair value)			$ 67,494,608	$ 67,494,608
Total Investments[5] (159% of net asset value at fair value)			$ 479,140,566	$ 436,497,694

See accompanying notes to financial statements.

1 A majority of the variable rate loans in 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 June 30, 2013.

2 Reflects the fair market value of all investments as of June 30, 2013, 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.

5 The aggregate cost of investments for federal income tax purposes is approximately $479 million. The aggregate gross unrealized appreciation is approximately $16 million, the aggregate gross unrealized depreciation is approximately $59 million, and the net unrealized depreciation is approximately $43 million.

6 Non-income producing.

7 An affiliate CLO Fund is managed by the Asset Manager Affiliates (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 Qualified asset for purposes of section 55(a) of the Investment Company Act of 1940.

11 As of June 30, 2013, this CLO Fund Security was not providing a dividend distribution.

12 As of June 30, 2013, investment was held in KCAP Senior Funding I, LLC.

KCAP FINANCIAL, INC.
SCHEDULE OF INVESTMENTS
As of December 31, 2012

Debt Securities Portfolio

Portfolio Company / Principal Business	Investment Interest Rate¹ / Maturity	Principal	Cost	Value[2]
Advanced Lighting Technologies, Inc.[10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	First Lien Bond — Bond10.5% Cash, Due 6/19	$ 3,000,000	$ 2,928,762	$ 3,000,000
Alaska Communications Systems Holdings, Inc. [10] *Telecommunications*	Senior Secured Loan — Term Loan 5.5% Cash, Due 10/16	2,940,000	2,952,655	2,783,196
Allison Transmission, Inc. *Automobile*	Senior Secured Loan — Term B-2 Loan 3.7% Cash, Due 8/17	1,980,000	1,969,312	1,995,672
Aramark Corporation[10] *Diversified/Conglomerate Service*	Senior Secured Loan — LC-3 Facility 3.5% Cash, Due 7/16	61,707	61,579	61,910
Aramark Corporation[10] *Diversified/Conglomerate Service*	Senior Secured Loan — U.S. Term C Loan 3.5% Cash, Due 7/16	938,293	936,347	941,390
Asurion, LLC (fka Asurion Corporation)[10] *Insurance*	Senior Secured Loan — Term Loan (First Lien) 5.5% Cash, Due 5/18	2,000,000	2,021,506	2,023,130
Avis Budget Car Rental, LLC *Personal Transportation*	Senior Secured Loan — Tranche C Term Loan 4.3% Cash, Due 3/19	1,985,007	2,012,685	2,005,353
Bankruptcy Management Solutions, Inc.[10] *Diversified/Conglomerate Service*	Junior Secured Loan — Loan (Second Lien) 1.2% Cash, 7.0% PIK, Due 8/15	1,405,472	1,225,488	47,435
Bankruptcy Management Solutions, Inc.[10] *Diversified/Conglomerate Service*	Senior Secured Loan — Term Loan B 6.5% Cash, 1.0% PIK, Due 8/14	1,439,164	1,405,984	773,551
Berry Plastics Holding Corporation *Containers, Packaging and Glass*	Senior Secured Loan — Term C Loan 2.2% Cash, Due 4/15	1,979,003	1,949,236	1,971,898

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
Burger King Corporation *Personal, Food and Miscellaneous Services*	Senior Secured Loan — Tranche B Term Loan (2012) 3.8% Cash, Due 9/19	$ 1,645,875	$ 1,641,896	$ 1,657,297
Caribe Media Inc. (fka Caribe Information Investments Incorporated)[10] *Printing and Publishing*	Senior Secured Loan — Loan 10.0% Cash, Due 11/14	621,074	621,074	613,373
Catalina Marketing Corporation[10] *Diversified/Conglomerate Service*	Senior Secured Loan — 2017 Term Loan 5.7% Cash, Due 9/17	1,704,212	1,672,227	1,711,140
Chrysler Group LLC[10] *Automobile*	Senior Secured Loan — Tranche B Term Loan 6.0% Cash, Due 5/17	1,979,899	1,979,899	2,024,724
CoActive Technologies LLC (fka CoActive Technologies, Inc.)[8, 10] *Machinery (Non-Agriculture, Non-Construction, Non-Electronic)*	Junior Secured Loan — Term Loan (Second Lien) 2.3% Cash, 4.8% PIK, Due 1/15	2,063,007	1,987,358	1,299,695
Del Monte Foods Company[10] *Beverage, Food and Tobacco*	Senior Secured Loan — Initial Term Loan 4.5% Cash, Due 3/18	949,124	950,905	952,237
Del Monte Foods Company[10] *Beverage, Food and Tobacco*	Senior Secured Loan — Initial Term Loan 4.5% Cash, Due 3/18	1,927,154	1,907,210	1,933,475
eInstruction Corporation[8, 10] *Healthcare, Education and Childcare*	Junior Secured Loan — Term Loan (Second Lien) 11.5% Cash, Due 7/14	10,000,000	10,000,000	1,000
ELO Touch Solutions, Inc.[10] *Electronics*	Senior Secured Loan — Term Loan (First Lien) 8.0% Cash, Due 6/18	1,990,000	1,915,453	1,989,603
First American Payment Systems, L.P.[10] *Finance*	Junior Secured Loan — Term Loan (Second Lien 2012) 10.8% Cash, Due 4/19	3,000,000	2,941,926	2,985,000
First Data Corporation[10] *Finance*	Senior Secured Loan — 2018 Dollar Term Loan 4.2% Cash, Due 3/18	2,000,000	1,806,842	1,906,710
Fram Group Holdings Inc./Prestone Holdings Inc.[10] *Automobile*	Senior Secured Loan — Term Loan (First Lien) 6.5% Cash, Due 7/17	989,975	996,484	991,212

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
Freescale Semiconductor, Inc. *Electronics*	Senior Subordinated Bond — Bond 10.1% Cash, Due 12/16	$ 1,036,000	$ 1,038,081	$ 1,064,490
Getty Images, Inc.[10] *Printing and Publishing*	Senior Secured Loan — Initial Term Loan (New) 4.8% Cash, Due 10/19	2,000,000	1,980,556	2,005,250
Ginn LA Conduit Lender, Inc.[8, 10] *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	38,506
Ginn LA Conduit Lender, Inc.[8, 10] *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	82,543
Ginn LA Conduit Lender, Inc.[8, 10] *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[10] *Retail Stores*	Senior Secured Loan — Term Loan 5.0% Cash, Due 2/18	1,421,105	1,355,901	1,312,746
HMSC Corporation (aka Swett and Crawford)[10] *Insurance*	Junior Secured Loan — Loan (Second Lien) 5.7% Cash, Due 10/14	5,000,000	4,948,801	4,410,000
Hunter Defense Technologies, Inc.[10] *Aerospace and Defense*	Junior Secured Loan — Term Loan (Second Lien) 7.0% Cash, Due 2/15	4,074,074	4,027,935	3,829,630
Iasis Healthcare LLC[10] *Healthcare, Education and Childcare*	Senior Unsecured Bond — Bond 8.4% Cash, Due 5/19	3,000,000	2,877,729	2,865,000
International Architectural Products, Inc.[8, 10] *Mining, Steel, Iron and Non-Precious Metals*	Senior Secured Loan — Term Loan 12.0% Cash, Due 5/15	507,431	480,868	263,864
Jones Stephens Corp.[10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Senior Secured Loan — Term Loan 7.0% Cash, Due 9/15	4,280,147	4,280,147	4,280,147
KIK Custom Products Inc.[10] *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	3,977,100

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
LBREP/L-Suncal Master I LLC[8, 10] *Buildings and Real Estate*[4]	Senior Secured Loan — Term Loan (First Lien) 7.5% Cash, Due 1/10	$ 3,345,759	$ 3,345,759	$ 303,460
Legacy Cabinets, Inc.[10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Senior Secured Loan — Term Loan 1.0% Cash, 6.3% PIK, Due 5/14	524,571	463,380	447,040
Lord & Taylor Holdings LLC (LT Propco LLC)[10] *Retail Stores*	Senior Secured Loan — Term Loan 5.8% Cash, Due 1/19	430,951	439,877	436,002
Merisant Company[10] *Beverage, Food and Tobacco*	Senior Secured Loan — Loan 7.5% Cash, Due 1/14	4,547,032	4,538,541	4,547,032
Michael Foods Group, Inc. (f/k/a M-Foods Holdings, Inc.)[10] *Beverage, Food and Tobacco*	Senior Secured Loan — Term B Facility 4.3% Cash, Due 2/18	1,825,626	1,828,589	1,838,934
Neiman Marcus Group Inc., The[10] *Retail Stores*	Senior Secured Loan — Term Loan 4.8% Cash, Due 5/18	2,000,000	1,985,894	2,005,800
Pegasus Solutions, Inc.[10] *Leisure, Amusement, Motion Pictures, Entertainment*	Senior Subordinated Bond — Senior Subordinated Second Lien PIK Notes 13.0% PIK, Due 4/14	1,691,007	1,691,007	1,671,391
Perseus Holding Corp.[10] *Leisure, Amusement, Motion Pictures, Entertainment*	Preferred Stock — Preferred Stock 14.0% PIK, Due 4/14	400,000	400,000	371,160
PetCo Animal Supplies, Inc.[10] *Retail Stores*	Senior Secured Loan — New Loan 4.5% Cash, Due 11/17	2,000,000	2,000,000	2,018,220
Pinnacle Foods Finance LLC[10] *Beverage, Food and Tobacco*	Senior Secured Loan — Extended Initial Term Loan 3.7% Cash, Due 10/16	293,014	293,014	295,025
Pinnacle Foods Finance LLC[10] *Beverage, Food and Tobacco*	Senior Secured Loan — Extended Initial Term Loan 3.7% Cash, Due 10/16	1,989,975	1,988,656	2,003,636
TPF Generation Holdings, LLC[10] *Utilities*	Senior Secured Loan — Synthetic LC Deposit (First Lien) 2.3% Cash, Due 12/13	169,532	169,280	169,956

Portfolio Company / Principal Business	Investment Interest Rate[1] / Maturity	Principal	Cost	Value[2]
TriZetto Group, Inc. (TZ Merger Sub, Inc.)[10] *Electronics*	Senior Secured Loan — Term Loan 4.8% Cash, Due 5/18	1,959,860	1,951,082	1,948,013
TRSO I, Inc.[10] *Oil and Gas*	Junior Secured Loan — Term Loan (Second Lien) 11.0% Cash, Due 12/17	10,400,000	10,192,913	10,192,000
TUI University, LLC[10] *Healthcare, Education and Childcare*	Senior Secured Loan — Term Loan (First Lien) 7.3% Cash, , Due 10/14	2,051,442	2,024,477	1,751,521
TWCC Holding Corp.[10] *Broadcasting and Entertainment*	Senior Secured Loan — Term Loan 4.3% Cash, Due 2/17	1,966,350	1,978,846	1,990,930
Univar Inc.[10] *Chemicals, Plastics and Rubber*	Senior Secured Loan — Term B Loan 5.0% Cash, Due 6/17	2,954,773	2,954,773	2,950,577
US Foods, Inc. (aka U.S. Foodservice, Inc.)[10] *Personal, Food and Miscellaneous Services*	Senior Secured Loan — Extended Term Loan 5.8% Cash, Due 3/17	1,978,284	1,932,524	1,983,536
Vertafore, Inc.[10] *Electronics*	Senior Secured Loan — Term Loan (First Lien) 5.3% Cash, Due 7/16	1,237,381	1,232,977	1,250,275
Wholesome Sweeteners, Inc.[10] *Beverage, Food and Tobacco*	Junior Secured Loan — Subordinated Note (Second Lien) 14.0% Cash, Due 10/17	6,648,596	6,605,857	6,715,082
WireCo WorldGroup Inc. [10] *Machinery (Non-Agriculture, Non-Construction, Non-Electronic)*	Senior Unsecured Bond — Bond 11.8% Cash, Due 5/17	8,000,000	7,920,733	8,320,000
Total Investment in Debt Securities (53% of net asset value at fair value)		$ 136,283,876	$ 134,377,151	$ 111,037,882

Equity Securities Portfolio

Portfolio Company / Principal Business	Investment	Percentage Interest/Shares	Cost	Value[2]
Aerostructures Holdings L.P.[6, 10] *Aerospace and Defense*	Partnership Interests	1.2%	$ 1,000,000	$ 1,000
Aerostructures Holdings L.P.[6, 10] *Aerospace and Defense*	Series A Preferred Interests	1.2%	250,961	44,112
Bankruptcy Management Solutions, Inc.[6, 10] *Diversified/Conglomerate Service*	Common Stock	1.2%	218,592	1,000
Bankruptcy Management Solutions, Inc.[6, 10] *Diversified/Conglomerate Service*	Warrants	0.1%	-	-
Coastal Concrete Holding II, LLC[6, 10] *Buildings and Real Estate*[4]	Class A Units	10.8%	8,625,626	1,000
eInstruction Acquisition, LLC[6, 10] *Healthcare, Education and Childcare*	Membership Units	1.1%	1,079,617	1,000
FP WRCA Coinvestment Fund VII, Ltd.[3, 6,] *Machinery (Non-Agriculture, Non-Construction, Non-Electronic)*	Class A Shares	1,500	1,500,000	1,961,550
International Architectural Products, Inc.[6, 10] *Mining, Steel, Iron and Non-Precious Metals*	Common Stock	2.5%	292,851	1,000
Legacy Cabinets, Inc.[6, 10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Equity	4.0%	115,580	1,000
Perseus Holding Corp.[6, 10] *Leisure, Amusement, Motion Pictures, Entertainment*	Common Stock	0.2%	400,000	10,930
Plumbing Holdings Corporation[6, 10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Common Stock	7.8%	-	644,937

