

PROSPECT CAPITAL CORP

Form 10-K

August 30, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-K**

**þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the fiscal year ended June 30, 2010**

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

**Commission File Number: 814-00659  
PROSPECT CAPITAL CORPORATION  
(Exact name of registrant as specified in its charter)**

**Maryland**  
(State or other jurisdiction of incorporation or  
organization)

**43-2048643**  
(I.R.S. Employer Identification No.)

**10 East 40th Street  
New York, New York**  
(Address of principal executive offices)

**10016**  
(Zip Code)

**(212) 448-0702**

(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act:**

**Common Stock, par value \$0.001 per share**  
(Title of each class)

**NASDAQ Global Market**  
(Name of each exchange where registered)

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
**Yes** o **No** **þ**

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. **Yes** o **No** **þ**

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** **þ** **No** o

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). **Yes** o **No** o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting

company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a 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 aggregate market value of common stock held by non-affiliates of the Registrant on December 31, 2009 based on the closing price on that date of \$11.81 on the NASDAQ Global Market was \$727 million. For the purposes of calculating this amount only, all directors and executive officers of the Registrant have been treated as affiliates.

As of August 30, 2010, there were 75,733,865 shares of the registrant's common stock outstanding.

**Documents Incorporated by Reference**

Portions of the Registrant's definitive Proxy Statement relating to the 2010 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission, are incorporated by reference in Part III of this Annual Report on Form 10-K to the extent described therein.

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**PART I**

*The terms we, us, our, Company and Prospect Capital refer to Prospect Capital Corporation; Prospect Capital Management or the Investment Adviser refers to Prospect Capital Management LLC; Prospect Administration or the Administrator refers to Prospect Administration LLC.*

**Item 1. Business.**

**General**

We are a financial services company that lends to and invests in middle market privately-held companies. We were originally organized under the name Prospect Street Energy Corporation and we changed our name to Prospect Energy Corporation in June 2004. We changed our name again to Prospect Capital Corporation in May 2007 and at the same time terminated our policy of investing at least 80% of our net assets in energy companies. While we expect to be less focused on the energy industry in the future, we will continue to have significant holdings in the energy and energy related industries.

On December 2, 2009, we completed our previously announced acquisition of Patriot Capital Funding, Inc., or Patriot, under the Agreement and Plan of Merger, dated as of August 3, 2009, by and among, us and Patriot. Pursuant to the terms of the merger agreement, we acquired Patriot for \$201.1 million comprised of our common stock and cash to repay all of Patriot's outstanding debt, which amounted to \$107.3 million. In the merger, each outstanding share of Patriot common stock was converted into the right to receive 0.363992 shares of common stock of Prospect, representing 8,444,068 shares of the Company's common stock, and the payment of cash in lieu of fractional shares of Prospect common stock of less than \$200 resulting from the application of the foregoing exchange ratio.

We have been organized as a closed-end investment company since April 13, 2004 and have filed an election to be treated as a business development company under the 1940 Act. We are a non-diversified company within the meaning of the 1940 Act. Our headquarters are located at 10 East 40th Street, 44th Floor, New York, NY 10016, and our telephone number is (212) 448-0702. Our investment adviser is Prospect Capital Management LLC.

**Patriot Acquisition**

On December 2, 2009, we acquired the outstanding shares of Patriot Capital Funding, Inc. (Patriot) common stock for \$201.1 million. Under the terms of the merger agreement, Patriot common shareholders received 0.363992 shares of our common stock for each share of Patriot common stock, resulting in 8,444,068 shares of common stock being issued by us. In connection with the transaction, we repaid all the outstanding borrowings of Patriot, in compliance with the merger agreement.

On December 2, 2009, Patriot made a final dividend equal to its undistributed net ordinary income and capital gains of \$0.38 per share. In accordance with a recent IRS revenue procedure, the dividend was paid 10% in cash and 90% in newly issued shares of Patriot's common stock. The exchange ratio was adjusted to give effect to the tax distribution. The merger has been accounted for as an acquisition of Patriot by Prospect Capital Corporation (Prospect) in accordance with acquisition method of accounting as detailed in ASC 805, *Business Combinations* (ASC 805). The fair value of the consideration paid was allocated to the assets acquired and liabilities assumed based on their fair values as the date of acquisition. As described in more detail in ASC 805, goodwill, if any, would have been recognized as of the acquisition date, if the consideration transferred exceeded the fair value of identifiable net assets acquired. As of the acquisition date, the fair value of the identifiable net assets acquired exceeded the fair value of the consideration transferred, and we recognized the excess as a gain. A preliminary gain of \$5.7 million was recorded by Prospect in the quarter ended December 31, 2009 related to the acquisition of Patriot, which was revised in the fourth quarter of Fiscal 2010, to \$7.7 million, when we settled severance accruals related to certain members of Patriot's top management. Under ASC 805, the adjustment to our preliminary estimates is reflected in the three and six months ended December 31, 2009 (See Note 13 to our consolidated financial statements.). The acquisition of Patriot was negotiated in July 2009 with the purchase agreement being signed on August 3, 2009. Between July 2009 and December 2, 2009, our valuation of certain of the investments acquired from Patriot increased due to market improvement, which resulted in the recognition of the gain at closing.



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**Our Investment Objective and Policies**

Our investment objective is to generate both current income and long-term capital appreciation through debt and equity investments. We focus on making investments in private companies, and many of our investments are in energy companies. We are a non-diversified company within the meaning of the 1940 Act.

Typically, we concentrate on making investments in companies with annual revenues of less than \$500 million and enterprise values of less than \$250 million. Our typical investment involves a secured loan of less than \$50 million with some form of equity participation. From time to time, we acquire controlling interests in companies in conjunction with making secured debt investments in such companies. In most cases, companies in which we invest are privately held at the time we invest in them. We refer to these companies as target or middle market companies and these investments as middle market investments.

We seek to maximize returns and protect risk for our investors by applying rigorous analysis to make and monitor our investments. While the structure of our investments varies, we can invest in senior secured debt, senior unsecured debt, subordinated secured debt, subordinated unsecured debt, mezzanine debt, convertible debt, convertible preferred equity, preferred equity, common equity, warrants and other instruments, many of which generate current yield. Our investments primarily range between approximately \$5 million and \$50 million each, although this investment size may vary as the size of our capital base changes.

While our primary focus is to seek current income through investment in the debt and/or dividend-paying equity securities of eligible privately-held, thinly-traded or distressed companies and long-term capital appreciation by acquiring accompanying warrants, options or other equity securities of such companies, we may invest up to 30% of the portfolio in opportunistic investments in order to seek enhanced returns for stockholders. Such investments may include investments in the debt and equity instruments of broadly-traded public companies. We expect that these public companies generally will have debt securities that are non-investment grade. Within this 30% basket, we may also invest in debt and equity securities of companies located outside of the United States.

Our investments may include other equity investments, such as warrants, options to buy a minority interest in a portfolio company, or contractual payment rights or rights to receive a proportional interest in the operating cash flow or net income of such company. When determined by our Investment Adviser to be in our best interest, we may acquire a controlling interest in a portfolio company. Any warrants we receive with our debt securities may require only a nominal cost to exercise, and thus, as a portfolio company appreciates in value, we may achieve additional investment return from this equity interest. We have structured, and will continue to structure, some warrants to include provisions protecting our rights as a minority-interest or, if applicable, controlling-interest holder, as well as puts, or rights to sell such securities back to the company, upon the occurrence of specified events. In many cases, we obtain registration rights in connection with these equity interests, which may include demand and piggyback registration rights.

We plan to hold many of our investments to maturity or repayment, but will sell our investments earlier if a liquidity event takes place, such as the sale or recapitalization of a portfolio company, or if we determine a sale of one or more of our investments to be in our best interest.

We have qualified and elected to be treated for U.S. Federal income tax purposes as a Registered Investment Company ( RIC ) under Subchapter M of the Code. As a RIC, we generally do not have to pay corporate-level U.S. Federal income taxes on any ordinary income or capital gains that we distribute to our stockholders as dividends. To continue to qualify as a RIC, we must, among other things, meet certain source-of-income and asset diversification requirements (as described below). In addition, to qualify for RIC tax treatment we must distribute to our stockholders, for each taxable year, at least 90% of our investment company taxable income, which is generally our ordinary income plus the excess of our realized net short-term capital gains over our realized net long-term capital losses.

For a discussion of the risks inherent in our portfolio investments, see Risk Factors Risks Relating to our Investments.



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### **Industry Sectors**

We have invested significantly in industrial and energy related companies. However, we continue to widen our focus in other sectors of the economy to diversify our portfolio holdings. The energy industry consists of companies in the direct energy value chain as well as companies that sell products and services to, or acquire products and services from, the direct energy value chain. In this report, we refer to all of these companies as energy companies and assets in these companies as energy assets. The categories of energy companies in this chain are described below. The direct energy value chain broadly includes upstream businesses, midstream businesses and downstream businesses:

Upstream businesses find, develop and extract energy resources, including natural gas, crude oil and coal, which are typically from geological reservoirs found underground or offshore, and agricultural products.