Portfolio Company / Principal Business	Investment	Percentage Interest/Shares		Cost		Value[2]
Plumbing Holdings Corporation[6, 10] *Home and Office Furnishings, Housewares, and Durable Consumer Products*	Preferred Stock	9.0%	$	3,032,596	$	3,240,496
Caribe Media Inc. (fka Caribe Information Investments Incorporated)[6, 10] *Printing and Publishing*	Common Stock	1.3%		359,764		612,691
TRSO II, Inc.[6, 10] *Oil and Gas*	Common Stock	5.4%		1,500,000		1,500,000
Total Investment in Equity Securities (4% of net asset value at fair value)			$	18,375,587	$	8,020,716

CLO Fund Securities

CLO Equity Investments

Portfolio Company	Investment	Percentage Interest		Cost		Value[2]
Grant Grove CLO, Ltd.[3]	Subordinated Securities	22.2%	$	4,925,009	$	3,124,924
Katonah III, Ltd.[3, 11]	Preferred Shares	23.1%		2,242,014		600,000
Katonah V, Ltd.[3, 11]	Preferred Shares	26.7%		3,320,000		1,000
Katonah VII CLO Ltd.[3, 7]	Subordinated Securities	16.4%		4,574,393		2,120,168
Katonah VIII CLO Ltd[3, 7]	Subordinated Securities	10.3%		3,450,705		2,171,998
Katonah IX CLO Ltd[3, 7]	Preferred Shares	6.9%		2,082,987		1,488,895
Katonah X CLO Ltd [3, 7]	Subordinated Securities	33.3%		11,934,600		9,455,511
Katonah 2007-I CLO Ltd.[3, 7]	Preferred Shares	100.0%		31,189,147		30,091,886
Trimaran CLO IV, Ltd.[3, 7]	Preferred Shares	19.0%		3,616,600		3,575,571
Trimaran CLO V, Ltd.[3, 7]	Subordinate Notes	20.8%		2,757,100		2,930,004
Trimaran CLO VI, Ltd.[3, 7]	Income Notes	16.2%		2,894,700		2,936,626
Trimaran CLO VII, Ltd.[3, 7]	Income Notes	10.5%		3,146,900		3,357,924
Catamaran CLO 2012-1 Ltd.[3, 7]	Subordinated Notes	24.9%		8,982,400		8,493,000
Total Investment in CLO Equity Securities			$	85,116,555	$	70,347,507

CLO Rated-Note Investment

Portfolio Company	Investment	Percentage Interest	Cost	Value[2]
Katonah 2007-I CLO Ltd.[3, 7]	Class B-2L Notes Par Value of $10,500,000 5.3%, Due 4/22	100.0%	$ 1,252,191	$ 9,140,000
Catamaran CLO 2012-1 Ltd.[3, 7]	Class F Notes Par Value of $4,500,000 6.8%, Due 12/23	42.9%	3,777,664	3,770,000
Total Investment in CLO Rated-Note			$ 5,029,855	$ 12,910,000
Total Investment in CLO Fund Securities (40% of net asset value at fair value)			$ 90,146,410	$ 83,257,507

Asset Manager Affiliates

Portfolio Company / Principal Business	Investment	Percentage Interest	Cost	Value[2]
Asset Manager Affiliates[10]	Asset Management Company	100.0%	$ 83,161,529	$ 77,242,000
Total Investment in Asset Manager Affiliates (37% of net asset value at fair value)			$ 83,161,529	$ 77,242,000

Time Deposits and Money Market Account

Time Deposit and Money Market Accounts	Investment	Yield	Par / Cost	Value[2]
JP Morgan Asset Account[10]	Time Deposit	0.01%	$ 1,942,834	$ 1,942,834
JP Morgan Business Money Market Account[9, 10]	Money Market Account	0.15%	195,856	195,856
US Bank Money Market Account[10]	Money Market Account	0.40%	30,347,968	30,347,968
Total Investment in Time Deposit and Money Market Accounts (16% of net asset value at fair value)			$ 32,486,658	$ 32,486,658
Total Investments[5] (150% of net asset value at fair value)			$ 358,547,336	$ 312,044,763

See accompanying notes to financial statements.

1 A majority of the variable rate loans to the Company's portfolio companies bear interest at a rate that may be determined by reference to either LIBOR or an alternate Base Rate (commonly based on the Federal Funds Rate or the Prime Rate), which typically resets semi-annually, quarterly, or monthly. For each such loan, the Company has provided the weighted average annual stated interest rate in effect at December 31, 2012.

2 Reflects the fair market value of all investments as of December 31, 2012, 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.

5 The aggregate cost of investments for federal income tax purposes is approximately $359 million. The aggregate gross unrealized appreciation is approximately $11 million, the aggregate gross unrealized depreciation is approximately $58 million, and the net unrealized depreciation is approximately $47 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 Qualified asset for purposes of section 55(a) of the Investment Company Act of 1940.

11 As of December 31, 2012, this CLO Fund Security was not providing a dividend distribution.

KCAP FINANCIAL, INC.
FINANCIAL HIGHLIGHTS
(unaudited)

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Per Share Data:		
Net asset value, at beginning of period	$ 7.85	$ 7.85
Net investment income[1]	0.43	0.38
Net realized gains (losses)[1] from investment transactions	(0.05)	0.01
Net change in unrealized appreciation (depreciation) on investments[1]	0.12	(0.43)
Net Income (Loss)	0.50	(0.04)
Net decrease in net assets resulting from distributions		
Dividends from net investment income	(0.28)	(0.18)
Net decrease in net assets resulting from distributions	(0.28)	(0.18)
Issuance of common stock (not including dividend reinvestment plan)	0.16	-
Issuance of common stock under dividend reinvestment plan	0.01	0.01
Stock based compensation expense	-	0.02
Net increase in net assets from distributions	0.17	0.03
Net asset value, end of period	$ 8.24	$ 7.66
Total net asset value return[2]	8.4%	(0.2)%
Ratio/Supplemental Data:		
Per share market value at beginning of period	$ 9.19	$ 6.31
Per share market value at end of period	$ 11.26	$ 7.26
Total market return[3]	25.5%	17.9%
Shares outstanding at end of period	33,298,674	26,664,132
Net assets at end of period	$ 274,307,840	$ 204,160,309
Portfolio turnover rate[4]	37.7%	10.9%
Average debt outstanding	$ 104,537,912	$ 67,604,396
Weighted average debt outstanding	7.8%	8.3%
Asset coverage ratio	239%	351%
Ratio of net investment income to average net assets[5]	10.9%	9.7%
Ratio of total expenses to average net assets[5]	7.3%	7.3%
Ratio of interest expense to average net assets[5]	3.6%	3.1%
Ratio of non-interest expenses to average net assets[5]	3.7%	4.2%

1 Based on 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 less proceeds from issuance of common shares.

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” 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 of 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 (“IPO”), converted to a corporation incorporated in Delaware on December 11, 2006. Prior to its 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., a leading middle market private equity firm, in exchange for the contribution to the Company 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.

On February 29, 2012, the Company purchased Trimaran Advisors, L.L.C. (“Trimaran Advisors”), a 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 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, 2013, Katonah Debt Advisors and Trimaran Advisors are the Company’s only wholly-owned portfolio companies (collectively, “Asset Manager Affiliates”) and have approximately $3.7 billion of par value assets under management. The Asset Manager Affiliates are registered under the Investment Advisers Act of 1940 and are managed independently from the Company by separate management teams and investment committees.

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 the Asset Manager Affiliates. The Asset Manager Affiliates manage CLO Funds which invest in broadly syndicated loans, high-yield bonds and other credit instruments.

While the Company’s primary investment focus is on making loans to, and selected equity investments in, privately-held middle market companies, the Company may also invest in other investments such as loans to larger, publicly-traded companies, high-yield bonds and distressed debt securities. The Company may also receive warrants or options to purchase common stock in connection with its debt investments. In addition, the Company may also invest in debt and equity securities issued by the CLO Funds managed by our Asset Manager Affiliates or by other asset managers.

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 and annual distribution 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.

The Company consolidated the results of KCAP Senior Funding I, LLC and KCAP Senior Funding I Holdings, LLC in its consolidated financial statements as KCAP Senior Funding I, LLC and KCAP Senior Funding I Holdings, LLC are operated solely for investment activities of the Company. The creditors of KCAP Senior Funding I, LLC have received security interests in the assets owned by KCAP Senior Funding I, LLC and such assets are not intended to be available to the creditors of KCAP Financial, Inc., or any other affiliate.

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, 2012, as filed with the U.S. 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 including with respect to the fair value of investments that do not have a readily available market value. 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.

The accompanying financial statements reflect the consolidated accounts of the Company and its special purpose financing subsidiaries, KCAP Funding, KCAP Senior Funding I, LLC and KCAP Senior Funding I Holdings, LLC, (see Note 4) with all significant intercompany balances eliminated. 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 (e.g., the Asset Manager Affiliates). The Asset Manager Affiliates are subject to Accounting Standards Codification Topic 810, “Consolidation” and although the Company cannot consolidate portfolio company investments, this guidance impacted the required disclosures relating to the Asset Manager Affiliates, as it requires the Asset Manager Affiliates to consolidate their managed CLO Funds. As a result of the consolidation of these CLOs into the Asset Manager Affiliates, the Asset Manager Affiliates qualify as a “significant subsidiary” and, as a result, the Company is required to include additional disclosures regarding the Asset Manager Affiliates in its filings with the SEC. The additional financial information regarding the Asset Manager Affiliates do not directly impact the financial position or results of operations of the Company.

In addition, Katonah 2007-I Ltd. qualifies as a “significant subsidiary” and the Company is also required to provide additional disclosures relating to it. Katonah 2007-I CLO Ltd is an exempted company incorporated in November 15, 2006 with limited liability under the laws of the Cayman Islands for the sole purpose of investing in broadly syndicated loans, high-yield bonds and other credit instruments. The fund is what is commonly known as a collateralized loan obligation fund (“CLO Fund”). The additional disclosures regarding Katonah 2007-I Ltd. do not directly impact the financial position or results of operations of the Company.

The additional financial information regarding the Asset Manager Affiliates and Katonah 2007-I CLO Ltd. (“Katonah 2007-I CLO”) can be found in Note 5 – Asset Manager Affiliates, below.

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.

The FASB issued guidance that clarified and required disclosures about fair value measurements. The clarifications and requirement to disclose the amounts and reasons for significant transfers between Level I and Level II, as well as significant transfers in and out of Level III of the fair value hierarchy. Note 4 - Investments below reflects the amended disclosure requirements. The guidance also required that purchases, sales, issuances and settlements be presented gross in the Level III reconciliation.

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.

Since 2010, the Company engaged an independent valuation firm to provide a third-party review of the 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 model for fair value purposes and that the inputs were being employed correctly.

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 of 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 5% of investments at fair value excluding our investments in the Asset Manager Affiliates and CLO Fund Securities for the three months ended June 30, 2013. 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 below 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) Debt securities, equity securities, CLO Fund securities and the Asset Manager Affiliates will 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.

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.

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, 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 securities. Because the Company has not identified any market index that directly correlates to the loan and debt securities 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 Securities. The Company's equity 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 (earnings before interest, taxes, depreciation and amortization) 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 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 securities include prices, earnings, EBITDA and cash flows after capital expenditures for similar peer comparables and the investment entity itself. Equity 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.

Asset Manager Affiliates. The Company's investments in its wholly-owned asset management companies, 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 securities held by CLO Funds generally relate to credit instruments issued by corporations.

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 or (iii) indicative prices provided by the underwriters or brokers who arrange CLO Funds. The Company recognizes unrealized appreciation or depreciation on the Company's investments in CLO Fund securities as comparable yields in the market change and/or based on changes in net asset values or estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each investment in CLO Fund securities ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool are updated and the revised cash flows are used in determining the fair value of the CLO Fund investment. The Company determines the fair value of its investments in CLO Fund securities on a security-by-security basis.

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

For bond 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 indicative prices provided by underwriters or brokers who arrange CLO Funds, and 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. 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. As of June 30, 2013, the Company had approximately $79 million of restricted cash, all of which related to the KCAP Senior Funding I Notes.

Time Deposits and Money Market Accounts. Time deposits primarily represent investments of cash held in a 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, 2013, five issuers representing less than 1% of total investments at fair value were on a non-accrual status.

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

Dividend Income from CLO Fund Securities. The Company generates dividend income from its investments in the most junior class of securities of CLO Funds (typically preferred shares or subordinated securities) managed by the Asset Manager Affiliates and selective investments in securities issued by funds managed by other asset management companies. The Company's CLO Fund junior class securities are subordinated to senior note 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 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 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-I CLO and Class F Notes of the Catamaran 2012-1 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.