Midstream businesses gather, process, refine, store and transmit energy resources and their by products in a form that is usable by wholesale power generation, utility, petrochemical, industrial and gasoline customers.

Downstream businesses include the power and electricity segment as well as businesses that process, refine, market or distribute hydrocarbons or other energy resources, such as customer-ready natural gas, propane and gasoline, to end-user customers.

### **Ongoing Relationships with Portfolio Companies**

#### *Monitoring*

Prospect Capital Management monitors our portfolio companies on an ongoing basis. Prospect Capital Management will continue to monitor the financial trends of each portfolio company to determine if it is meeting its business plan and to assess the appropriate course of action for each company.

Prospect Capital Management employs several methods of evaluating and monitoring the performance and value of our investments, which may include, but are not limited to, the following:

Assessment of success in adhering to the portfolio company's business plan and compliance with covenants;

Regular contact with portfolio company management and, if appropriate, the financial or strategic sponsor, to discuss financial position, requirements and accomplishments;

Attendance at and participation in board meetings of the portfolio company; and

Review of monthly and quarterly financial statements and financial projections for the portfolio company.

#### *Investment Valuation*

Our Board of Directors has established procedures for the valuation of our investment portfolio. These procedures are detailed below.

Investments for which market quotations are readily available are valued at such market quotations.

For most of our investments, market quotations are not available. With respect to investments for which market quotations are not readily available or when such market quotations are deemed not to represent fair value, our Board of Directors has approved a multi-step valuation process each quarter, as described below:

- 1) Each portfolio company or investment is reviewed by our investment professionals with the independent valuation firm engaged by our Board of Directors;
- 2) the independent valuation firm conducts independent appraisals and makes their own independent assessment;
- 3) the audit committee of our Board of Directors reviews and discusses the preliminary valuation of our Investment Adviser and that of the independent valuation firm; and
- 4) the Board of Directors discusses valuations and determines the fair value of each investment in our portfolio in good faith based on the input of our Investment Adviser, the respective independent valuation firm and the audit committee.

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Investments are valued utilizing a market approach, an income approach, a liquidation approach, or a combination of approaches, as appropriate. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present value amount (discounted) calculated based on an appropriate discount rate. The measurement is based on the net present value indicated by current market expectations about those future amounts. In following these approaches, the types of factors that we may take into account in fair value pricing our investments include, as relevant: available current market data, including relevant and applicable market trading and transaction comparables, applicable market yields and multiples, security covenants, call protection provisions, information rights, the nature and realizable value of any collateral, the portfolio company's ability to make payments, its earnings and discounted cash flows, the markets in which the portfolio company does business, comparisons of financial ratios of peer companies that are public, M&A comparables, the principal market and enterprise values, among other factors.

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Codification ( ASC or Codification ) 820, *Fair Value Measurements and Disclosures* ( ASC 820 ). ASC 820 defines fair value and establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. We adopted ASC 820 on a prospective basis beginning in the quarter ended September 30, 2008.

ASC 820 classifies the inputs used to measure these fair values into the following hierarchy:

*Level 1:* Quoted prices in active markets for identical assets or liabilities, accessible by the Company at the measurement date.

*Level 2:* Quoted prices for similar assets or liabilities in active markets, or quoted prices for identical for similar assets or liabilities in markets that are not active, or other observable inputs other than quoted prices.

*Level 3:* Unobservable inputs for the asset or liability.

In all cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined 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 considers factors specific to each investment.

The changes to generally accepted accounting principles from the application of ASC 820 relate to the definition of fair value, framework for measuring fair value, and the expanded disclosures about fair value measurements. ASC 820 applies to fair value measurements already required or permitted by other standards.

In accordance with ASC 820, the fair value of our investments is defined as the price that we would receive upon selling an investment in an orderly transaction to an independent buyer in the principal or most advantageous market in which that investment is transacted.

In April 2009, the FASB issued ASC 820-10-65, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ( ASC 820-10-65 ). This update provides further clarification for ASC 820 in markets that are not active and provides additional guidance for determining when the volume of trading level of activity for an asset or liability has significantly decreased and for identifying circumstances that indicate a transaction is not orderly. ASC 820-10-65 is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of ASC 820-10-65 for the year ended June 30, 2010, did not have any effect on our net asset value, financial position or results of operations as there was no change to the fair value measurement principles set forth in ASC 820.

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In January 2010, the FASB issued Accounting Standards Update 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* ( ASC 2010-06 ). ASU 2010-06 amends ASC 820-10 and clarifies and provides additional disclosure requirements related to recurring and non-recurring fair value measurements and employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2010. Our management does not believe that the adoption of the amended guidance in ASC 820-10 will have a significant effect on our financial statements.

For a discussion of the risks inherent in determining the value of securities for which readily available market values do not exist, see Risk Factors Risks relating to our business Most of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty as to the value of our portfolio investments.

*Valuation of Other Financial Assets and Financial Liabilities*

In February 2007, FASB issued ASC Subtopic 820-10-05-1, *The Fair Value Option for Financial Assets and Financial Liabilities* ( ASC 820-10-05-1 ). ASC 820-10-05-1 permits an entity to elect fair value as the initial and subsequent measurement attribute for many of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. We have adopted this statement on July 1, 2008 and have elected not to value some assets and liabilities at fair value as would be permitted by ASC 820-10-05-1.

*Managerial Assistance*

As a business development company, we offer, and must provide upon request, managerial assistance to certain of our portfolio companies. This assistance could involve, among other things, monitoring the operations of our portfolio companies, participating in board and management meetings, consulting with and advising officers of portfolio companies and providing other organizational and financial guidance. We may receive fees for these services. Such fees would not qualify as good income for purposes of the 90% income test that we must meet each year to qualify as a RIC. Prospect Administration provides such managerial assistance on our behalf to portfolio companies when we are required to provide this assistance.

**Market Conditions**

While the economy continues to show signs of recovery from the deteriorating credit markets of 2008 and 2009, there is still a level of uncertainty and volatility in the capital markets. The growth and improvement in the capital markets that began during the second half of 2009 carried over into the first quarter of 2010. While encouraged by the signs of improvement, we operate in a challenging environment that is still recovering from a recession and financial services industry negatively affected by the deterioration of credit quality in subprime residential mortgages that spread rapidly to other credit markets. Market liquidity and credit quality conditions continue to remain weaker today than three years ago.

We believe that Prospect is well positioned to navigate through these adverse market conditions. As a business development company, we are limited to a maximum 1 to 1 debt to equity ratio, and as of June 30, 2010, we had \$180.7 million available under our credit facility, of which \$100.3 million was outstanding. Further, as we make additional investments that are eligible to be pledged under the credit facility, we will generate additional credit facility availability. The revolving period for our credit facility continues until June 13, 2012, with an amortization running to June 13, 2013, with interest distributions to us allowed.

We also continue to generate liquidity through public and private stock offerings. On July 7, 2009, we completed a public stock offering for 5,175,000 shares of our common stock at \$9.00 per share, raising \$46.6 million of gross proceeds. On August 20, 2009 and September 24, 2009, we issued 3,449,686 shares and 2,807,111 shares, respectively, of our common stock at \$8.50 and \$9.00 per share, respectively, in private stock offerings, raising \$29.3 million, and \$25.3 million of gross proceeds, respectively. Concurrent with the sale of these shares, we entered into a registration rights agreement in which we granted the purchasers certain registration rights with respect to the shares. Under the terms and conditions of the registration rights agreement, we filed with the SEC a post-effective amendment to the registration statement on Form N-2 on November 6, 2009. Such amendment was declared effective by the SEC on November 9, 2009.



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On March 4, 2010, our Registration Statement on Form N-2 was declared effective by the SEC. Under this Shelf Registration Statement, we can issue up to \$439.6 million of additional equity securities as of June 30, 2010.

On March 17, 2010, we established an at-the-market program through which we sold shares of our common stock. An at-the-market offering is a registered offering by a publicly traded issuer of its listed equity securities selling shares directly into the market at market prices. We engaged two broker-dealers to act as agents and sell our common stock directly into the market over a period of time. We paid a 2% commission to the broker-dealer on shares sold. Through this program we issued 8,000,000 shares of our common stock at an average price of \$10.90 per share, raising \$87.2 million of gross proceeds, from March 23, 2010 through July 21, 2010.

On July 19, 2010, we established a new at-the-market program, as we had sold all the shares authorized in the original at-the-market program, through which we may sell, from time to time and at our discretion, 6,000,000 shares of our common stock. We engaged three broker-dealers to act as potential agents and sell our common stock directly into the market over a period of time. We currently pay a 2% commission to the broker-dealer on shares sold. Through this program we issued 3,814,528 shares of our common stock at an average price of \$9.71 per share, raising \$37.1 million of gross proceeds, from July 22, 2010 through August 24, 2010.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ( GAAP ) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reported period. Changes in the economic environment, financial markets and any other parameters used in determining these estimates could cause actual results to differ.