During March 2011, the Company issued $60 million of Convertible Notes (the "Convertible Notes") and incurred debt issuance costs of approximately $2.4 million which are being amortized over a five-year period. During October 2012, the Company issued $41.4 million of 7.375% Notes due 2019 (the "Retail Notes") and incurred debt issuance costs of approximately $1.5 million, which are being amortized over a seven year period. At June 30, 2013, there was an unamortized debt issuance cost of approximately $2.4 million included in other assets in the accompanying balance sheet. Amortization expense related to the Convertible Notes and Retail Notes for the six months ended June 30, 2013 and 2012 was approximately $285,000 and $354,000, respectively, and is included in interest and amortization of debt issuance costs on the statement of operations.

On June 18, 2013, the Company completed the sale of notes in a $140,000,000 debt securitization financing transaction. The notes offered in this transaction (the "Notes") were issued by KCAP Senior Funding I, LLC, a newly formed special purpose vehicle (the "Issuer"), in which KCAP Senior Funding I Holdings, LLC, a wholly-owned subsidiary of the Company (the "Depositor"), owns all of the equity, and are backed by a diversified portfolio of bank loans. The secured Notes (the "Secured Notes") were issued as Class A-1 senior secured floating rate notes which have an initial face amount of $77,250,000; and bear interest at the three-month London Interbank Offered Rate ("LIBOR") plus 1.50%, Class B-1 senior secured floating rate notes which have an initial face amount of $9,000,000, bear interest at three-month LIBOR plus 3.25%, Class C-1 secured deferrable floating rate notes which have an initial face amount of $10,000,000, bear interest at three-month LIBOR plus 4.25%, and Class D-1 secured deferrable floating rate notes which have an initial face amount of $9,000,000 bear interest at three-month LIBOR plus 5.25%. The Depositor retained all of the subordinated notes of the Issuer (the "Subordinated Notes"), which have an initial face amount of $34,750,000. The Subordinated Notes do not bear interest. Both the Secured Notes and the Subordinated Notes have a stated maturity on the payment date occurring in July, 2024 and are subject to a two year non-call period. The Issuer has a four year reinvestment period. At June 30, 2013, there were unamortized issuance costs of approximately $3.9 million and unamortized original issue discount, ("OID") costs of approximately $3.3 million included in other assets in the accompanying balance sheet. Amortization expense for the six months ended June 30, 2013 was approximately $46,000 and $15,000, for issuance costs and OID respectively, and is included in interest and amortization of debt issuance costs on the statement of operations.

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.

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 distributable taxable income 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.

3. EARNINGS PER SHARE

The following information sets forth the computation of basic and diluted net increase (decrease) in stockholders' equity per share for the three and six months ended June 30, 2013 and 2012 (unaudited):

	(unaudited) Three Months Ended June 30,		(unaudited) Six Months Ended June 30,	
	2013	**2012**	**2013**	**2012**
Net increase in net assets from operations	$ 8,528,825	$ 1,617,456	$ 15,742,105	$ 2,194,109
Net decrease in net assets allocated to unvested share awards	(47,138)	(19,531)	(53,665)	(27,971)
Add: Interest on Convertible Notes	1,122,357	—	2,434,857	—
Add: Amortization of Capitalized Costs on Convertible Notes	92,360	—	198,475	—
Net increase in net assets available to common stockholders	9,696,404	1,597,925	18,321,772	2,166,138
Weighted average number of common shares outstanding for basic shares computation	33,040,155	26,633,122	31,163,596	25,451,974
Effect of dilutive securities - stock options	16,330	8,966	15,717	10,469
Effect of dilutive Convertible Notes	6,338,639	—	6,843,429	—
Weighted average number of common and common stock equivalent shares outstanding for diluted shares computation	39,395,124	26,642,088	38,022,742	25,462,443
Net increase in net assets per basic common shares:				
Net increase in net assets from operations	0.26	0.06	0.51	0.09
Net increase in net assets per diluted shares:				
Net increase in net assets from operations	0.25	0.06	0.48	0.09

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 the Company's 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. Subsequent to June 30, 2013, 14,360 shares were issued under the Company's Dividend Reinvestment Plan. Had these shares been issued during the quarter, their impact would have been immaterial to earning per share.

The Company's Convertible 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, 2013, the effect of the convertible debt was dilutive. For the three and six months ended June 30, 2012, the effect of the convertible debt was antidilutive.

The if-converted method of computing the dilutive effects on convertible debt assumes a conversion even if the contracted conversion price exceeds the market value of the shares. As of June 30, 2013 the conversion price of the convertible senior is approximately 123.8203 shares of our common stock per $1,000 principal amount of the conversion rate, equivalent to a conversion price of approximately $8.08 per share of the Company's common stock. Subsequent to the reporting period, the Convertible Notes is approximately 125.0814 shares of the Company's common stock per $1,000 principal amount of the Convertible Notes, equivalent to a conversion price of approximately $7.99 per share of our common stock. Upon conversion, the Company may issue the full amount of common stock 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. However, the Company may invest in other companies if it is presented with attractive opportunities.

The following table shows the Company's portfolio by security type at June 30, 2013 and December 31, 2012:

	June 30, 2013 (unaudited)			December 31, 2012		
Security Type	**Cost**	**Fair Value**	**%[1]**	**Cost**	**Fair Value**	**%[1]**
Time Deposits	$ -	$ -	-%	$ 1,942,834	$ 1,942,834	1%
Money Market Account	67,494,608	67,494,608	25	30,543,824	30,543,824	15
Senior Secured Loan	143,450,925	136,475,845	50	67,874,565	60,258,885	29
Junior Secured Loan	51,226,118	38,393,950	14	49,646,273	33,486,956	17
First Lien Bond	2,932,604	2,550,300	1	2,928,762	3,000,000	1
Senior Subordinated Bond	2,838,822	2,017,899	1	2,729,088	2,735,881	1
Senior Unsecured Bond	10,812,702	11,293,900	4	10,798,463	11,185,000	5
CLO Fund Securities	97,909,419	81,484,885	30	90,146,410	83,257,507	40
Equity Securities	18,841,238	9,485,307	3	18,375,588	8,020,716	4
Preferred Stock	400,000	1,000	-	400,000	371,160	-
Asset Manager Affiliates	83,234,131	87,300,000	32	83,161,529	77,242,000	37
Total	$ 479,140,566	$ 436,497,694	160%	$ 358,547,336	$ 312,044,763	150%

[1] Calculated as a percentage of net asset value.

The industry concentrations based on the fair value of the Company's investment portfolio as of June 30, 2013 and December 31, 2012, were as follows:

	June 30, 2013 (unaudited)			December 31, 2012		
Industry Classification	**Cost**	**Fair Value**	**%[1]**	**Cost**	**Fair Value**	**%[1]**
Aerospace and Defense	$ 9,250,122	$ 7,918,491	3%	$ 5,278,896	$ 3,874,742	2%
Asset Management Companies[2]	83,234,131	87,300,000	32	83,161,529	77,242,000	37
Automobile	14,533,445	14,586,994	5	4,945,695	5,011,608	2
Beverage, Food and Tobacco	26,528,685	26,571,120	10	18,112,772	18,285,421	9
Broadcasting and Entertainment	5,959,919	5,953,016	2	1,978,846	1,990,930	1
Buildings and Real Estate	18,535,511	492,555	-	18,535,511	455,524	-
Cargo Transport	3,550,969	3,551,437	1	-	-	-
Chemicals, Plastics and Rubber	2,939,892	2,875,624	1	2,954,773	2,950,577	1
CLO Fund Securities	97,909,420	81,484,885	30	90,146,410	83,257,507	40
Containers, Packaging and Glass	1,949,168	1,969,183	1	1,949,236	1,971,898	1
Diversified/Conglomerate Service	3,721,600	3,757,521	1	5,520,217	3,536,426	2
Ecological	2,970,000	2,970,000	1	-	-	-
Electronics	14,901,328	14,864,381	5	6,137,592	6,252,380	3
Finance	4,773,995	4,955,920	2	4,748,767	4,891,710	2
Healthcare, Education and Childcare	30,541,220	20,094,990	7	15,981,824	4,618,521	2
Home and Office Furnishings, Housewares, and Durable Consumer Products	14,658,179	15,408,937	6	10,820,467	11,613,621	5
Hotels, Motels, Inns, and Gaming	2,713,392	2,711,416	1	-	-	-
Insurance	2,016,406	1,973,831	1	6,970,307	6,433,130	3
Leisure, Amusement, Motion Pictures, Entertainment	2,600,922	955,408	-	2,491,007	2,053,481	1
Machinery (Non-Agriculture, Non-Construction, Non-Electronic)	11,415,102	11,420,638	4	11,408,091	11,581,245	6
Mining, Steel, Iron and Non-Precious Metals	521,414	1,995	-	773,718	264,864	-
Oil and Gas	11,713,564	12,390,094	4	11,692,913	11,692,000	6
Personal and Non Durable Consumer Products (Mfg. Only)	6,962,959	6,921,418	3	5,000,000	3,977,100	2
Personal, Food and Miscellaneous Services	4,622,969	4,625,442	2	3,574,421	3,640,835	2
Personal Transportation	2,015,845	1,986,975	1	2,012,685	2,005,353	1
Printing and Publishing	10,998,071	11,184,798	4	2,961,395	3,231,314	2
Retail Stores	5,351,506	5,361,758	2	5,781,672	5,772,767	3
Telecommunications	14,756,224	14,714,259	5	2,952,654	2,783,195	1
Time Deposit and Money Market Accounts	67,494,608	67,494,608	26	32,486,658	32,486,658	16
Utilities	-	-	-	169,280	169,956	-
Total	$ 479,140,566	$ 436,497,694	160%	$ 358,547,336	$ 312,044,763	150%

1 Calculated as a percentage of net asset value.

2 Represents the Asset Manager Affiliates.

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.

At June 30, 2013 and December 31, 2012, approximately 20% and 27% 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 27% of its portfolio on such dates), respectively.

At June 30, 2013 and December 31, 2012, 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 which are its wholly owned asset manager affiliates represented 20% and 25% of the total fair value of the Company's investments at June 30, 2013 and December 31, 2012, respectively. Excluding the Asset Manager Affiliates and CLO Fund securities, the Company's ten largest portfolio companies represented approximately 12% and 17% of the total fair value of the Company's investments at June 30, 2013 and December 31, 2012, 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. 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 the Asset Manager Affiliates ("CLO Fund securities managed by 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 the Company has an investment are generally diversified secured or unsecured corporate debt. 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 June 30, 2013 and December 31, 2012, the Company had approximately $81 million and $83 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, 2013 was approximately $98 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 equity securities as of December 31, 2012, was approximately $90 million and aggregate unrealized depreciation on the CLO Fund securities totaled approximately $7 million.

In December 2012, the Company purchased $4.5 million par value of the class F Notes and $8.9 million par value of the Subordinated Notes of Catamaran 2012-1 CLO ("Catamaran 2012-1") managed by Trimaran Advisors. The Company purchased the class F and Subordinated Notes for 84% and 100% of the par value, respectively.

In June 2013, the Company purchased $9 million of 100% par value of the Subordinated Notes of Catamaran 2013-1 CLO ("Catamaran 2013-1") managed by Trimaran Advisors.

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 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 generally included in this category include illiquid debt securities 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. A majority 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 June 30, 2013 (unaudited) and December 31, 2012, respectively:

As of June 30, 2013 (unaudited)

	Level I	Level II	Level III	Total
Money market account	$ —	$ 67,494,608	$ —	$ 67,494,608
Debt securities	—	63,989,553	126,743,341	190,732,894
CLO Fund securities	—	—	81,484,885	81,484,885
Equity securities	—	—	9,485,307	9,485,307
Asset Manager Affiliates	—	—	87,300,000	87,300,000
Total	—	131,484,161	305,013,533	436,497,694

As of December 31, 2012

	Level I	Level II	Level III	Total
Time deposit and money market account	$ —	$ 32,486,658	$ —	$ 32,486,658
Debt securities	—	59,172,476	51,865,406	111,037,882
CLO Fund securities	—	—	83,257,507	83,257,507
Equity securities	—	—	8,020,716	8,020,716
Asset Manager Affiliates	—	—	77,242,000	77,242,000
Total	—	91,659,134	220,385,629	312,044,763

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 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 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 generally deemed to be Level III values. For those that have observable trades, we consider them to be Level II.

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.

Since 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 I or Level II 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.

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.

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

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

The Company's policy for determining transfers between levels is based solely on the previously defined three-level hierarchy for fair value measurement. Transfers between the levels of the fair value hierarchy are separately noted in the tables below and the reason for such transfer described in each table's respective footnotes. 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, 2013 (unaudited)				
	Debt Securities	CLO Fund Securities	Equity Securities	Asset Manager Affiliates	Total
Balance, December 31, 2012	$ 51,865,406	$ 83,257,507	$ 8,020,716	$ 77,242,000	$ 220,385,629
Transfers out of Level III[1]	(2,783,195)	—	—	—	(2,783,195)
Transfers into Level III[2]	29,939,791	—	—	—	29,939,791
Net accretion of discount	62,091	88,392	—	—	150,483
Purchases	42,163,398	9,000,000	1,128,647	—	52,292,045
Sales/Paydowns	(1,812,161)	(603,332)	(404,213)	—	(2,819,706)
Total realized gain (loss) included in earnings	20,246	—	(258,785)	—	(238,539)
Total unrealized gain (loss) included in earnings	7,287,765	(10,257,682)	998,942	10,058,000	8,087,025
Balance, June 30, 2013	$ 126,743,341	$ 81,484,885	$ 9,485,307	$ 87,300,000	$ 305,013,533
Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date	$ 7,287,765	(10,257,682)	998,942	10,058,000	8,087,025

[1] The transfers to Level II from Level III in the six months ended June 30, 2013 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.

[2] Transfers into Level III represent a transfer of $29,939,791 relating to debt securities for which pricing inputs, other than their quoted prices in active markets were unobservable as of June 30, 2013.

	Year Ended December 31, 2012				
	Debt Securities	CLO Fund Securities	Equity Securities	Asset Manager Affiliates	Total
Balance, December 31, 2011	$ 83,094,677	$ 48,438,317	$ 6,040,895	$ 40,814,000	$ 178,387,889
Transfers out of Level III[1]	(5,611,522)	—	—	—	(5,611,522)
Transfers into Level III[2]	5,978,696	—	—	—	5,978,696
Net accretion of discount	96,275	1,137,344	—	—	1,233,619
Purchases	24,076,063	24,715,500	1,815,978	13,263,228	63,870,769
Sales/Paydowns	(34,476,308)	(2,234,916)	—	—	(36,711,224)
Total realized gain included in earnings	467,320	—	—	—	467,320
Total unrealized gain (loss) included in earnings	(21,759,795)	11,201,262	163,843	(2,395,228)	(12,789,918)
Issuance of Common Stock	—	—	—	25,560,000	25,560,000
Balance, December 31, 2012	$ 51,865,406	$ 83,257,507	$ 8,020,716	$ 77,242,000	$ 220,385,629
Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date	$ (8,246,695)	11,908,905	163,843	(2,880,201)	945,852

[1] Transfers out of Level III represent a transfer of $5,611,522 relating to debt securities for which pricing inputs, other than their quoted prices in active markets were observable as of December 31, 2013.

[2] Transfers into Level III represent a transfer of $5,978,696 relating to debt securities for which pricing inputs, other than their quoted prices in active markets were unobservable as of December 31, 2012.

As of June 30, 2013, 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 $131,484,161 as of June 30, 2013.

As of June 30, 2013, the Company's Level III portfolio investments had the following valuation techniques and significant inputs:

Type	Fair Value	Valuation Technique	Unobservable Inputs	Range of Inputs (Weighted Average)
Debt Securities	$ 4,859,898	Enterprise Value	Average EBITDA Multiple	7.8x - 25.5x (17.4x)
	$ 57,009,357	Income Approach	Market Yield	3.7% - 11.9% (6.1%)
	$ 64,380,536	Market Approach	Third Party Bid	95 - 101 (99)
	$ 190,090	Options Value	Qualitative Inputs [1]	
	$ 303,460	Recovery Approach	Qualitative Inputs [1]	
Equity Securities	$ 9,165,982	Enterprise Value	Average EBITDA Multiple	4.5x - 6.9x (6.2x)
	$ 314,325	Market Approach	Transaction Price	
	$ 5,000	Options Value	Qualitative Inputs [1]	
CLO Fund Securities	$ 61,585,885	Discounted Cash Flow	Discount Rate	7.5% - 14.0% (13.0%)
			Probability of Default	1.00% - 2.50% (1.47%-2.18%) [2]
			Loss Severity	30% - 40% (31%-36%) [2]
			Recovery Rate	60% - 70% (64%-69%) [2]
			Prepayment Rate	25%
	$ 19,899,000	Market Approach	Third Party Bid	85-92
Asset Manager Affiliates	$ 87,300,000	Discounted Cash Flow	Discount Rate	1.76% - 11.86% (7.96%) [2]
Total Level III Investments	$ 305,013,533			

[1] The qualitative inputs used in the fair value measurements of the Debt Securities include estimates of the distressed liquidation value of the pledged collateral.

[2] The Range of Inputs (Weighted Average) for the CLO Fund Securities is a result of the range of significant unobservable inputs used over the multi-period cash flows.

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

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

Significant unobservable inputs used in the fair value measurement of the Company’s CLO Fund securities include default rates, recovery rates, prepayment rates, and spreads and the discount rate by which to value the resulting underlying cash flows. Such assumptions can vary significantly, depending on market data sources which often vary in depth and level of analysis, understanding of the CLO market, detailed or broad characterization of the CLO market and the application of such data to an appropriate framework for analysis. The application of data points are based on the specific attributes of each individual CLO Fund security’s underlying assets, historic, current and prospective performance, vintage, and other quantitative and qualitative factors that would be evaluated by market participants. The Company evaluates the source of market data for reliability as an indicative market input, consistency amongst other inputs and results and also the context in which such data is presented. Significant increases or decreases in probability of default and loss severity inputs in isolation would result in a significantly lower or higher fair value measurement. In general, a change in the assumption of the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity in an event of default. Significant increases or decreases in the discount rate in isolation would result in a significantly lower or higher fair value measurement.

The significant unobservable inputs used in the fair value measurement of the 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. 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, 2013, Asset Manager Affiliates had approximately $3.7 billion of par value of assets under management, and the Company’s 100% equity interest in the Asset Manager Affiliates was valued at approximately $87 million.

As a manager of the CLO Funds, the Asset Manager Affiliates receive contractual and recurring management fees 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” and are recorded as declared (where declaration date represents ex-dividend date) by the Asset Manager Affiliates as income on the Company’s statement of operations. For the six months ended June 30, 2013, the Asset Manager Affiliates made distributions of $6.3 million to the Company. For the six months ended June 30, 2012, the Asset Manager Affiliates made distributions of $2.03 million to the Company; dividends are recorded as declared (where declaration date represents ex-dividend date) by the Asset Manager Affiliates as income on the Company’s statement of operations.

The Asset Manager Affiliates’ fair value is determined quarterly. The valuation is primarily based on an analysis of both a percentage of their assets under management and the Asset Manager Affiliates’ estimated operating income. Any change in value from period to period is recognized as unrealized gain or loss. See Note 2, “Significant Accounting Policies” and Note 4, “Investments” for further information relating to the Company’s valuation methodology. For the six months ended June 30, 2013 the Asset Manager Affiliates had an increase in unrealized appreciation of approximately $10 million.

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. In addition, Katonah 2007-I CLO qualifies as a "significant subsidiary" of the Company and the Company is also required to make the additional disclosures about it below. These disclosures regarding the Asset Manager Affiliates and Katonah 2007-I CLO 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, 2013	As of December 31, 2012
Investments of CLO Funds, at fair value	$ 3,142,614,333	$ 3,255,805,442
Restricted cash of CLO Funds	584,223,959	53,322,266
Total assets	3,788,771,911	3,847,297,787
CLO Fund liabilities at fair value	3,527,546,449	3,459,529,711
Total liabilities	3,753,324,641	3,698,915,974
Appropriated retained earnings of consolidated VIEs	(14,228,077)	104,870,995

Asset Manager Affiliates
Summarized Statements of Operations Information (unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
	2013	2012	2013	2012
Interest income - investments of CLO Funds	$ 30,590,388	$ 31,546,365	$ 63,857,815	$ 61,311,055
Total income	34,157,203	34,461,811	70,468,474	66,457,780
Interest expense of CLO Fund liabilities	27,448,332	27,730,344	57,220,417	58,271,673
Total expenses	39,698,341	32,418,761	74,542,565	67,005,566
Net realized and unrealized gains (losses)	95,000,154	180,512,853	85,521,217	174,285,895
Net income (loss) attributable to noncontrolling interests in consolidated consolidated Variable Interest Entities	87,206,075	182,189,641	78,034,934	173,573,693
Net income (loss) attributable to Asset Manager Affiliates	2,252,941	324,375	3,015,589	(55,646)

Katonah 2007-I CLO Ltd.
Summarized Balance Sheet Information (unaudited)

	As of June 30, 2013	As of December 31, 2012
Total investments at fair value	$ 317,943,927	$ 310,402,779
Cash	10,580,512	13,018,610
Total assets	329,207,644	324,159,013
CLO Debt at fair value	314,410,321	310,470,318
Total liabilities	324,975,990	315,824,162
Total Net Assets	4,231,654	8,334,851

Katonah 2007-I CLO Ltd.
Summarized Statements of Operations Information (unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
	2013	2012	2013	2012
Interest income from investments	$ 3,090,911	$ 3,211,588	$ 6,316,598	$ 6,316,842
Total income	3,378,618	3,352,203	6,765,226	6,627,337
Interest expense	2,849,391	2,806,337	5,843,283	5,500,757
Total expenses	3,213,437	3,049,470	6,484,434	6,139,914
Net realized and unrealized gains (losses)	(2,624,539)	1,323,633	(4,383,989)	(1,950,228)
Decrease in net assets resulting from operations	(2,459,358)	1,626,366	(4,103,197)	(1,462,805)

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 U.S. GAAP to report the Asset Manager Affiliates as a portfolio company at fair value.

As separately regarded entities for tax purposes, the Asset Manager Affiliates are taxed at normal corporate rates. For tax purposes, any distributions of taxable net income earned by the Asset Manager Affiliates to the Company would generally need to be distributed to the Company's shareholders. Generally, such distributions of the Asset Manager Affiliates' income to the Company's shareholders will be considered as qualified dividends for tax purposes. The Asset Manager Affiliates' taxable net income will differ from U.S. 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 U.S. 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 U.S. GAAP income and taxable income by approximately $2 million per year over such period.

Additional goodwill amortization for tax purposes was created upon the purchase of 100% of the equity interests in Trimaran Advisors by its sole member, Commodore Holdings, L.L.C., in exchange for shares of the KCAP Financial's stock valued at $25.5 million and cash of $13.0 million. The transaction was considered an asset purchase under Section 351(a) of the Code and resulted in tax goodwill of approximately $22.8 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 $1.5 million per year over such period.

At June 30, 2013 there were no intercompany balances between the Company and its Asset Manager Affiliates.

Related Party Transactions

On November 20, 2012, the Company entered into a senior credit agreement (the “Senior Credit Facility”) with Trimaran Advisors, pursuant to which Trimaran Advisors may borrow from time to time up to $20 million from the Company in order to provide the capital necessary to support one or more of Trimaran Advisors’ warehouse lines and/or working capital in connection with Trimaran Advisors’ warehouse activities. The Senior Credit Facility expires on November 20, 2017 and bears interest at an annual rate of 9.0%. The Company’s average debt obligation relating to the Senior Credit Facility was $20 million. As of December 27, 2012, the Senior Credit Facility was terminated and there were no borrowings outstanding.

On February 26, 2013, the Company entered into a senior credit agreement (the “Trimaran Credit Facility”) with Trimaran Advisors, pursuant to which Trimaran Advisors may borrow from time to time up to $20 million from the Company in order to provide capital necessary to support one or more of Trimaran Advisors’ warehouse lines of credit and/or working capital in connection with Trimaran Advisors’ warehouse activities. The Trimaran Credit Facility expires on November 20, 2017 and bears interest at an annual rate of 9.0%. On April 15, 2013, the Trimaran Credit Facility was amended and upsized from $20 million to $23 million. At June 30, 2013, there was no amount outstanding under the Trimaran Credit Facility.

For the six months ended June 30, 2013 the Company recognized interest income related to the Senior Credit Facility of $660,000.

6. BORROWINGS

The Company’s debt obligations consist of the following:

	As of June 30, 2013 (unaudited)	As of December 31, 2012
Convertible Notes, due March 15, 2016	$ 51,008,000	$ 60,000,000
Retail Notes, due September 30, 2019	$ 41,400,000	$ 41,400,000
KCAP Senior Funding I, LLC	$ 105,250,000	—

The weighted average stated interest rate and weighted average maturity on all our debt outstanding as of June, 2013 were 5.16% and 7.88 years, respectively, and as of December 31, 2012 were 8.19% and 4.68 years, respectively.

Convertible Notes

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

The Convertible Notes are convertible into shares of Company’s common stock. As of June 30, 2013 the conversion rate was 123.8203 shares of common stock per $1,000 principal amount of Convertible Notes, which is equivalent to a conversion price of approximately $8.08 per share of common stock. The conversion rate is subject to adjustment upon certain events. Subsequent to the reporting period, the conversion rate is approximately 125.0814 shares of the Company’s common stock per $1,000 principal amount of the Convertible Notes, equivalent to a conversion price of approximately $7.99 per share of common stock. Upon conversion, the Company would issue the full amount of common stock and retire the full amount of debt outstanding.

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 Notes.

No holder of Convertible 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. At June 30, 2013, the Company was in compliance with all of its debt covenants.

Subject to certain exceptions, holders may require us to repurchase, for cash, all or part of their Convertible Notes upon a fundamental change at a price equal to 100% of the principal amount of the Convertible 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 Notes, the Company incurred approximately $2.4 million of debt offering costs, which are being amortized over the term of the facility on an effective yield method, of which approximately $1.4 million remains to be amortized. On April 4, 2013, approximately $9 million of the Company's 8.75% Convertible Senior Notes were converted at a price basis per share of $8.159 into 1,102,093 shares of KCAP common stock.

The Convertible 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. At June 30, 2013, the Company was in compliance with all of its debt covenants.

Fair Value of Convertible Notes. The Company carries the Convertible Notes at cost. The Convertible 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 Notes was approximately $71.6 million at June 30, 2013. The fair value was determined based on the average of indicative bid and offer pricing for the Convertible Notes.