### **Our Investment Adviser**

Prospect Capital Management manages our investments as our investment adviser. Prospect Capital Management is a Delaware limited liability corporation that has been registered as an investment adviser under the Advisers Act since March 31, 2004. Prospect Capital Management is led by John F. Barry III and M. Grier Eliasek, two senior executives with significant investment advisory and business experience. Both Messrs. Barry and Eliasek spend a significant amount of their time in their roles at Prospect Capital Management working on the Company's behalf. The principal executive offices of Prospect Capital Management are 10 East 40th Street, 44th Floor, New York, NY 10016. We depend on the due diligence, skill and network of business contacts of the senior management of our Investment Adviser. We also depend, to a significant extent, on our Investment Adviser's investment professionals and the information and deal flow generated by those investment professionals in the course of their investment and portfolio management activities. The Investment Adviser's senior management team evaluates, negotiates, structures, closes, monitors and services our investments. Our future success depends to a significant extent on the continued service of the senior management team, particularly John F. Barry III and M. Grier Eliasek. The departure of any of the senior managers of our Investment Adviser could have a materially adverse effect on our ability to achieve our investment objective. In addition, we can offer no assurance that Prospect Capital Management will remain our Investment Adviser or that we will continue to have access to its investment professionals or its information and deal flow. Under our Investment Advisory Agreement, we pay Prospect Capital Management investment advisory fees, which consist of an annual base management fee based on our gross assets as well as a two-part incentive fee based on our performance. Mr. Barry currently controls Prospect Capital Management.

### **Investment Advisory Agreement**

#### *Terms*

We have entered into an investment advisory and management agreement (the Investment Advisory Agreement) with Prospect Capital Management, under which the Investment Adviser, subject to the overall supervision of our Board of Directors, manages our day-to-day operations and provides us with investment advisory services. Under the terms of the Investment Advisory Agreement, our Investment Adviser: (i) determines the composition of our portfolio, the nature and timing of the changes to our portfolio and the manner of implementing such changes, (ii) identifies, evaluates and negotiates the structure of the investments we make (including performing due diligence on our prospective portfolio companies); and (iii) closes and monitors investments we make.



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Prospect Capital Management's services under the Investment Advisory Agreement are not exclusive, and it is free to furnish similar services to other entities so long as its services to us are not impaired. For providing these services the Investment Adviser receives a fee from us, consisting of two components: a base management fee and an incentive fee. The base management fee is calculated at an annual rate of 2.00% on our gross assets (including amounts borrowed). For services currently rendered under the Investment Advisory Agreement, the base management fee is payable quarterly in arrears. The base management fee is calculated based on the average value of our gross assets at the end of the two most recently completed calendar quarters and appropriately adjusted for any share issuances or repurchases during the current calendar quarter. Base management fees for any partial month or quarter are appropriately prorated.

The incentive fee has two parts. The first part, the income incentive fee, is calculated and payable quarterly in arrears based on our pre-incentive fee net investment income for the immediately preceding calendar quarter. For this purpose, pre-incentive fee net investment income means interest income, dividend income and any other income (including any other fees (other than fees for providing managerial assistance), such as commitment, origination, structuring, diligence and consulting fees and other fees that we receive from portfolio companies) accrued during the calendar quarter, minus our operating expenses for the quarter (including the base management fee, expenses payable under the Administration Agreement described below, and any interest expense and dividends paid on any issued and outstanding preferred stock, but excluding the incentive fee). Pre-incentive fee net investment income includes, in the case of investments with a deferred interest feature (such as original issue discount, debt instruments with payment in kind interest and zero coupon securities), accrued income that we have not yet received in cash. Pre-incentive fee net investment income does not include any realized capital gains, realized capital losses or unrealized capital appreciation or depreciation. Pre-incentive fee net investment income, expressed as a rate of return on the value of our net assets at the end of the immediately preceding calendar quarter, is compared to a hurdle rate of 1.75% per quarter (7.00% annualized).

The net investment income used to calculate this part of the incentive fee is also included in the amount of the gross assets used to calculate the 2.00% base management fee. We pay the Investment Adviser an income incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

- no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate;

- 100.00% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 125.00% of the quarterly hurdle rate in any calendar quarter (8.75% annualized with a 7.00% annualized hurdle rate); and

- 20.00% of the amount of our pre-incentive fee net investment income, if any, that exceeds 125.00% of the quarterly hurdle rate in any calendar quarter (8.75% annualized with a 7.00% annualized hurdle rate).

These calculations are appropriately prorated for any period of less than three months and adjusted for any share issuances or repurchases during the current quarter.

The second part of the incentive fee, the capital gains incentive fee, is determined and payable in arrears as of the end of each calendar year (or upon termination of the Investment Advisory Agreement, as of the termination date), and equals 20.00% of our realized capital gains for the calendar year, if any, computed net of all realized capital losses and unrealized capital depreciation at the end of such year. In determining the capital gains incentive fee payable to the Investment Adviser, we calculate the aggregate realized capital gains, aggregate realized capital losses and aggregate unrealized capital depreciation, as applicable, with respect to each investment that has been in our portfolio. For the purpose of this calculation, an investment is defined as the total of all rights and claims which may be asserted against a portfolio company arising our participation in the debt, equity, and other financial instruments issued by that company. Aggregate realized capital gains, if any, equals the sum of the differences between the aggregate net sales price of each investment and the aggregate cost basis of such investment when sold or otherwise disposed of. Aggregate realized capital losses equal the sum of the amounts by which the aggregate net sales price of each investment is less than the aggregate cost basis of such investment when sold or otherwise disposed. Aggregate unrealized capital depreciation equals the sum of the differences, if negative, between the aggregate valuation of each investment and the aggregate cost basis of such investment as of the applicable calendar year-end. At the end of the

applicable calendar year, the amount of capital gains that serves as the basis for our calculation of the capital gains incentive fee involves netting aggregate realized capital gains against aggregate realized capital losses on a since-inception basis and then reducing this amount by the aggregate unrealized capital depreciation. If this number is positive, then the capital gains incentive fee payable is equal to 20.00% of such amount, less the aggregate amount of any capital gains incentive fees paid since inception.



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*Examples of Quarterly Incentive Fee Calculation*

Example 1: Income Incentive Fee (\*):

Alternative 1

*Assumptions*

Investment income (including interest, dividends, fees, etc.) = 1.25%

Hurdle rate(1) = 1.75%

Base management fee(2) = 0.50%

Other expenses (legal, accounting, custodian, transfer agent, etc.)(3) = 0.20%

Pre-incentive fee net investment income (investment income - (base management fee + other expenses)) = 0.55%

Pre-incentive net investment income does not exceed hurdle rate, therefore there is no income incentive fee.

Alternative 2

*Assumptions*

Investment income (including interest, dividends, fees, etc.) = 2.70%

Hurdle rate(1) = 1.75%

Base management fee(2) = 0.50%

Other expenses (legal, accounting, custodian, transfer agent, etc.)(3) = 0.20%

Pre-incentive fee net investment income (investment income - (base management fee + other expenses)) = 2.00%

Pre-incentive net investment income exceeds hurdle rate, therefore there is an income incentive fee payable by us to our Investment Adviser.

Income incentive Fee =  $100\% \times \text{Catch Up} + \text{the greater of } 0\% \text{ AND } (20\% \times (\text{pre-incentive fee net investment income} - 2.1875\%))$

$= (100\% \times (2.00\% - 1.75\%)) + 0\%$

$= 100\% \times 0.25\% + 0\%$

$= 0.25\%$

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**Alternative 3**

*Assumptions*

Investment income (including interest, dividends, fees, etc.) = 3.00%

Hurdle rate(1) = 1.75%

Base management fee(2) = 0.50%

Other expenses (legal, accounting, custodian, transfer agent, etc.)(3) = 0.20%

Pre-incentive fee net investment income (investment income - (base management fee + other expenses)) = 2.30%

Pre-incentive net investment income exceeds hurdle rate, therefore there is an income incentive fee payable by us to our Investment Adviser.

Income incentive Fee = 100% × Catch Up + the greater of 0% AND (20% × (pre-incentive fee net investment income - 2.1875%))

= (100% × (2.1875% - 1.75%)) + the greater of 0% AND (20% × (2.30% - 2.1875%))

= (100% × 0.4375%) + (20% × 0.1125%)

= 0.4375% + 0.0225%

= 0.46%

(1) Represents 7% annualized hurdle rate.

(2) Represents 2% annualized base management fee.

(3) Excludes organizational and offering expenses.

(\* The hypothetical amount of pre-incentive fee net investment income shown is based on a percentage of total net assets.