Retail Notes

On October 10, 2012, the Company issued $41.4 million in aggregate principal amount of unsecured 7.375% Retail Notes due 2019. The net proceeds for the Retail Notes, following underwriting expenses, were approximately $39.9 million. Interest on the Retail Notes is paid quarterly in arrears on March 30, June 30, September 30 and December 30, at a rate of 7.375%, commencing December 30, 2012. The Notes mature on September, 30, 2019. The Retail Notes are senior unsecured obligations of the Company. In addition, due to the asset coverage test applicable to the Company as a BDC and a covenant that the Company agreed to in connection with the issuance of the Retail Notes, the Company is limited in its ability to make distributions in certain circumstances. At June 30, 2013, the Company was in compliance with all of its debt covenants.

In connection with the issuance of the Retail Notes, the Company incurred approximately $1.5 million of debt offering costs which are being amortized over the term of the facility on an effective yield method, of which approximately $1.4 million remains to be amortized.

Fair Value of Retail Notes. The Retail Notes were issued in a public offering on October 10, 2012 and are carried at cost. The fair value of the Company's outstanding Retail Notes was approximately $42 million at June 30, 2013. The fair value was determined based on the average of indicative bid and offer pricing for the Retail Notes.

The Facility

In February 2012, we entered into a Note Purchase Agreement with Credit Suisse AG, Cayman Islands Branch ("CS"), Credit Suisse Securities (USA) LLC, as arranger, The Bank of New York Mellon Trust Company, National Association, as collateral administrator and collateral agent, and KCAP Funding, a special-purpose bankruptcy remote wholly-owned subsidiary of ours, under which we may obtain up to $30 million in financing (the "Facility"). The scheduled maturity date for the Facility is December 20, 2014. Interest on the Facility is LIBOR + 300 basis points and payable quarterly. As of June 30, 2013, there were no amounts outstanding under the Facility and the Company was in compliance with all of its debt covenants.

KCAP Senior Funding I, LLC (Debt Securitization).

On June 18, 2013, Company completed the sale of notes in a $140,000,000 debt securitization financing transaction. The notes offered in this transaction (the "Senior Funding I Notes") were issued by KCAP Senior Funding I, LLC, a newly formed special purpose vehicle (the "Issuer"), in which KCAP Senior Funding I Holdings, LLC, a wholly-owned subsidiary of the Company (the "Depositor"), owns all of the equity, and are backed by a diversified portfolio of bank loans.

The secured notes (the “Senior Funding I Secured Notes”) were issued as Class A-1 senior secured floating rate notes which have an initial face amount of $77,250,000, are rated AAA (sf)/Aaa (sf) by Standard & Poor’s Ratings Services and Moody’s Investors Service, Inc., respectively, and bear interest at the three-month London Interbank Offered Rate (“LIBOR”) plus 1.50%, Class B-1 senior secured floating rate notes which have an initial face amount of $9,000,000, are rated AA (sf)/Aa2 (sf) by Standard & Poor’s Ratings Services and Moody’s Investors Service, Inc., respectively, and bear interest at three-month LIBOR plus 3.25%, Class C-1 secured deferrable floating rate notes which have an initial face amount of $10,000,000, are rated A (sf)/A2 (sf) by Standard & Poor’s Ratings Services and Moody’s Investors Service, Inc., respectively, and bear interest at three-month LIBOR plus 4.25%, and Class D-1 secured deferrable floating rate notes which have an initial face amount of $9,000,000, are rated BBB (sf)/Baa2 (sf) by Standard & Poor’s Ratings Services and Moody’s Investors Service, Inc., respectively, and bear interest at three-month LIBOR plus 5.25%. The Depositor retained all of the subordinated notes of the Issuer (the “Senior Funding I Subordinated Notes”), which have an initial face amount of $34,750,000. The Senior Funding I Subordinated Notes do not bear interest and are not rated. Both the Senior Funding I Secured Notes and the Senior Funding I Subordinated Notes have a stated maturity on the payment date occurring in July, 2024, and are subject to a two year non-call period. The Issuer has a four year reinvestment period.

As part of this transaction, the Company entered into a master loan sale agreement with the Depositor and the Issuer under which the Company sold or contributed certain bank loans to the Depositor, and the Depositor sold such loans to the Issuer in exchange for a combination of cash and the issuance of the Senior Funding I Subordinated Notes to the Depositor.

In connection with the issuance and sale of the Senior Funding I Notes, the Company has made customary representations, warranties and covenants in the purchase agreement by and between the Company, the Depositor, the Issuer and Guggenheim Securities, LLC, which served as the initial purchaser of the Senior Funding I Secured Notes. The Senior Funding I Secured Notes are the secured obligations of the Issuer, and an indenture governing the Senior Funding I Notes includes customary covenants and events of default. The Senior Funding I Notes were sold in a private placement transaction and have not been, and will not be, registered under the Securities Act of 1933, as amended, or any state “blue sky” laws and may not be offered or sold in the United States absent registration with the Securities and Exchange Commission or an applicable exemption from registration.

The Company will serve as collateral manager to the Issuer under a collateral management agreement, which contains customary representations, warranties and covenants. Under the collateral management agreement, the Company will perform certain investment management functions, including supervising and directing the investment and reinvestment of the Issuer’s assets, as well as perform certain administrative and advisory functions.

In addition, because each is a consolidated subsidiary, we did not recognize any gain or loss on the transfer of any of our portfolio assets to such vehicles in connection with the issuance and sale of the Senior Funding I Notes.

As of June 30, 2013, there were 44 investments in portfolio companies with a total fair value of approximately $111.9 million, collateralizing the secured notes of the Issuer. At June 30, 2013, there were unamortized issuance costs of approximately $3.9 million and unamortized original issue discount, (“OID”) costs of approximately $3.3 million included in other assets in the accompanying balance sheet. The pool of loans in the securitization must meet certain requirements, including asset mix and concentration, collateral coverage, term, agency rating, minimum coupon, minimum spread and sector diversity requirements.

For the period ended June 30, 2013, interest expense, including the amortization of deferred debt issuance costs and the discount on the face amount of the notes was approximately $155,000 consisting of stated interest expense of approximately $97,000, accreted discount of approximately $19,000 and deferred debt issuance costs of approximately $46,000. Effective June 18, 2013 and as of June 30, 2013 the interest charged under the securitization was based on an initial LIBOR, which was 0.32%. The classes, interest rates, spread over LIBOR, and stated interest expense are as follows:

	Stated Interest Rate	**LIBOR Spread (basis points)**	**Stated Interest Expense**
KCAP Senior Funding LLC Class A-1 Notes	1.82%	150	$ 50,854
KCAP Senior Funding LLC Class B-1 Notes	3.57%	325	11,612
KCAP Senior Funding LLC Class C-1 Notes	4.57%	425	16,514
KCAP Senior Funding LLC Class D-1 Notes	5.57%	525	18,112
Total			$ 97,091

The amounts, ratings and interest rates (expressed as a spread to LIBOR) of the Class A-1, B-1, C-1, and D-1 are as follows:

Description	**Class A-1 Notes**	**Class B-1 Notes**	**Class C-1 Notes**	**Class D-1 Notes**
Type	Senior Secured Floating Rate	Senior Secured Floating Rate	Secured Deferrable Floating Rate	Secured Deferrable Floating Rate
Amount Outstanding	$ 77,250,000	$9,000,000	$10,000,000	$9,000,000
Moody's Rating (*sf*)	"Aaa"	"Aa2"	"A2"	"Baa2"
Standard & Poor's Rating (*sf*)	"AAA"	"AA"	"A"	"BBB"
Interest Rate	LIBOR + 1.50 %	LIBOR + 3.25 %	LIBOR + 4.25 %	LIBOR + 5.25 %
Stated Maturity	July, 2024	July, 2024	July, 2024	July, 2024
Junior Classes	B-1, C-1, D-1 and Subordinated	C-1, D-1 and Subordinated	D-1 and Subordinated	Subordinated

The Company’s outstanding principal amounts, carrying values and fair values of the Class A-1, B-1, C-1 and D-1 Notes are as follows:

	As of June 30, 2013 (unaudited)					
	Principal Amount		**Carrying Value**		**Fair Value**	
KCAP Senior Funding LLC Class A-1 Notes	$	77,250,000	$	75,056,666	$	75,056,666
KCAP Senior Funding LLC Class B-1 Notes		9,000,000		8,678,336		8,678,336
KCAP Senior Funding LLC Class C-1 Notes		10,000,000		9,586,630		9,586,630
KCAP Senior Funding LLC Class D-1 Notes		9,000,000		8,632,894		8,632,894
Total	$	105,250,000	$	101,954,526	$	101,954,526

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 2013). 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 2013.

The following reconciles net increase in net assets resulting from operations to taxable income for the six months ended June 30, 2013:

		Six Months Ended June 30, 2013 (unaudited)
Net increase in net assets resulting from operations	$	15,742,105
Net change in unrealized (appreciation) depreciation from investments		3,859,701
Excess capital losses over capital gains		(1,645,466)
Income not on GAAP books currently taxable		93,323
Income not currently taxable		(36,720)
Expenses not currently deductible		40,609
Taxable income before deductions for distributions	$	18,053,552
Taxable income before deductions for distributions per weighted average shares for the period	$	0.58

For the quarter ended June 30, 2013, the Company declared a dividend on June 17, 2013 of $0.28 per share for a total of approximately $9.2 million. The record date was July 5, 2013 and the dividend was distributed on July 26, 2013.

Taxable income differs from net increase (decrease) in net assets resulting from operations primarily due to: (1) unrealized appreciation (depreciation) on investments, as investment gains and losses are not included in taxable income until they are realized; (2) amortization of discount on CLO Fund securities; (3) amortization of organizational costs; (4) non-deductible expenses; (5) stock compensation expense that is not currently deductible for tax purposes; (6) excess of capital losses over capital gains; and (7) recognition of interest income on certain loans.

At June 30, 2013, the Company had a net capital loss carryforward of approximately $52 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 June 30, 2013, the Company had an undrawn commitment of $23 million relating to the Trimaran Credit Facility, which currently earns 50 basis point per year. As of December 31, 2012, the Company committed to make no investments in delayed draw senior secured loans.

9. STOCKHOLDERS' EQUITY

During the six months ended June 30, 2013 and the year ended December 31, 2012, the Company issued 37,932 and 76,208 shares, respectively, of common stock under its dividend reinvestment plan. For the six months ended June 30, 2013, the Company issued 245,741 shares of restricted stock, no shares were forfeited and 5,000 shares of restricted stock were vested. For the year ended December 31, 2012, the Company issued 34,757 shares of restricted stock, 232,768 shares were forfeited and 97,071 shares vested. The total number of shares of the Company's common stock issued and outstanding as of June 30, 2013 and December 31, 2012 was 33,298,674 and 26,470,408, respectively.

10. EQUITY INCENTIVE PLAN

During 2006 and as amended in 2008, the Company established the 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.

Information with respect to options granted, exercised and forfeited under the Plan for the period January 1, 2012 through June 30, 2013 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, 2012	60,000	$ 7.24		
Granted	—	—		
Exercised	—	—		
Forfeited	—	—		
Options outstanding at December 31, 2012	60,000	$ 7.24	6.5	$ 172,400
Granted	—	—		
Exercised	(10,000)	—		
Forfeited	—	—		
Outstanding at June 30, 2013	50,000	$ 7.72	5.9	$ 235,600
Total vested at June 30, 2013	50,000	$ 7.72	5.9	

1 Represents the difference between the market value of shares of the Company upon exercise of the options at June 30, 2013 and the cost for the option holders to exercise the options.

The Company uses a Binary Option Pricing Model (American, call option) to establish the expected value of all stock option grants. For the six months ended June 30, 2013 and 2012, the Company recognized no non-cash compensation expense related to stock options. At June 30, 2013, 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 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 June 30, 2013, 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.

On May 5, 2013, the Company's Board of Directors approved the grant of 240,741 shares of restricted stock to the employees of the Company as partial compensation for their services. 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 14, 2013, 5,000 shares of restricted stock were awarded to the Company's Board of Directors. 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.

During the six months ended June 30, 2013, 5,000 shares of restricted stock had vested. As of June 30, 2013, after giving effect to these restricted stock awards, there were 272,998 shares of restricted stock outstanding. Information with respect to restricted stock granted, exercised and forfeited under the Plan for the period January 1, 2012 through June 30, 2013 is as follows:

	Unvested Restricted Shares	**Weighted Average Exercise Price per Share**
Unvested shares outstanding at January 01, 2012	327,339	$ 6.46
Granted	34,757	$ 6.66
Vested	(97,071)	$ 9.08
Forfeited	(232,768)	$ 5.37
Unvested shares outstanding at December 31, 2012	32,257	$ 6.69
Granted	245,741	$ 10.79
Vested	(5,000)	$ 8.25
Forfeited	—	$ —
Outstanding at June 30, 2013	272,998	$ 10.35
Total non-vested shares at June 30, 2013	272,998	$ 10.35

For the six months ended June 30, 2013, non-cash compensation expense related to restricted stock was approximately $151,000; of this amount approximately $82,000 was expensed at the Company, and approximately $69,000 was a reimbursable expense allocated to the Asset Manager Affiliates. 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.

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, 2013, the company had approximately $1.3 million of total unrecognized compensation cost related to non-vested share-based awards. That cost is expected to be recognized over a weighted average period of 3.7 years.