Example 2: Capital Gains Incentive Fee:

**Alternative 1**

*Assumptions*

Year 1: \$20 million investment made

Year 2: Fair market value ( FMV ) of investment determined to be \$22 million

Year 3: FMV of investment determined to be \$17 million

Year 4: Investment sold for \$21 million



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The impact, if any, on the capital gains portion of the incentive fee would be:

Year 1: No impact

Year 2: No impact

Year 3: Decrease base amount on which the second part of the incentive fee is calculated by \$3 million (unrealized capital depreciation)

Year 4: Increase base amount on which the second part of the incentive fee is calculated by \$4 million (\$1 million of realized capital gain and \$3 million reversal in unrealized capital depreciation)

**Alternative 2**

*Assumptions*

Year 1: \$20 million investment made

Year 2: FMV of investment determined to be \$17 million

Year 3: FMV of investment determined to be \$17 million

Year 4: FMV of investment determined to be \$21 million

Year 5: FMV of investment determined to be \$18 million

Year 6: Investment sold for \$15 million

The impact, if any, on the capital gains portion of the incentive fee would be:

Year 1: No impact

Year 2: Decrease base amount on which the second part of the incentive fee is calculated by \$3 million (unrealized capital depreciation)

Year 3: No impact

Year 4: Increase base amount on which the second part of the incentive fee is calculated by \$3 million (reversal in unrealized capital depreciation)

Year 5: Decrease base amount on which the second part of the incentive fee is calculated by \$2 million (unrealized capital depreciation)

Year 6: Decrease base amount on which the second part of the incentive fee is calculated by \$3 million (\$5 million of realized capital loss offset by a \$2 million reversal in unrealized capital depreciation)

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**Alternative 3**

*Assumptions*

Year 1: \$20 million investment made in company A ( Investment A ), and \$20 million investment made in company B ( Investment B )

Year 2: FMV of Investment A is determined to be \$21 million, and Investment B is sold for \$18 million

Year 3: Investment A is sold for \$23 million

The impact, if any, on the capital gains portion of the incentive fee would be:

Year 1: No impact

Year 2: Decrease base amount on which the second part of the incentive fee is calculated by \$2 million (realized capital loss on Investment B)

Year 3: Increase base amount on which the second part of the incentive fee is calculated by \$3 million (realized capital gain on Investment A)

**Alternative 4**

*Assumptions*

Year 1: \$20 million investment made in company A ( Investment A ), and \$20 million investment made in company B ( Investment B )

Year 2: FMV of Investment A is determined to be \$21 million, and FMV of Investment B is determined to be \$17 million

Year 3: FMV of Investment A is determined to be \$18 million, and FMV of Investment B is determined to be \$18 million

Year 4: FMV of Investment A is determined to be \$19 million, and FMV of Investment B is determined to be \$21 million

Year 5: Investment A is sold for \$17 million, and Investment B is sold for \$23 million

The impact, if any, on the capital gains portion of the incentive fee would be:

Year 1: No impact

Year 2: Decrease base amount on which the second part of the incentive fee is calculated by \$3 million (unrealized capital depreciation on Investment B)

Year 3: Decrease base amount on which the second part of the incentive fee is calculated by \$1 million (\$2 million in unrealized capital depreciation on Investment A and \$1 million recovery in unrealized capital depreciation on Investment B)

Year 4: Increase base amount on which the second part of the incentive fee is calculated by \$3 million (\$1 million recovery in unrealized capital depreciation on Investment A and \$2 million recovery in unrealized capital depreciation on Investment B)

Year 5: Increase base amount on which the second part of the incentive fee is calculated by \$1 million (\$3 million realized capital gain on Investment B offset by \$3 million realized capital loss on Investment A plus a \$1 million reversal in unrealized capital depreciation on Investment A from Year 4).

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*Duration and Termination*

The Investment Advisory Agreement was originally approved by our Board of Directors on June 23, 2004 and was recently re-approved by the Board of Directors on June 15, 2010 for an additional one-year term expiring June 24, 2011. Unless terminated earlier as described below, it will remain in effect from year to year thereafter if approved annually by our Board of Directors or by the affirmative vote of the holders of a majority of our outstanding voting securities, including, in either case, approval by a majority of our directors who are not interested persons. The Investment Advisory Agreement will automatically terminate in the event of its assignment. The Investment Advisory Agreement may be terminated by either party without penalty upon not more than 60 days' written notice to the other. See Risk factors Risks relating to our business We are dependent upon Prospect Capital Management's key management personnel for our future success.

*Indemnification*

The Investment Advisory Agreement provides that, absent willful misfeasance, bad faith or gross negligence in the performance of its duties or by reason of the reckless disregard of its duties and obligations, Prospect Capital Management and its officers, managers, agents, employees, controlling persons, members and any other person or entity affiliated with it are entitled to indemnification from us for any damages, liabilities, costs and expenses (including reasonable attorneys' fees and amounts reasonably paid in settlement) arising from the rendering of Prospect Capital Management's services under the Investment Advisory Agreement or otherwise as our investment adviser.

**Administration Agreement**

We have also entered into an Administration Agreement with Prospect Administration under which Prospect Administration, among other things, provides (or arranges for the provision of) administrative services and facilities for us. For providing these services, we reimburse Prospect Administration for our allocable portion of overhead incurred by Prospect Administration in performing its obligations under the Administration Agreement, including rent and our allocable portion of the costs of our chief compliance officer and chief financial officer and his staff, including the internal legal staff. Under this agreement, Prospect Administration furnishes us with office facilities, equipment and clerical, bookkeeping and record keeping services at such facilities. Prospect Administration also performs, or oversees the performance of, our required administrative services, which include, among other things, being responsible for the financial records that we are required to maintain and preparing reports to our stockholders and reports filed with the Securities and Exchange Commission, or the SEC. In addition, Prospect Administration assists us in determining and publishing our net asset value, overseeing the preparation and filing of our tax returns and the printing and dissemination of reports to our stockholders, and generally oversees the payment of our expenses and the performance of administrative and professional services rendered to us by others. Under the Administration Agreement, Prospect Administration also provides on our behalf managerial assistance to those portfolio companies to which we are required to provide such assistance. The Administration Agreement may be terminated by either party without penalty upon 60 days' written notice to the other party. Prospect Administration is a wholly owned subsidiary of our Investment Adviser.

Prospect Administration previously engaged Vastardis Fund Services LLC ( Vastardis ) to serve as our sub-administrator to perform certain services required of Prospect Administration. On April 30, 2009 we gave a 60-day notice to Vastardis of termination of our agreement for Vastardis to provide sub-administration services effective June 30, 2009. We entered into a new consulting services agreement for the period from July 1, 2009 until the filing of our Form 10-K for the year ended June 30, 2009. We paid Vastardis a total of \$30,000 for services rendered in conjunction with preparation of Form 10-K under the new agreement. All administration services were assumed by Prospect Administration effective September 14, 2009.

We reimbursed Prospect Administration \$3.4 million, \$2.9 million and \$2.1 million for the twelve months ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively, for services it provided to the Company at cost.

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### **Payment of Our Expenses**

All investment professionals of the Investment Adviser and its respective staff, when and to the extent engaged in providing investment advisory and management services, and the compensation and routine overhead expenses of such personnel allocable to such services, will be provided and paid for by the Investment Adviser. We bear all other costs and expenses of our operations and transactions, including those relating to: organization and offering; calculation of our net asset value (including the cost and expenses of any independent valuation firm); expenses incurred by Prospect Capital Management payable to third parties, including agents, consultants or other advisers (such as independent valuation firms, accountants and legal counsel), in monitoring our financial and legal affairs and in monitoring our investments and performing due diligence on our prospective portfolio companies; interest payable on debt, if any, and dividends payable on preferred stock, if any, incurred to finance our investments; offerings of our debt, our preferred shares, our common stock and other securities; investment advisory fees; fees payable to third parties, including agents, consultants or other advisors, relating to, or associated with, evaluating and making investments; transfer agent and custodial fees; registration fees; listing fees; taxes; independent directors fees and expenses; costs of preparing and filing reports or other documents with the SEC; the costs of any reports, proxy statements or other notices to stockholders, including printing costs; our allocable portion of the fidelity bond, directors and officers/errors and omissions liability insurance, and any other insurance premiums; direct costs and expenses of administration, including auditor and legal costs; and all other expenses incurred by us, by our Investment Adviser or by Prospect Administration in connection with administering our business, such as our allocable portion of overhead under the administration agreement, including rent and our allocable portion of the costs of our chief compliance officer and chief financial officer and their respective staffs under the sub-administration agreement, as further described below.

### **License Agreement**

We entered into a license agreement with Prospect Capital Management, pursuant to which Prospect Capital Management agreed to grant us a nonexclusive, royalty free license to use the name Prospect Capital. Under this agreement, we have a right to use the Prospect Capital name, for so long as Prospect Capital Management or one of its affiliates remains our Investment Adviser. Other than with respect to this limited license, we have no legal right to the Prospect Capital name. This license agreement will remain in effect for so long as the Investment Advisory Agreement with our Investment Adviser is in effect.

### **Determination of Net Asset Value**

The net asset value per share of our outstanding shares of common stock will be determined quarterly by dividing the value of total assets minus liabilities by the total number of shares outstanding.

In calculating the value of our total assets, we will value investments for which market quotations are readily available at such market quotations. Short-term investments which mature in 60 days or less, such as U.S. Treasury bills, are valued at amortized cost, which approximates market value. The amortized cost method involves recording a security at its cost (i.e., principal amount plus any premium and less any discount) on the date of purchase and thereafter amortizing/accreting that difference between the principal amount due at maturity and cost assuming a constant yield to maturity as determined at the time of purchase. Short-term securities which mature in more than 60 days are valued at current market quotations by an independent pricing service or at the mean between the bid and ask prices obtained from at least two brokers or dealers (if available, or otherwise by a principal market maker or a primary market dealer). Investments in money market mutual funds are valued at their net asset value as of the close of business on the day of valuation.

Most of the investments in our portfolio do not have market quotations which are readily available, meaning the investments do not have actively traded markets. Debt and equity securities for which market quotations are not readily available are valued with the assistance of an independent valuation service using a documented valuation policy and a valuation process that is consistently applied under the direction of our Board of Directors. For a discussion of the risks inherent in determining the value of securities for which readily available market values do not exist, see Risk Factors Risks Relating to Our Business. Most of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty as to the value of our portfolio investments.





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The factors that may be taken into account in valuing such investments include, as relevant, the portfolio company's ability to make payments, its estimated earnings and projected discounted cash flows, the nature and realizable value of any collateral, the financial environment in which the portfolio company operates, comparisons to securities of similar publicly traded companies, changes in interest rates for similar debt instruments and other relevant factors. Due to the inherent uncertainty of determining the fair value of investments that do not have readily available market quotations, the fair value of these investments may differ significantly from the values that would have been used had such market quotations existed for such investments, and any such differences could be material.

As part of the fair valuation process, the independent valuation firm engaged by the Board of Directors performs a review of each debt and equity investment and provides a range of values for each investment, which, along with management's valuation recommendations, is reviewed by the Audit Committee. Management and the independent valuation firm may adjust their preliminary evaluations to reflect comments provided by the Audit Committee. The Audit Committee reviews the final valuation report and management's valuation recommendations and makes a recommendation to the Board of Directors based on its analysis of the methodologies employed and the various weights that should be accorded to each portion of the valuation as well as factors that the independent valuation firm and management may not have included in their evaluation processes. The Board of Directors then evaluates the Audit Committee recommendations and undertakes a similar analysis to determine the fair value of each investment in the portfolio in good faith.

Determination of fair values involves subjective judgments and estimates not susceptible to substantiation by auditing procedures. Accordingly, under current accounting standards, the notes to our financial statements will refer to the uncertainty with respect to the possible effect of such valuations, and any change in such valuations, on our financial statements.

### **Dividend Reinvestment Plan**

We have adopted a dividend reinvestment plan that provides for reinvestment of our distributions on behalf of our stockholders, unless a stockholder elects to receive cash as provided below. As a result, when our Board of Directors authorizes, and we declare, a cash dividend, then our stockholders who have not opted out of our dividend reinvestment plan will have their cash dividends automatically reinvested in additional shares of our common stock, rather than receiving the cash dividends.

No action is required on the part of a registered stockholder to have their cash dividend reinvested in shares of our common stock. A registered stockholder may elect to receive an entire dividend in cash by notifying the plan administrator and our transfer agent and registrar, in writing so that such notice is received by the plan administrator no later than the record date for dividends to stockholders. The plan administrator sets up an account for shares acquired through the plan for each stockholder who has not elected to receive dividends in cash and hold such shares in non-certificated form. Upon request by a stockholder participating in the plan, the plan administrator will, instead of crediting shares to the participant's account, issue a certificate registered in the participant's name for the number of whole shares of our common stock and a check for any fractional share. Such request by a stockholder must be received three days prior to the dividend payable date in order for that dividend to be paid in cash. If such request is received less than three days prior to the dividend payable date, then the dividends are reinvested and shares are repurchased for the stockholder's account; however, future dividends are paid out in cash on all balances. Those stockholders whose shares are held by a broker or other financial intermediary may receive dividends in cash by notifying their broker or other financial intermediary of their election.

We primarily use newly issued shares to implement the plan, whether our shares are trading at a premium or at a discount to net asset value. However, we reserve the right to purchase shares in the open market in connection with our implementation of the plan. The number of shares to be issued to a stockholder is determined by dividing the total dollar amount of the dividend payable to such stockholder by the market price per share of our common stock at the close of regular trading on The NASDAQ Global Select Market on the valuation date for such dividend. If we use newly-issued shares to implement the plan, the valuation date will not be earlier than the last day that stockholders have the right to elect to receive cash in lieu of shares. Market price per share on that date will be the closing price for such shares on The NASDAQ Global Select Market or, if no sale is reported for such day, at the average of their reported bid and asked prices. The number of shares of our common stock to be outstanding after giving effect to

payment of the dividend cannot be established until the value per share at which additional shares will be issued has been determined and elections of our stockholders have been tabulated. Stockholders who do not elect to receive dividends in shares of common stock may experience accretion to the net asset value of their shares if our shares are trading at a premium at the time we issue new shares under the plan and dilution if our shares are trading at a discount. The level of accretion or discount would depend on various factors, including the proportion of our stockholders who participate in the plan, the level of premium or discount at which our shares are trading and the amount of the dividend payable to a stockholder.

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There are no brokerage charges or other charges to stockholders who participate in the plan. The plan administrator's fees under the plan are paid by us. If a participant elects by written notice to the plan administrator to have the plan administrator sell part or all of the shares held by the plan administrator in the participant's account and remit the proceeds to the participant, the plan administrator is authorized to deduct a \$15 transaction fee plus a \$0.10 per share brokerage commissions from the proceeds.

Stockholders who receive dividends in the form of stock are subject to the same U.S. Federal, state and local tax consequences as are stockholders who elect to receive their dividends in cash. A stockholder's basis for determining gain or loss upon the sale of stock received in a dividend from us will be equal to the total dollar amount of the dividend payable to the stockholder. Any stock received in a dividend will have a new holding period for tax purposes commencing on the day following the day on which the shares are credited to the U.S. stockholder's account.

Participants may terminate their accounts under the plan by notifying the plan administrator via its website at [www.amstock.com](http://www.amstock.com) or by filling out the transaction request form located at the bottom of their statement and sending it to the plan administrator at American Stock Transfer & Trust Company, P.O. Box 922, Wall Street Station, New York, NY 10269-0560 or by calling the plan administrator's Interactive Voice Response System at (888) 888-0313.

The plan may be terminated by us upon notice in writing mailed to each participant at least 30 days prior to any payable date for the payment of any dividend by us. All correspondence concerning the plan should be directed to the plan administrator by mail at American Stock Transfer & Trust Company, 59 Maiden Lane, New York, NY 10007 or by telephone at (718) 921-8200.

Stockholders who purchased their shares through or hold their shares in the name of a broker or financial institution should consult with a representative of their broker or financial institution with respect to their participation in our dividend reinvestment plan. Such holders of our stock may not be identified as our registered stockholders with the plan administrator and may not automatically have their cash dividend reinvested in shares of our common stock by the administrator.

**Material U.S. Federal Income Tax Considerations**

The following discussion is a general summary of the material U.S. Federal income tax considerations applicable to us and to an investment in our shares. This summary does not purport to be a complete description of the income tax considerations applicable to us or our investors on such an investment. For example, we have not described tax consequences that we assume to be generally known by investors or certain considerations that may be relevant to certain types of holders subject to special treatment under U.S. Federal income tax laws, including stockholders subject to the alternative minimum tax, tax-exempt organizations, insurance companies, dealers in securities, pension plans and trusts, financial institutions, U.S. stockholders (as defined below) whose functional currency is not the U.S. dollar, persons who mark-to-market our shares and persons who hold our shares as part of a straddle, hedge or conversion transaction. This summary assumes that investors hold our common stock as capital assets (within the meaning of the Code). The discussion is based upon the Code, Treasury regulations, and administrative and judicial interpretations, each as of the date of this report and all of which are subject to change, possibly retroactively, which could affect the continuing validity of this discussion. This summary does not discuss any aspects of U.S. estate or gift tax or foreign, state or local tax. It does not discuss the special treatment under U.S. Federal income tax laws that could result if we invested in tax-exempt securities or certain other investment assets.

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A U.S. stockholder is a beneficial owner of shares of our common stock that is for U.S. Federal income tax purposes: a citizen or individual resident of the United States;

a corporation, or other entity treated as a corporation for U.S. Federal income tax purposes, created or organized in or under the laws of the United States or any state thereof or the District of Columbia;

an estate, the income of which is subject to U.S. Federal income taxation regardless of its source; or

a trust if (1) a U.S. court is able to exercise primary supervision over the administration of such trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or (2) it has a valid election in place to be treated as a U.S. person.

A Non-U.S. stockholder is a beneficial owner of shares of our common stock that is not a partnership and is not a U.S. stockholder.

If a partnership (including an entity treated as a partnership for U.S. Federal income tax purposes) holds shares of our common stock, the tax treatment of a partner in the partnership will generally depend upon the status of the partner and the activities of the partnership. A prospective stockholder that is a partner of a partnership holding shares of our common stock should consult its tax advisors with respect to the purchase, ownership and disposition of shares of our common stock.