11. OTHER EMPLOYEE COMPENSATION

The Company adopted a 401(k) plan ("401K Plan") effective January 1, 2007. The 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% of the $250,000 maximum eligible compensation, which fully vest at the time of contribution. For the six months ended June 30, 2013 and 2012, the Company made contributions to the 401K Plan of approximately $22,000 and $34,000, 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 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 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 six months ended June 30, 2013, the Company made a contribution of approximately $90,000 to the Profit-Sharing Plan and a contribution of $70,000 to the Profit Sharing Plan Plan for the six months ended June 30, 2012.

12. SUBSEQUENT EVENTS

The Company has evaluated events and transactions occurring subsequent to the Balance Sheet date of June 30, 2013 for items that should potentially be recognized or disclosed in these financial statements. The Company did not identify any items which would require disclosure in or adjustment to the financial statements.

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

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

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

- our future operating results;
- our business prospects and the prospects of our existing and prospective portfolio companies;
- the return or impact of current and future investments;
- our contractual arrangements and other relationships with third parties;
- the dependence of our future success on the general economy and its impact on the industries in which we invest;
- the financial condition and ability of our existing and prospective portfolio companies to achieve their objectives;
- our expected financings and investments;
- our regulatory structure and tax treatment;
- our ability to operate as a business development company and a registered investment company, including the impact of changes in laws or regulations governing our operations, or the operations of our portfolio companies;
- the adequacy of our cash resources and working capital;
- the timing of cash flows, if any, from the operations of our portfolio companies;
- the impact of a protracted decline in the liquidity of credit markets on our business;
- the impact of fluctuations in interest rates on our business;
- the valuation of our investments in portfolio companies, particularly those having no liquid trading market;
- our ability to recover unrealized losses;
- market conditions and our ability to access additional capital; and
- the timing, form and amount of any dividend distributions.

There are a number of important risks and uncertainties that could cause our actual results to differ materially from those indicated by such forward-looking statements. For a discussion of factors that could cause our actual results to differ from forward-looking statements contained in this Quarterly Report, please see the discussion in Part II, "Item 1A. Risk Factors", and in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012. You should not place undue reliance on these forward-looking statements. The forward-looking statements made in this Quarterly Report relate only to events as of the date on which the statements are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances occurring after the date this Quarterly Report is filed with the SEC.

GENERAL

We are an internally managed, non-diversified closed-end investment company that is regulated as a 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 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 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. 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% after such borrowing.

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.

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, 2013, Katonah Debt Advisors and Trimaran Advisors are our only wholly-owned portfolio companies (collectively, "Asset Manager Affiliates") and collectively have approximately $3.7 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.

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 Gains (Losses) from Investment Transactions."

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 this election, we generally will not have to pay corporate-level U.S. federal income 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, 2013 was $8.24. On June 28, 2013, the last reported sale price of a share of our common stock on The NASDAQ Global Select Market was $11.26.

KEY QUANTITATIVE AND QUALITATIVE FINANCIAL MEASURES AND INDICATORS

Net Asset Value

Our net asset value per share was $8.24 and $7.85 as of June 30, 2013 and December 31, 2012, 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, 2013 (unaudited)		December 31, 2012	
	Fair Value [1]	Per Share [1]	Fair Value [1]	Per Share [1]
Investments at fair value:				
Investments in time deposits	$ —	$ -	$ 1,942,834	$ 0.07
Investments in money market accounts	67,494,608	2.03	30,543,824	1.15
Investments in debt securities	190,732,894	5.73	111,037,882	4.19
Investments in CLO Fund securities	81,484,885	2.45	83,257,507	3.15
Investments in equity securities	9,485,307	0.28	8,020,716	0.30
Investments in Asset Manager Affiliates	87,300,000	2.62	77,242,000	2.92
Cash	7,669,782	0.23	738,756	0.03
Restricted Cash	78,985,473	2.37	—	-
Other assets	18,345,539	0.55	6,476,954	0.24
Total Assets	$ 541,498,488	$ 16.26	$ 319,260,473	$ 12.06
Convertible Notes	$ 51,008,000	$ 1.53	$ 60,000,000	$ 2.27
Retail Notes	41,400,000	1.24	41,400,000	1.56
KCAP Senior Funding I, LLC	105,250,000	3.16	—	-
Payable for open trades	66,840,035	2.01	—	-
Other liabilities	2,692,613	0.08	9,984,814	0.38
Total Liabilities	$ 267,190,648	$ 8.02	$ 111,384,814	$ 4.21
NET ASSET VALUE	$ 274,307,840	$ 8.24	$ 207,875,659	$ 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.

Investment Portfolio Summary Attributes as of and for the Six Months ended June 30, 2013

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 $9 million, which comprises approximately 2% of our investment portfolio. Below are summary attributes for each of our primary investment portfolio components (see "—Investment Securities" for a more detailed description) as of and for the six months ended June 30, 2013:

Debt Securities

- represent approximately 44% of investment assets;
- represent credit instruments issued by corporate borrowers;
- primarily senior secured and junior secured loans (72% and 20% of debt securities, respectively);
- spread across 26 different industries and 67 different entities;
- average balance per investment of approximately $2.8 million;
- all but five issuers (representing less than 1% of total investments at fair value) are current on their debt service obligations; and
- weighted average interest rate of 6.8% on income producing debt investments.

CLO Fund Securities (as of the last monthly trustee report prior to June 30, 2013 unless otherwise specified)

- represent approximately 19% of investment assets at June 30, 2013;
- 84% of CLO Fund securities represent investments in subordinated securities or equity securities issued by CLO Funds and 16% of CLO Fund securities are rated notes;
- all CLO Funds invest primarily in credit instruments issued by corporate borrowers;
- 16 different CLO Fund securities; 13 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 $276,000, are not currently providing a dividend payment to the Company.

Asset Manager Affiliates

- represent approximately 20% of fair value of investment assets;
- have approximately $3.7 billion of assets under management;
- receive contractual and recurring asset management fees based on par value of managed investments;
- may receive an incentive fee provided that the CLO Fund achieves a minimum designated return on investment;
- dividends paid by our Asset Manager Affiliates are recognized as dividend income from affiliate asset manager on our statement of operations and are an additional source of income to pay our dividend;
- for the six months ended June 30, 2013, our Asset Manager Affiliates had EBITDA of approximately $5.2 million; and
- for the six months ended June 30, 2013, our Asset Manager Affiliates made a distribution of $6.3 million 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 and Interest from Investments in CLO Fund Securities. We generate dividend and interest 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-I CLO of Class F notes of the Catamaran 2012-1, 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 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.

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, with respect to certain of our borrowings, 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 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, 2013, net investment income and net realized gains were approximately $5 million, or $0.15 per share. For the three months ended June 30, 2012, net investment income and net realized gains were approximately $6 million or $0.23 per share.

Net Change in Unrealized Appreciation (Depreciation) on Investments

During the three and six months ended June 30, 2013, the Company's investments had a net increase in unrealized appreciation of approximately $3.5 million and $3.9 million, respectively. 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.

The net increase in unrealized appreciation of approximately $3.5 million for the three months ended June 30, 2013 is primarily due to (i) an approximate $1.2 million net increase in the unrealized appreciation of certain loans and equity positions as a result of credit considerations and current market conditions; (ii) a net decrease of approximately $4.6 million in the unrealized appreciation of CLO Fund securities; and (iii) an approximate increase of $6.9 million in the unrealized depreciation of our Asset Manager Affiliates.

The net increase in unrealized appreciation of approximately $3.9 million for the six months ended June 30, 2013 is primarily due to (i) an approximate $3.4 million net increase in the unrealized depreciation of certain loans and equity positions as a result of credit considerations and current market conditions; (ii) a net decrease of approximately $9.5 in the unrealized appreciation of CLO Fund securities; and (iii) an approximate increase of $10 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, 2013 and 2012 was an increase of approximately $8.5 million and $1.6 million, respectively, or $0.26 and $0.06 per share, respectively. The net change in net assets resulting from operations for the six months ended June 30, 2013 and 2012 was an increase of approximately $15.7 million and $2.1 million, respectively, or $0.51 and $0.09 per share, respectively.

Dividends

For the three months ended June 30, 2013, we declared a $0.28 dividend per share. As a result, there was a dividend distribution of approximately $9.2 million for the second quarter declaration, which was booked in the third quarter. We intend to continue to distribute quarterly dividends to our stockholders. To avoid certain excise taxes imposed on RICs, we currently intend to distribute during each calendar year an amount at least equal to the sum of:

- 98% of our ordinary net taxable income for the calendar year;
- 98.2% of our capital gains, if any, in excess of capital losses for the one-year period ending on October 31 of the calendar year; and
- any net ordinary income and net capital gains for the preceding year that were not distributed during such year.

The amount of our declared dividends, as evaluated by management and approved by our Board of Directors, is based on our evaluation of distributable income for tax purposes. Generally, we seek to fund our dividends from 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
2013:				
Second quarter	0.28	6/17/2013	7/5/2013	7/26/2013
First quarter	$ 0.28	3/15/2013	4/5/2013	4/26/2013
Total declared in 2013	$ 0.56			
2012:				
Fourth quarter	$ 0.28	12/17/2012	12/28/2012	1/28/2013
Third quarter	0.24	9/17/2012	10/10/2012	10/29/2012
Second quarter	0.24	6/18/2012	7/6/2012	7/27/2012
First quarter	0.18	3/16/2012	4/6/2012	4/27/2012
Total declared in 2012	$ 0.94			

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, 2013, our Asset Manager Affiliates had approximately $5.2 million of EBITDA and made a distribution of $6.3 million to us. For the six months ended June 30, 2012, our Asset Manager Affiliates earned approximately $1.3 million of EBITDA and made a distribution of $2.0 million to us. 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 will make further dividend distributions to us during 2013.

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, 2013 and December 31, 2012:

	June 30, 2013 (unaudited)			December 31, 2012		
Security Type	**Cost**	**Fair Value**	**%[1]**	**Cost**	**Fair Value**	**%[1]**
Time Deposits	$ -	$ -	-%	$ 1,942,834	$ 1,942,834	1%
Money Market Account	67,494,608	67,494,608	25	30,543,824	30,543,824	15
Senior Secured Loan	143,450,925	136,475,845	50	67,874,565	60,258,885	29
Junior Secured Loan	51,226,118	38,393,950	14	49,646,273	33,486,956	17
First Lien Bond	2,932,604	2,550,300	1	2,928,762	3,000,000	1
Senior Subordinated Bond	2,838,822	2,017,899	1	2,729,088	2,735,881	1
Senior Unsecured Bond	10,812,702	11,293,900	4	10,798,463	11,185,000	5
CLO Fund Securities	97,909,419	81,484,885	30	90,146,410	83,257,507	40
Equity Securities	18,841,238	9,485,307	3	18,375,588	8,020,716	4
Preferred Stock	400,000	1,000	-	400,000	371,160	-
Asset Manager Affiliates	83,234,131	87,300,000	32	83,161,529	77,242,000	37
Total	$ 479,140,566	$ 436,497,694	160%	$ 358,547,336	$ 312,044,763	150%

[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, 2013 and December 31, 2012, our investments in income producing loans and debt securities, excluding CLO Fund securities, had a weighted average interest rate of approximately 6.8% and 7.5%, respectively.

The investment portfolio (excluding the Company's investments in its Asset Manager Affiliates and CLO Funds) at June 30, 2013 was spread across 26 different industries and 69 different entities with an average balance per entity of approximately $2.8 million. As of June 30, 2013, all but five of our issuers (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 or, distressed debt or equity securities of public companies. At June 30, 2013, approximately 18.3% of our total assets were invested in such assets.