Tax matters are very complicated and the tax consequences to an investor of an investment in our shares will depend on the facts of his, her or its particular situation. We encourage investors to consult their own tax advisors regarding the specific consequences of such an investment, including tax reporting requirements, the applicability of U.S. Federal, state, local and foreign tax laws, eligibility for the benefits of any applicable tax treaty and the effect of any possible changes in the tax laws.

*Election To Be Taxed As A RIC*

As a business development company, we have qualified and elected to be treated as a RIC under Subchapter M of the Code. As a RIC, we generally are not subject to corporate-level U.S. Federal income taxes on any ordinary income or capital gains that we distribute to our stockholders as dividends. To qualify as a RIC, we must, among other things, meet certain source-of-income and asset diversification requirements (as described below). In addition, to obtain RIC tax treatment, we must distribute to our stockholders, for each taxable year, at least 90% of our investment company taxable income, which is generally our ordinary income plus the excess of realized net short-term capital gains over realized net long-term capital losses, or the Annual Distribution Requirement.

*Taxation As A RIC*

Provided that we qualify as a RIC and satisfy the Annual Distribution Requirement, we will not be subject to U.S. Federal income tax on the portion of our investment company taxable income and net capital gain (which we define as net long-term capital gains in excess of net short-term capital losses) we timely distribute to stockholders. We will be subject to U.S. Federal income tax at the regular corporate rates on any income or capital gain not distributed (or deemed distributed) to our stockholders.

We will be subject to a 4% non-deductible U.S. Federal excise tax on certain undistributed income of RICs unless we distribute in a timely manner an amount at least equal to the sum of (1) 98% of our ordinary income for each calendar year, (2) 98% of our capital gain net income for the one-year period ending October 31 in that calendar year and (3) any income realized, but not distributed, in preceding years.

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In December 2008, our Board of Directors elected to retain excess profits generated in the quarter ended September 30, 2008 and pay a 4% excise tax on such retained earnings. We paid \$533,000 for the excise tax with the filing of our tax return in March 2009.

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

qualify to be treated as a business development company or be registered as a management investment company under the 1940 Act at all times during each taxable year;

derive in each taxable year at least 90% of our gross income from dividends, interest, payments with respect to certain securities loans, gains from the sale or other disposition of stock or other securities or currencies or other income derived with respect to our business of investing in such stock, securities or currencies and net income derived from an interest in a qualified publicly traded partnership (as defined in the Code) or the 90% Income Test; and

diversify our holdings so that at the end of each quarter of the taxable year:

at least 50% of the value of our assets consists of cash, cash equivalents, U.S. Government securities, securities of other RICs, and other securities if such other securities of any one issuer do not represent more than 5% of the value of our assets or more than 10% of the outstanding voting securities of the issuer (which for these purposes includes the equity securities of a qualified publicly traded partnership); and

no more than 25% of the value of our assets is invested in the securities, other than U.S.

Government securities or securities of other RICs, (i) of one issuer (ii) of two or more issuers that are controlled, as determined under applicable tax rules, by us and that are engaged in the same or similar or related trades or businesses or (iii) of one or more qualified publicly traded partnerships, or the Diversification Tests.

To the extent that we invest in entities treated as partnerships for U.S. Federal income tax purposes (other than a qualified publicly traded partnership), we generally must include the items of gross income derived by the partnerships for purposes of the 90% Income Test, and the income that is derived from a partnership (other than a qualified publicly traded partnership) will be treated as qualifying income for purposes of the 90% Income Test only to the extent that such income is attributable to items of income of the partnership which would be qualifying income if realized by us directly. In addition, we generally must take into account our proportionate share of the assets held by partnerships (other than a qualified publicly traded partnership) in which we are a partner for purposes of the diversification tests.

In order to meet the 90% Income Test, we may establish one or more special purpose corporations to hold assets from which we do not anticipate earning dividend, interest or other qualifying income under the 90% Income Test. Any such special purpose corporation would generally be subject to U.S. Federal income tax, and could result in a reduced after-tax yield on the portion of our assets held there.

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

Gain or loss realized by us from warrants acquired by us as well as any loss attributable to the lapse of such warrants generally will be treated as capital gain or loss. Such gain or loss generally will be long-term or short-term, depending on how long we held a particular warrant.



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Although we do not presently expect to do so, we are authorized to borrow funds and to sell assets in order to satisfy distribution requirements. However, under the 1940 Act, we are not permitted to make distributions to our stockholders while our debt obligations and other senior securities are outstanding unless certain asset coverage tests are met. See Regulation Senior Securities. Moreover, our ability to dispose of assets to meet our distribution requirements may be limited by (1) the illiquid nature of our portfolio and/or (2) other requirements relating to our status as a RIC, including the diversification tests. If we dispose of assets in order to meet the Annual Distribution Requirement or to avoid the excise tax, we may make such dispositions at times that, from an investment standpoint, are not advantageous.

If we fail to satisfy the Annual Distribution Requirement or otherwise fail to qualify as a RIC in any taxable year, we will be subject to tax in that year on all of our taxable income, regardless of whether we make any distributions to our stockholders. In that case, all of such income will be subject to corporate-level U.S. Federal income tax, reducing the amount available to be distributed to our stockholders. See Failure To Obtain RIC Tax Treatment.

As a regulated investment company, we are not allowed to carry forward or carry back a net operating loss for purposes of computing our investment company taxable income in other taxable years. Certain of our investment practices may be subject to special and complex U.S. Federal income tax provisions that may, among other things, (i) disallow, suspend or otherwise limit the allowance of certain losses or deductions, (ii) convert lower taxed long-term capital gain and qualified dividend income into higher taxed short-term capital gain or ordinary income, (iii) convert an ordinary loss or a deduction into a capital loss (the deductibility of which is more limited), (iv) cause us to recognize income or gain without a corresponding receipt of cash, (v) adversely affect the time as to when a purchase or sale of stock or securities is deemed to occur, (vi) adversely alter the characterization of certain complex financial transactions, and (vii) produce income that will not be qualifying income for purposes of the 90% Income Test. We will monitor our transactions and may make certain tax elections in order to mitigate the effect of these provisions.

As described above, to the extent that we invest in equity securities of entities that are treated as partnerships for U.S. Federal income tax purposes, the effect of such investments for purposes of the 90% Income Test and the diversification tests will depend on whether or not the partnership is a qualified publicly traded partnership (as defined in the Code). If the partnership is a qualified publicly traded partnership, the net income derived from such investments will be qualifying income for purposes of the 90% Income Test and will be securities for purposes of the diversification tests. However, if the partnership is not treated as a qualified publicly traded partnership, then the consequences of an investment in the partnership will depend upon the amount and type of income and assets of the partnership allocable to us. The income derived from such investments may not be qualifying income for purposes of the 90% Income Test and, therefore, could adversely affect our qualification as a RIC. We intend to monitor our investments in equity securities of entities that are treated as partnerships for U.S. Federal income tax purposes to prevent our disqualification as a RIC.

We may invest in preferred securities or other securities the U.S. Federal income tax treatment of which may not be clear or may be subject to recharacterization by the IRS. To the extent the tax treatment of such securities or the income from such securities differs from the expected tax treatment, it could affect the timing or character of income recognized, requiring us to purchase or sell securities, or otherwise change our portfolio, in order to comply with the tax rules applicable to RICs under the Code.

### **Taxation Of U.S. Stockholders**

Distributions by us generally are taxable to U.S. stockholders as ordinary income or capital gains. Distributions of our investment company taxable income (which is, generally, our ordinary income plus realized net short-term capital gains in excess of realized net long-term capital losses) will be taxable as ordinary income to U.S. stockholders to the extent of our current or accumulated earnings and profits, whether paid in cash or reinvested in additional common stock. For taxable years beginning on or before December 31, 2010, to the extent such distributions paid by us to noncorporate stockholders (including individuals) are attributable to dividends from U.S. corporations and certain qualified foreign corporations, such distributions generally will be eligible for taxation at rates applicable to long term capital gains (currently a maximum tax rate of 15%) *provided* that we properly designate such distribution as derived from qualified dividend income and certain holding period and other requirements are satisfied. In this regard, it is not

anticipated that a significant portion of distributions paid by us will be attributable to qualified dividends and, therefore, generally will not qualify for the long term capital gains. Distributions of our net capital gains (which is generally our realized net long-term capital gains in excess of realized net short-term capital losses) properly designated by us as capital gain dividends will be taxable to a U.S. stockholder as long-term capital gains (currently at a maximum rate of 15% in the case of individuals, trusts or estates), regardless of the U.S. stockholder's holding period for his, her or its common stock and regardless of whether paid in cash or reinvested in additional common stock. Distributions in excess of our current and accumulated earnings and profits first will reduce a U.S. stockholder's adjusted tax basis in such stockholder's common stock and, after the adjusted basis is reduced to zero, will constitute capital gains to such U.S. stockholder.