At June 30, 2013, 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 20% of the total fair value of our investments. Excluding our Asset Manager Affiliates and CLO Fund securities, our ten largest portfolio companies represent approximately 12% 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, 2013, we had approximately $81 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, 2013 and December 31, 2012 are as follows:

			June 30, 2013 (unaudited)		December 31, 2012	
CLO Fund Securities	**Investment**	**%[1]**	**Cost**	**Fair Value**	**Cost**	**Fair Value**
Grant Grove CLO, Ltd.	Subordinated Securities	22.2%	$ 4,774,950	$ 1,508,300	$ 4,925,009	$ 3,124,924
Katonah III, Ltd.[3]	Preferred Shares	23.1	1,638,683	275,000	2,242,014	600,000
Katonah V, Ltd.[3]	Preferred Shares	16.4	3,320,000	1,000	3,320,000	1,000
Katonah VII CLO Ltd.[2]	Subordinated Securities	10.3	4,506,993	1,794,645	4,574,393	2,120,168
Katonah VIII CLO Ltd.[2]	Subordinated Securities	6.9	3,402,805	1,693,953	3,450,705	2,171,998
Katonah IX CLO Ltd.[2]	Preferred Shares	26.7	2,048,387	1,152,825	2,082,987	1,488,895
Katonah X CLO Ltd.[2]	Subordinated Securities	33.3	11,808,757	7,248,469	11,934,600	9,455,511
Katonah 2007-I CLO Ltd.[2]	Preferred Shares	100.0	31,086,319	28,839,886	31,189,147	30,091,886
Katonah 2007-I CLO Ltd.[2]	Class B-2L Notes	100.0	1,271,689	9,300,000	1,252,191	9,140,000
Trimaran CLO IV, Ltd.[2]	Preferred Shares	19.0	3,564,300	2,720,782	3,616,600	3,575,571
Trimaran CLO V, Ltd.[2]	Subordinated Notes	20.8	2,725,500	2,285,013	2,757,100	2,930,004
Trimaran CLO VI, Ltd.[2]	Income Notes	16.2	2,822,200	2,100,121	2,894,700	2,936,626
Trimaran CLO VII, Ltd.[2]	Income Notes	10.5	3,135,000	2,665,891	3,146,900	3,357,924
Catamaran CLO 2012-1 Ltd.[2]	Subordinated Notes	24.9	8,991,591	7,599,000	8,982,400	8,493,000
Catamaran CLO 2012-1 Ltd.[2]	Class F Notes	42.9	3,803,846	4,020,000	3,777,664	3,770,000
Catamaran CLO 2013-1 Ltd.[2]	Subordinated Notes	23.5	9,008,400	8,280,000	—	—
Total			$ 97,909,420	$ 81,484,885	$ 90,146,410	$ 83,257,507

[1] Represents percentage of class held.
[2] An affiliate CLO Fund managed by an Asset Manager Affiliate.
[3] As of June 30, 2013, 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, 2013:

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]	261	215	32	$ 837,991	$ 1,017,282
Katonah III, Ltd.[2]	6	3	3	37,182	74,364
Katonah V, Ltd.[2]	51	17	12	248,402	745,205
Katonah VII CLO Ltd.	75	68	23	1,971,802	2,174,781
Katonah VIII CLO Ltd.	84	94	25	2,596,567	2,320,337
Katonah IX CLO Ltd.	167	117	24	1,870,083	2,669,264
Katonah X CLO Ltd.	228	181	28	2,056,667	2,590,719
Katonah 2007-I CLO Ltd.	190	155	27	1,592,496	1,952,092
Trimaran CLO IV, Ltd.	62	55	18	2,911,106	3,281,610
Trimaran CLO V, Ltd.	104	88	22	2,167,624	2,561,738
Trimaran CLO VI, Ltd.	106	89	20	1,857,266	2,212,024
Trimaran CLO VII, Ltd.	161	136	25	2,792,807	3,306,190
Catamaran 2012-1 CLO Ltd.	155	142	26	2,506,438	2,735,901
Catamaran 2013-1 CLO Ltd.	143	134	31	2,489,536	2,656,744

[1] All data from most recent Trustee reports as of June 30, 2013.
[2] Managed by non-affiliates as of June 30, 2013.

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, 2013, our Asset Manager Affiliates had approximately $3.7 billion of par value of assets under management on which they earn management fees, and were valued at approximately $87 million.

As a manager of the CLO Funds, the Asset Manager Affiliates receive contractual and recurring management fees 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 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 asset manager affiliates" 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, 2013 (unaudited) and for the year ended December 31, 2012 was as follows:

	Debt Securities	CLO Fund Securities	Equity Securities	Asset Manager Affiliates	Total Portfolio
Fair Value at December 31, 2011	$ 114,673,506	$48,438,317	$ 6,040,895	$ 40,814,000	$ 209,966,718
2012 Activity:					
Purchases / originations /draws	$ 107,417,624	$24,715,500	$ 1,815,978	$ 38,823,228	$ 172,772,330
Pay-downs / pay-offs / sales	(104,504,327)	(2,234,916)	—	—	(106,739,243)
Net accretion of interest	385,590	1,137,344	—	—	1,522,934
Net realized losses	(3,232,975)	—	—	—	(3,232,975)
Increase (decrease) in fair value	(3,701,536)	11,201,262	163,843	(2,395,228)	5,268,341
Fair Value at December 31, 2012	111,037,882	83,257,507	8,020,716	77,242,000	279,558,105
Year to Date 2013 Activity:					
Purchases / originations /draws	212,321,168	9,000,000	1,128,647	—	222,449,815
Pay-downs / pay-offs / sales	(133,897,690)	(603,332)	(404,212)	—	(134,905,234)
Net accretion of interest	247,223	88,392	—	—	335,615
Net realized losses	(1,386,681)	(722,051)	(258,785)	72,601	(2,294,916)
Increase (decrease) in fair value	2,410,992	(9,535,631)	998,941	9,985,399	3,859,701
Fair Value at June 30, 2013	$ 190,732,894	$81,484,885	$ 9,485,307	$ 87,300,000	$ 369,003,086

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

RESULTS OF OPERATIONS

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

Set forth below is a discussion of our results of operations for the three and six months ended June 30, 2013 and 2012.

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, 2013 and 2012 was approximately $11 million and $9 million, respectively. Of these amounts, approximately $3.0 million and $2.7 million was attributable to interest income on our loan and bond investments, respectively. For the three months ended June 30, 2013 and 2012, approximately $5 million and $5 million of investment income is attributable to dividends earned on CLO equity investments, respectively.

Investment income for the six months ended June 30, 2013 and 2012 was approximately $23 million and $17 million, respectively. Of these amounts, approximately $5 million and $5 million was attributable to interest income on our loan and bond investments, respectively. For the six months ended June 30, 2013 and 2012, approximately $11 million and $10 million of investment income is attributable to dividends earned on CLO equity investments, respectively.

Dividends from Asset Manager Affiliates

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

As of June 30, 2013, our investment in the Asset Manager Affiliates was valued at approximately $87 million. For the three months ended June 30, 2013 and 2012, our Asset Manager Affiliates had EBITDA of approximately $3.2 million and $1.3 million, respectively. For the six months ended June 30, 2013 and 2012, our Asset Manager Affiliates had EBITDA of approximately $5.2 million and $1.3 million, respectively. For the three months ended June 30, 2013 and 2012, our Asset Manager Affiliates made distributions of income of $3.3 million and $1.2 million, respectively. For the six months ended June 30, 2013 and 2012, our Asset Manager Affiliates made distributions of income of $6.3 million and $2.03 million, respectively. The distributions from our Asset Manager Affiliates in 2013 represent a portion of the expected net income for our Asset Manager Affiliates for the year ending December 31, 2013.

Expenses

Total expenses for the six months ended June 30, 2013 and 2012 were approximately $9 million and $7 million, respectively. Interest expense and amortization on debt issuance costs for the periods, which includes facility and program fees on the unused loan balance, were approximately $5 million and $3 million, respectively, on average debt outstanding of $105 million and $68 million, respectively. Approximately $2 million and $2 million of expenses were attributable to employment compensation, including salaries, bonuses and stock option expense for the six months ended June 30, 2013 and 2012, respectively. For the three months ended June 30, 2013, other expenses included approximately $1 million for professional fees, insurance, administrative and other. For the six months ended June 30, 2012, other expenses included approximately $757,000 for professional fees, insurance, administrative and other. For the six months ended June 30, 2013 and 2012, administrative and other costs (including occupancy expense, insurance, technology and other office expenses) totaled approximately $513,000 and $369,000, respectively. Total expenses for the three months ended June 30, 2013 and 2012 were approximately $5 million and $3 million, respectively. Interest expense and amortization on debt issuance costs for the periods, which includes facility and program fees on the unused loan balance, were approximately $2 million and $2 million, respectively, on average debt outstanding of $96 million and $75 million, respectively. Approximately $1 million and $1 million of expenses were attributable to employment compensation, including salaries, bonuses and stock option expense for the three months ended June 30, 2013 and 2012, 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.

Net Unrealized (Depreciation) Appreciation on Investments

During the three months ended June 30, 2013, our total investments had an increase in net unrealized appreciation of approximately $1.9 million. During the three months ended June 30, 2012, our total investments had an increase in net unrealized depreciation of approximately $4.4 million. For the three months ended June 30, 2013, our Asset Manager Affiliates had an increase in net unrealized appreciation of approximately $6.9 million. For the three months ended June 30, 2012, our Asset Manager Affiliates had a decrease in net unrealized appreciation of approximately $1.7 million. For the three months ended June 30, 2013, our middle market portfolio of debt securities, equity securities, and CLO Fund securities had a net decrease in unrealized appreciation due to fair value adjustments of approximately $3.4 million. 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 appreciation due to fair value adjustments of approximately $2.7 million.

During the six months ended June 30, 2013, our total investments had an increase in net unrealized appreciation of approximately $2.2 million. During the six months ended June 30, 2012, our total investments had an increase in net unrealized depreciation of approximately $7.4 million. For the six months ended June 30, 2013, our Asset Manager Affiliates had an increase in net unrealized appreciation of approximately $10 million. For the six months ended June 30, 2012, our Asset Manager Affiliates had a decrease in net unrealized appreciation of approximately $7 million. For the six months ended June 30, 2013, our middle market portfolio of debt securities, equity securities, and CLO Fund securities had a net decrease in unrealized depreciation due to fair value adjustments of approximately $6.1 million. 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 appreciation due to fair value adjustments of approximately $750,000.

Net Increase (Decrease) in Net Assets Resulting From Operations

For the three months ended June 30, 2013 the net change in net assets resulting from operations was an approximate increase of $8.5 million, or $0.26 per share. For the six months ended June 30, 2013 the net change in net assets resulting from operations was an approximate increase of $16 million, or $0.51 per share. The net change in net assets resulting from operations for the three and six months ended June 30, 2012 was an approximate increase of $2 million and $2 million, or $0.06 and $0.09 per share, respectively.

FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES

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

As of June 30, 2013 and December 31, 2012 the fair value of investments and cash were as follows:

	Investments at Fair Value	
Security Type	**June 30, 2013 (unaudited)**	**December 31, 2012**
Cash	$ 7,669,782	$ 738,756
Time Deposits	—	1,942,834
Money Market Accounts	67,494,608	30,543,824
Senior Secured Loan	136,475,846	60,258,885
Junior Secured Loan	38,393,950	33,486,956
First Lien Bond	2,550,300	3,000,000
Senior Subordinated Bond	2,017,898	2,735,881
Senior Unsecured Bond	11,293,900	11,185,000
CLO Fund Securities	81,484,885	83,257,507
Equity Securities	9,485,307	8,020,716
Preferred	1,000	371,160
Affiliate Asset Managers	87,300,000	77,242,000
Total	$ 444,167,476	$ 312,783,519

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, 2013, we had approximately $198 million of outstanding borrowings and our asset coverage ratio of total assets to total borrowings was 239%, 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.

On June 18, 2013, the Company completed the sale of notes in a $140,000,000 debt securitization financing transaction. The notes offered in this transaction (the "Senior Funding I Notes") were issued by KCAP Senior Funding I, LLC, a newly formed special purpose vehicle (the "Issuer"), in which KCAP Senior Funding I Holdings, LLC, a wholly-owned subsidiary of the Company (the "Depositor"), owns all of the equity, and are secured by a diversified portfolio of bank loans.

In October 2012, we issued $41.4 million in aggregate principal amount of 7.375% unsecured notes due 2019 (the "Retail Notes"). The Retail Notes mature on September 30, 2019, and 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. The Retail Notes bear interest at a rate of 7.375% per year payable quarterly on March 30, June 30, September 30 and December 30 of each year, beginning December 30, 2012.

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

On March 16, 2011, we issued $60 million in aggregate principal amount of unsecured 8.75% convertible notes due March 15, 2016 ("Convertible Notes"). The net proceeds for the Convertible Notes, following underwriting expenses, were approximately $57.7 million. Interest on the Convertible 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 Notes are senior unsecured obligations of the Company.

The Convertible Notes are convertible into shares of Company's 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. The conversion price of the Convertible Senior Notes as of June 30, 2013 is approximately 123.8203 shares of our common stock per $1,000 principle amount of Convertible Senior Notes, equivalent to a conversion price of approximately $8.08 per share of our common stock. 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.

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. We are currently in the process of obtaining approval from our stockholders to do so. Even if we obtain approval, 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 such approval.

COMMITMENTS AND OFF-BALANCE SHEET ARRANGEMENTS

We are, from time to time, 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 both June 30, 2013 and December 31, 2012, we had $23 million and $0 commitments to fund investments, respectively.

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, 2012, 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, 2013, five issuers representing less than 1% of our total investments at fair value were on non-accrual status. As of December 31, 2012, five 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-I CLO and the class F notes of Catamaran 2012-1, 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 ASC 718 *Compensation – Stock Compensation*, a method by which the fair value of options or restricted stock is determined and expensed. We use a Binary Option Pricing Model (American, call option) as its valuation model to establish the expected value of all stock option grants.

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

United States Federal Income Taxes

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

Dividends

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

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

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

Our investment income is affected by fluctuations in various interest rates, including LIBOR and prime rates. As of June 30, 2013, approximately 95% 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, 2013, we had $197.7 million of borrowings outstanding at a weighted average rate of 8.09%.

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

We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that our balance sheet at June 30, 2013 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 $540,000 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 $127,000 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, 2013.

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 2012 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.

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

Item 4 Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

Changes in Internal Control Over Financial Reporting

During the quarter ended June 30, 2013, the Company had no changes in its internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. Other Information

Item 1. Legal Proceedings

The Company is not currently a party to any material legal proceedings, other than routine litigation arising in the ordinary course of business. Such litigation is not expected to have a material adverse effect on the business, financial condition, or results of the Company's operations.

Item 1A. *Risk Factors*

Other than as set forth below, there have been no material changes from the risk factors previously disclosed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2012.

We are subject to risks associated with our debt securitization financing transactions.

As a result of the debt securitization financing transaction that we completed on June 18, 2013, we are subject to a variety of risks, including those set forth below:

We are subject to certain risks as a result of our indirect interests in the subordinated notes and membership interests of KCAP Senior Funding I, LLC.

Under the terms of the master loan sale agreement governing the debt securitization financing transaction, (1) we sold and/or contributed to KCAP Senior Funding I Holdings, LLC ("Holdings") all of our ownership interest in our portfolio loans and participations for the purchase price and other consideration set forth in the master loan sale agreement and (2) Holdings, in turn, sold and/or contributed to KCAP Senior Funding I, LLC (the "Issuer") all of its ownership interest in such portfolio loans and participations for the purchase price and the consideration set forth in the master loan sale agreement. Following these transfers, the Issuer, and not Holdings or us, held all of the ownership interest in such portfolio loans and participations. As a result of the debt securitization financing transaction, we hold indirectly through Holdings all of the subordinated notes and membership interests of the Issuer. As a result, we consolidate the financial statements of Holdings and the Issuer in our consolidated financial statements. Because Holdings and the Issuer are disregarded as entities separate from its owner for U.S. federal income tax purposes, each of the sale or contribution of portfolio loans by us to Holdings, and the sale of portfolio loans by Holdings to the Issuer, did not constitute a taxable event for U.S. federal income tax purposes. If the U.S. Internal Revenue Service were to take a contrary position, there could be a material adverse effect on our business, financial condition, results of operations or cash flows.

The subordinated notes and membership interests of the Issuer are subordinated obligations of the Issuer.

The subordinated notes of the Issuer are the junior class of notes issued by the Issuer, are subordinated in priority of payment to the secured notes issued by the Issuer and are subject to certain payment restrictions set forth in the indenture governing the notes of the Issuer. Therefore, Holdings only receives cash distributions on the subordinated notes if the Issuer has made all cash interest payments on the secured notes it has issued, and we only receive cash distributions in respect of our indirect ownership of the Issuer to the extent that Holdings receives any cash distributions in respect of its direct ownership of the Issuer. The subordinated notes of the Issuer are also unsecured and rank behind all of the secured creditors, known or unknown, of the Issuer, including the holders of the secured notes it has issued. Consequently, to the extent that the value of either the Issuer's portfolio of loan investments has been reduced as a result of conditions in the credit markets, or as a result of defaulted loans or individual fund assets, the value of the subordinated notes of such securitization issuer at their redemption could be reduced. Accordingly, our investment in the Issuer may be subject to complete loss.

The membership interests in the Issuer represent all of the equity interest in the Issuer. As such, the holder of the membership interests of the Issuer is the residual claimant on distributions, if any, made by the Issuer after holders of all classes of notes issued by the Issuer have been paid in full on each payment date or upon maturity of such notes under the debt securitization financing transaction documents.

If an event of default has occurred and acceleration occurs in accordance with the terms of the indenture governing the notes of the Issuer, the secured notes of the Issuer then outstanding will be paid in full before any further payment or distribution on the subordinated notes of the Issuer. In addition, if an event of default occurs, holders of a majority of the most senior class of secured notes then outstanding will be entitled to determine the remedies to be exercised under the indenture, subject to the terms of the indenture. For example, upon the occurrence of an event of default with respect to the notes issued by the Issuer, the trustee or holders of a majority of the most senior class of secured notes of the Issuer then outstanding may declare the principal, together with any accrued interest, of all the notes of such class and any junior classes to be immediately due and payable. This would have the effect of accelerating the principal on such notes, triggering a repayment obligation on the part of the Issuer. If at such time the portfolio loans of the Issuer were not performing well, the Issuer may not have sufficient proceeds available to enable the trustee under the indenture to repay the obligations of holders of the subordinated notes of the Securitization Issuer, or to pay a dividend to holders of the membership interests of the Issuer.

Remedies pursued by the holders of the secured notes of the Issuer could be adverse to the interests of the holders of the subordinated notes of the Issuer, and the holders of such secured notes will have no obligation to consider any possible adverse effect on such other interests. Thus, any remedies pursued by the holders of the secured notes of the Issuer may not be in our best interests and we may not receive payments or distributions upon an acceleration of the secured notes. Any failure of the Issuer to make distributions on the subordinated notes we hold, directly or indirectly, whether as a result of an event of default or otherwise, could have a material adverse effect on our business, financial condition, results of operations and cash flows and may result in an inability of us to make distributions sufficient to allow our qualification as a RIC.

The Issuer may fail to meet certain asset coverage tests.

Under the documents governing the debt securitization financing transaction, there are two coverage tests applicable to the secured notes. The first such test compares the amount of interest received on the portfolio loans held by the Issuer to the amount of interest payable in respect of the secured notes of the Issuer. To meet this test at any time, interest received on the portfolio loans must equal at least 127% to 150% (based upon a graduated scale for the most senior class of secured notes then outstanding as provided for in the indenture) of the interest payable in respect of the secured notes of the Issuer. The second such test compares the principal amount of the portfolio loans held by the Issuer to the aggregate outstanding principal amount of the secured notes of the Issuer. To meet this test at any time, the aggregate principal amount of the portfolio loans held by the Issuer must equal at least 124% to 147% (based upon a graduated scale for the most senior class of secured notes then outstanding as provided for in the indenture) of the outstanding principal amount of the secured notes of the Issuer. If either coverage test is not satisfied, interest and principal received by the Issuer are diverted on the following payment date to pay the most senior class or classes of secured notes to the extent necessary to cause all coverage tests to be satisfied on a pro forma basis after giving effect to all payments made in respect of the notes, which, with respect to the payment of any principal amount of the secured notes, we refer to as a mandatory redemption. If any asset coverage test with respect to the secured notes is not met, proceeds from the portfolio of loan investments that otherwise would have been distributed to the Issuer and the holders of its subordinated notes will instead be used to redeem first the secured notes of the Issuer, to the extent necessary to satisfy the applicable asset coverage tests.

We may not receive cash on our equity interests in the Issuer.

We receive cash from the Issuer only to the extent that we or Holdings, as applicable, receives payments on the subordinated notes or membership interests of the Issuer. The Issuer may only make payments on such securities to the extent permitted by the payment priority provisions of the indenture governing the notes, which generally provides that principal payments on the subordinated notes may not be made on any payment date unless all amounts owing under the secured notes issued under such indenture are paid in full. In addition, if the Issuer does not meet the asset coverage tests set forth in the documents governing the debt securitization financing transaction, cash would be diverted from the subordinated notes of the Issuer to first pay the secured notes of the Issuer in amounts sufficient to cause such tests to be satisfied. In the event that we fail to directly or indirectly receive cash from the Issuer, we could be unable to make such distributions in amounts sufficient to maintain our status as a RIC, or at all. We also could be forced to sell investments in portfolio companies at less than their fair value in order to continue making such distributions. However, the indenture places significant restrictions on the Issuer’s ability to sell investments. As a result, there may be times or circumstances during which the Issuer are unable to sell investments or take other actions that might be in our best interests.

We may incur liability to the Issuer.

As part of the debt securitization financing transaction, we entered into a master loan sale agreement under which we would be required to repurchase any loan (or participation interest therein) which was sold to the Issuer in breach of any representation or warranty made by us with respect to such loan on the date such loan was sold. To the extent we fail to satisfy any such repurchase obligation, the trustee may, on behalf of the Issuer, bring an action against us to enforce these repurchase obligations.

In connection with our debt securitization financing transaction, we indirectly transferred all of our interests in certain portfolio loans to the Issuer. In doing so, we transferred any right we previously had to the payments made on such portfolio loans in exchange for 100% of the residual interests in the Issuer. As a result, we face a heightened risk of loss due to the impact of leverage utilized by the Issuer, which would have the effect of magnifying the impact on us of a loss on any portfolio loan held by the Issuer. In addition, while we serve as the collateral manager for the Issuer, which provides us with the authority to enforce payment obligations and loan covenants of the portfolio loans that we transferred to the Issuer, we are required to exercise such authority for the interests of the Issuer, rather than for our own interests alone.

The structure of the debt securitization financing transaction is intended to prevent, in the event of our bankruptcy or the bankruptcy of Holdings, the consolidation for purposes of such bankruptcy proceedings of the Issuer with our operations or those of Holdings. If the true sale of these assets were not respected in the event of our insolvency, a trustee or debtor-in-possession might reclaim the assets of the Issuer for our estate. However, in doing so, we would become directly liable for all of the indebtedness then outstanding under the debt securitization financing transaction, which would equal the full amount of debt of the Issuer reflected on our consolidated balance sheet. In addition, we cannot assure that the recovery in the event we were consolidated with the Issuer for purposes of any bankruptcy proceeding would exceed the amount to which we would otherwise be entitled as a direct or indirect holder of the subordinated notes had we not been consolidated with the Issuer.

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

While we did not engage in any sales of unregistered securities during the three months ended June 30, 2013, we issued a total of 14,360 shares of common stock under our dividend reinvestment plan ("DRIP"). This issuance was not subject to the registration requirements of the Securities Act of 1933. For the six months ended June 30, 2013, the aggregate value of the shares of our common stock issued under our DRIP was approximately $238,000.

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

None.

Item 4. ***Mine Safety Disclosures***

Not Applicable.

Item 5. ***Other Information***

On August 2, 2013, KCAP Financial, Inc. ("the Compnay") appointed Jill Simeone, General Counsel, as its Chief Compliance Officer, effective immediately. She succeeds Daniel P. Gilligan, who stepped down after more than a year of service in that role.

Item 6. ***Exhibits***

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

SIGNATURES

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

		KCAP FINANCIAL, INC.
Date: August 6, 2013	By	/s/ Dayl W. Pearson Dayl W. Pearson *President and Chief Executive Officer* *(Principal Executive Officer)*
Date: August 6, 2013	By	/s/ Edward U. Gilpin Edward U. Gilpin *Chief Financial Officer* *(Principal Financial and Accounting Officer)*

* * * * *

Exhibit Index

Exhibit Number	Description of Document
10.1	Purchase Agreement, dated June 16, 2013, by and among KCAP Financial, Inc., KCAP Senior Funding I Holdings, LLC, KCAP Senior Funding I, LLC and Guggenheim Securities, LLC (previously filed as Exhibit 10.1 to KCAP Financial, Inc.'s Current Report on Form 8-K filed June 19, 2013)
10.2	Master Loan Sale Agreement, dated June 18, 2013, by and among KCAP Financial, Inc., KCAP Senior Funding I Holdings, LLC and KCAP Senior Funding I, LLC (previously filed as Exhibit 10.2 to KCAP Financial, Inc.'s Current Report on Form 8-K filed June 19, 2013)
10.3	Indenture, dated June 18, 2013, by and between KCAP Senior Funding I, LLC and U.S. Bank National Association (previously filed as Exhibit 10.3 to KCAP Financial, Inc.'s Current Report on Form 8-K filed June 19, 2013)
10.4	Collateral Management Agreement, dated June 18, 2013, by and between KCAP Senior Funding I, LLC and KCAP Financial, Inc. (previously filed as Exhibit 10.4 to KCAP Financial, Inc.'s Current Report on Form 8-K filed June 19, 2013)
10.5	Collateral Administration Agreement, dated June 18, 2013, by and among KCAP Senior Funding I, LLC, KCAP Financial, Inc. and U.S. Bank National Association (previously filed as Exhibit 10.5 to KCAP Financial, Inc.'s Current Report on Form 8-K filed June 19, 2013)
31.1**	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2**	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of Chief Executive Officer Pursuant to 18 U. S. C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of Chief Financial Officer Pursuant to 18 U. S. C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Indicates a management contract or compensatory plan, contract or agreement.
** Submitted herewith.

Exhibit 31.1

CERTIFICATION PURSUANT TO
RULE 13a-14(a) and 15d-14(a) UNDER THE SECURITIES EXCHANGE ACT OF 1934,
AS AMENDED

I, Dayl W. Pearson, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarter ended June 30, 2013 of KCAP Financial, Inc. (the "registrant");

2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 6, 2013	By:	/ s / Dayl W. Pearson
		Dayl W. Pearson
		President and Chief Executive Officer
		(Principal Executive Officer)

Exhibit 31.2

CERTIFICATION PURSUANT TO
RULE 13a-14(a) and 15d-14(a) UNDER THE SECURITIES EXCHANGE ACT OF 1934,
AS AMENDED

I, Edward U. Gilpin, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarter ended June 30, 2013 of KCAP Financial, Inc. (the "registrant");

2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 6, 2013 By: / s / Edward U. Gilpin

Edward U. Gilpin
Chief Financial Officer
(Principal Financial Officer)

Exhibit 32.1

CERTIFICATION PURSUANT TO
SECTION 1350, CHAPTER 63 OF TITLE 18, UNITED STATES CODE,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the accompanying Quarterly Report of KCAP Financial, Inc. (the "Company") on Form 10-Q for the quarter ended June 30, 2013 (the "Report"), I, Dayl W. Pearson, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 6, 2013

By: / s / DAYL W. PEARSON

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

Exhibit 32.2

CERTIFICATION PURSUANT TO
SECTION 1350, CHAPTER 63 OF TITLE 18, UNITED STATES CODE,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the accompanying Quarterly Report of KCAP Financial, Inc. (the “Company”) on Form 10-Q for the quarter ended June 30, 2013 (the “Report”), I, Edward U. Gilpin, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 6, 2013

By: / s / Edward U. Gilpin

Edward U. Gilpin
Chief Financial Officer
(Principal Financial Officer)