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Although we currently intend to distribute any long-term capital gains at least annually, we may in the future decide to retain some or all of our long-term capital gains, but designate the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount, each U.S. stockholder will be required to include his, her or its proportionate share of the deemed distribution in income as if it had been actually distributed to the U.S. stockholder, and the U.S. stockholder will be entitled to claim a credit equal to his, her or its allocable share of the tax paid thereon by us. The amount of the deemed distribution net of such tax will be added to the U.S. stockholder's tax basis for his, her or its common stock. Since we expect to pay tax on any retained capital gains at our regular corporate tax rate, and since that rate is in excess of the maximum rate currently payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid and for which they will receive a credit will exceed the tax they owe on the retained net capital gain. Such excess generally may be claimed as a credit against the U.S. stockholder's other U.S. Federal income tax obligations or may be refunded to the extent it exceeds a stockholder's liability for U.S. Federal income tax. A stockholder that is not subject to U.S. Federal income tax or otherwise required to file a U.S. Federal income tax return would be required to file a U.S. Federal income tax return on the appropriate form in order to claim a refund for the taxes we paid. In order to utilize the deemed distribution approach, we must provide written notice to our stockholders prior to the expiration of 60 days after the close of the relevant taxable year. We cannot treat any of our investment company taxable income as a deemed distribution.

For purposes of determining (1) whether the Annual Distribution Requirement is satisfied for any year and (2) the amount of capital gain dividends paid for that year, we may, under certain circumstances, elect to treat a dividend that is paid during the following taxable year as if it had been paid during the taxable year in question. If we make such an election, the U.S. stockholder will still be treated as receiving the dividend in the taxable year in which the distribution is made. However, any dividend declared by us in October, November or December of any calendar year, payable to stockholders of record on a specified date in any such month and actually paid during January of the following year, will be treated as if it had been received by our U.S. stockholders on December 31 of the year in which the dividend was declared.

If an investor purchases shares of our common stock shortly before the record date of a distribution, the price of the shares will include the value of the distribution and the investor will be subject to tax on the distribution even though it represents a return of his, her or its investment.

A U.S. stockholder generally will recognize taxable gain or loss if the stockholder sells or otherwise disposes of his, her or its shares of our common stock. Any gain arising from such sale or disposition generally will be treated as long-term capital gain or loss if the stockholder has held his, her or its shares for more than one year. Otherwise, it would be classified as short-term capital gain or loss. However, any capital loss arising from the sale or disposition of shares of our common stock held for six months or less will be treated as long-term capital loss to the extent of the amount of capital gain dividends received, or undistributed capital gain deemed received, with respect to such shares. In addition, all or a portion of any loss recognized upon a disposition of shares of our common stock may be disallowed if other substantially identical shares are purchased (whether through reinvestment of distributions or otherwise) within 30 days before or after the disposition. The ability to otherwise deduct capital losses may be subject to other limitations under the code.

In general, individual U.S. stockholders currently are subject to a maximum U.S. Federal income tax rate of 15% on their net capital gain, or the excess of realized net long-term capital gain over realized net short-term capital loss for a taxable year, including a long-term capital gain derived from an investment in our shares. Such rate is lower than the maximum rate on ordinary income currently payable by individuals. Corporate U.S. stockholders currently are subject to U.S. Federal income tax on net capital gain at the maximum 35% rate also applied to ordinary income. Noncorporate stockholders with net capital losses for a year (which we define as capital losses in excess of capital gains) generally may deduct up to \$3,000 of such losses against their ordinary income each year; any net capital losses of a noncorporate stockholder in excess of \$3,000 generally may be carried forward and used in subsequent years as provided in the Code. Corporate stockholders generally may not deduct any net capital losses for a year, but may carry back such losses for three years or carry forward such losses for five years.



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We will send to each of our U.S. stockholders, as promptly as possible after the end of each calendar year, a notice detailing, on a per share and per distribution basis, the amounts includible in such U.S. stockholder's taxable income for such year as ordinary income and as long-term capital gain. In addition, the U.S. Federal tax status of each year's distributions generally will be reported to the IRS (including the amount of dividends, if any, eligible for the 15% maximum rate). Distributions may also be subject to additional state, local and foreign taxes depending on a U.S. stockholder's particular situation. Dividends distributed by us generally will not be eligible for the dividends-received deduction or the preferential rate applicable to qualifying dividends.

We may be required to withhold U.S. Federal income tax, or backup withholding, currently at a rate of 28% (until January 1, 2011 when a higher rate of 31% will apply absent Congressional action) from all taxable distributions to any noncorporate U.S. stockholder (1) who fails to furnish us with a correct taxpayer identification number or a certificate that such stockholder is exempt from backup withholding, or (2) with respect to whom the IRS notifies us that such stockholder has failed to properly report certain interest and dividend income to the IRS and to respond to notices to that effect. An individual's taxpayer identification number is his or her social security number. Backup withholding is not an additional tax, and any amount withheld may be refunded or credited against the U.S. stockholder's U.S. Federal income tax liability, *provided* that proper information is timely provided to the IRS.

**Taxation Of Non-U.S. Stockholders**

Whether an investment in the shares is appropriate for a Non-U.S. stockholder will depend upon that person's particular circumstances. An investment in the shares by a Non-U.S. stockholder may have adverse tax consequences. Non-U.S. stockholders should consult their tax advisers before investing in our common stock.

Distributions of our investment company taxable income to Non-U.S. stockholders that are not effectively connected with a U.S. trade or business carried on by the Non-U.S. stockholder, will generally be subject to withholding of U.S. Federal income tax at a rate of 30% (or lower rate provided by an applicable treaty) to the extent of our current and accumulated earnings and profits. However, effective for taxable years beginning before January 1, 2010, we generally will not be required to withhold any amounts with respect to distributions of (i) U.S.-source interest income that would not have been subject to withholding of U.S. Federal income tax if they had been earned directly by a Non-U.S. stockholder, and (ii) net short-term capital gains in excess of net long-term capital losses that would not have been subject to withholding of U.S. Federal income tax if they had been earned directly by a Non-U.S. stockholder, in each case only to the extent that such distributions are properly designated by us as interest-related dividends or short-term capital gain dividends, as the case may be, and certain other requirements are met.

Actual or deemed distributions of our net capital gains to a Non-U.S. stockholder, and gains realized by a Non-U.S. stockholder upon the sale of our common stock, that are not effectively connected with a U.S. trade or business carried on by the Non-U.S. stockholder, will generally not be subject to U.S. Federal withholding tax and generally will not be subject to U.S. Federal income tax unless the Non-U.S. stockholder is a nonresident alien individual and is physically present in the United States for more than 182 days during the taxable year and meets certain other requirements. However, withholding of U.S. Federal income tax at a rate of 30% on capital gains of nonresident alien individuals who are physically present in the United States for more than the 182 day period only applies in exceptional cases because any individual present in the United States for more than 182 days during the taxable year is generally treated as a resident for U.S. income tax purposes; in that case, he or she would be subject to U.S. income tax on his or her worldwide income at the graduated rates applicable to U.S. citizens, rather than the 30% U.S. Federal withholding tax.

If we distribute our net capital gains in the form of deemed rather than actual distributions (which we may do in the future), a Non-U.S. stockholder will be entitled to a U.S. Federal income tax credit or tax refund equal to the stockholder's allocable share of the tax we pay on the capital gains deemed to have been distributed. In order to obtain the refund, the Non-U.S. stockholder must obtain a U.S. taxpayer identification number and file a U.S. Federal income tax return even if the Non-U.S. stockholder would not otherwise be required to obtain a U.S. taxpayer identification number or file a U.S. Federal income tax return. Accordingly, investment in the shares may not be appropriate for a Non-U.S. stockholder.



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Distributions of our investment company taxable income and net capital gains (including deemed distributions) to Non-U.S. stockholders, and gains realized by Non-U.S. stockholders upon the sale of our common stock that is effectively connected with a U.S. trade or business carried on by the Non-U.S. stockholder (or if an income tax treaty applies, attributable to a permanent establishment in the United States), will be subject to U.S. Federal income tax at the graduated rates applicable to U.S. citizens, residents and domestic corporations. Corporate Non-U.S. stockholders may also be subject to an additional branch profits tax at a rate of 30% imposed by the Code (or lower rate provided by an applicable treaty). In the case of a non-corporate Non-U.S. stockholder, we may be required to withhold U.S. Federal income tax from distributions that are otherwise exempt from withholding tax (or taxable at a reduced rate) unless the Non-U.S. stockholder certifies his or her foreign status under penalties of perjury or otherwise establishes an exemption.

The tax consequences to a Non-U.S. stockholder entitled to claim the benefits of an applicable tax treaty may differ from those described herein. Non-U.S. stockholders are advised to consult their own tax advisers with respect to the particular tax consequences to them of an investment in our shares.

A Non-U.S. stockholder who is a nonresident alien individual may be subject to information reporting and backup withholding of U.S. Federal income tax on dividends unless the Non-U.S. stockholder provides us or the dividend paying agent with an IRS Form W-8BEN (or an acceptable substitute form) or otherwise meets documentary evidence requirements for establishing that it is a Non-U.S. stockholder or otherwise establishes an exemption from backup withholding. Non-U.S. persons should consult their own tax advisers with respect to the U.S. Federal income tax and withholding tax, and state, local and foreign tax consequences of an investment in the shares.

*Failure To Obtain RIC Tax Treatment*

If we were unable to obtain tax treatment as a RIC, we would be subject to tax on all of our taxable income at regular corporate rates. We would not be able to deduct distributions to stockholders, nor would they be required to be made. Distributions would generally be taxable to our stockholders as ordinary dividend income (currently eligible for the 15% maximum rate) to the extent of our current and accumulated earnings and profits. Subject to certain limitations under the Code, corporate distributees would be eligible for the dividends-received deduction.

Distributions in excess of our current and accumulated earnings and profits would be treated first as a return of capital to the extent of the stockholder's tax basis, and any remaining distributions would be treated as a capital gain.

The discussion set forth herein does not constitute tax advice, and potential investors should consult their own tax advisers concerning the tax considerations relevant to their particular situation.

**Regulation as a Business Development Company**

*General*

We are a closed-end, non-diversified investment company that has filed an election to be treated as a business development company under the 1940 Act and has elected to be treated as a RIC under Subchapter M of the Code. The 1940 Act contains prohibitions and restrictions relating to transactions between business development companies and their affiliates (including any investment advisers or sub-advisers), principal underwriters and affiliates of those affiliates or underwriters and requires that a majority of the directors be persons other than interested persons, as that term is defined in the 1940 Act. In addition, the 1940 Act provides that we may not change the nature of our business so as to cease to be, or to withdraw our election as, a business development company unless approved by a majority of our outstanding voting securities.

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We may invest up to 100% of our assets in securities acquired directly from issuers in privately negotiated transactions. With respect to such securities, we may, for the purpose of public resale, be deemed an underwriter as that term is defined in the Securities Act. Our intention is to not write (sell) or buy put or call options to manage risks associated with the publicly traded securities of our portfolio companies, except that we may enter into hedging transactions to manage the risks associated with interest rate and other market fluctuations. However, in connection with an investment or acquisition financing of a portfolio company, we may purchase or otherwise receive warrants to purchase the common stock of the portfolio company. Similarly, in connection with an acquisition, we may acquire rights to require the issuers of acquired securities or their affiliates to repurchase them under certain circumstances. We also do not intend to acquire securities issued by any investment company that exceed the limits imposed by the 1940 Act. Under these limits, except with respect to money market funds, we generally cannot acquire more than 3% of the voting stock of any registered investment company, invest more than 5% of the value of our total assets in the securities of one investment company or invest more than 10% of the value of our total assets in the securities of more than one investment company. With regard to that portion of our portfolio invested in securities issued by investment companies, it should be noted that such investments subject our stockholders indirectly to additional expenses. None of these policies are fundamental and may be changed without stockholder approval.

*Qualifying Assets*

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

- (1) Securities purchased in transactions not involving any public offering from the issuer of such securities, which issuer (subject to certain limited exceptions) is an eligible portfolio company, or from any person who is, or has been during the preceding 13 months, an affiliated person of an eligible portfolio company, or from any other person, subject to such rules as may be prescribed by the SEC. An eligible portfolio company is defined in the 1940 Act and rules adopted pursuant thereto as any issuer which:
  - (a) is organized under the laws of, and has its principal place of business in, the United States;
  - (b) is not an investment company (other than a small business investment company wholly owned by the business development company) or a company that would be an investment company but for certain exclusions under the 1940 Act for certain financial companies such as banks, brokers, commercial finance companies, mortgage companies and insurance companies; and
  - (c) satisfies any of the following:
    1. does not have any class of securities with respect to which a broker or dealer may extend margin credit;
    2. is controlled by a business development company or a group of companies including a business development company and the business development company has an affiliated person who is a director of the eligible portfolio company; or
    3. is a small and solvent company having total assets of not more than \$4 million and capital and surplus of not less than \$2 million;
    4. does not have any class of securities listed on a national securities exchange; or
    5. has a class of securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity of less than \$250 million.
- (2) Securities in companies that were eligible portfolio companies when we made our initial investment if certain other requirements are satisfied.

- (3) Securities of any eligible portfolio company which we control.
- (4) Securities purchased in a private transaction from a U.S. issuer that is not an investment company or from an affiliated person of the issuer, or in transactions incident thereto, if the issuer is in bankruptcy and subject to reorganization or if the issuer, immediately prior to the purchase of its securities was unable to meet its obligations as they came due without material assistance other than conventional lending or financing agreements.

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- (5) Securities of an eligible portfolio company purchased from any person in a private transaction if there is no ready market for such securities and we already own 60% of the outstanding equity of the eligible portfolio company.
- (6) Securities received in exchange for or distributed on or with respect to securities described in (1) through (4) above, or pursuant to the exercise of warrants or rights relating to such securities.
- (7) Cash, cash equivalents, U.S. government securities or high-quality debt securities maturing in one year or less from the time of investment.

In addition, a business development company must have been organized and have its principal place of business in the United States and must be operated for the purpose of making investments in the types of securities described in (1), (2), (3) or (4) above.

*Managerial Assistance to Portfolio Companies*

In order to count portfolio securities as qualifying assets for the purpose of the 70% test, the business development company must either control the issuer of the securities or must offer to make available to the issuer of the securities (other than small and solvent companies described above) significant managerial assistance; except that, where the business development company purchases such securities in conjunction with one or more other persons acting together, one of the other persons in the group may make available such managerial assistance. Making available significant managerial assistance means, among other things, any arrangement whereby the business development company, through its directors, officers or employees, offers to provide, and, if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of a portfolio company.

*Temporary Investments*

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

*Senior Securities*

We are permitted, under specified conditions, to issue multiple classes of indebtedness and one class of stock senior to our common stock if our asset coverage, as defined in the 1940 Act, is at least equal to 200% immediately after each such issuance. In addition, while any preferred stock or public debt securities remain outstanding, we must make provisions to prohibit any distribution to our stockholders or the repurchase of such securities or shares unless we meet the applicable asset coverage ratios after giving effect to such distribution or repurchase. We may also borrow amounts up to 5% of the value of our total assets for temporary or emergency purposes without regard to asset coverage. For a discussion of the risks associated with leverage, see Risk Factors.



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*Code of Ethics*

We, Prospect Capital Management and Prospect Administration, have each adopted a code of ethics pursuant to Rule 17j-1 under the 1940 Act that establishes procedures for personal investments and restricts certain personal securities transactions. Personnel subject to each code may invest in securities for their personal investment accounts, including securities that may be purchased or held by us, so long as such investments are made in accordance with the code's requirements. For information on how to obtain a copy of each code of ethics, see Available Information.

*Investment Concentration*

Our investment objective is to generate both current income and long-term capital appreciation through debt and equity investments. While we are diversifying the portfolio, many of our existing investments are in the energy and energy related industries.

*Compliance Policies and Procedures*

We and our Investment Adviser have adopted and implemented written policies and procedures reasonably designed to prevent violation of the U.S. Federal securities laws, and are required to review these compliance policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a Chief Compliance Officer to be responsible for administering the policies and procedures. Brian H. Oswald serves as our Chief Compliance Officer.

*Proxy Voting Policies and Procedures*

We have delegated our proxy voting responsibility to Prospect Capital Management. The Proxy Voting Policies and Procedures of Prospect Capital Management are set forth below. The guidelines are reviewed periodically by Prospect Capital Management and our independent directors, and, accordingly, are subject to change.

*Introduction.* As an investment adviser registered under the Advisers Act, Prospect Capital Management has a fiduciary duty to act solely in the best interests of its clients. As part of this duty, Prospect Capital Management recognizes that it must vote client securities in a timely manner free of conflicts of interest and in the best interests of its clients.

These policies and procedures for voting proxies for Prospect Capital Management's Investment Advisory clients are intended to comply with Section 206 of, and Rule 206(4)-6 under, the Advisers Act.

*Proxy policies.* These policies are designed to be responsive to the wide range of subjects that may be the subject of a proxy vote. These policies are not exhaustive due to the variety of proxy voting issues that Prospect Capital Management may be required to consider. In general, Prospect Capital Management will vote proxies in accordance with these guidelines unless: (1) Prospect Capital Management has determined to consider the matter on a case-by-case basis (as is stated in these guidelines), (2) the subject matter of the vote is not covered by these guidelines, (3) a material conflict of interest is present, or (4) Prospect Capital Management might find it necessary to vote contrary to its general guidelines to maximize stockholder value and vote in its clients' best interests. In such cases, a decision on how to vote will be made by the Proxy Voting Committee (as described below). In reviewing proxy issues, Prospect Capital Management will apply the following general policies:

*Elections of directors.* In general, Prospect Capital Management will vote in favor of the management-proposed slate of directors. If there is a proxy fight for seats on the Board of Directors or Prospect Capital Management determines that there are other compelling reasons for withholding votes for directors, the Proxy Voting Committee will determine the appropriate vote on the matter. Prospect Capital Management believes that directors have a duty to respond to stockholder actions that have received significant stockholder support. Prospect Capital Management may withhold votes for directors that fail to act on key issues such as failure to implement proposals to declassify boards, failure to implement a majority vote requirement, failure to submit a rights plan to a stockholder vote and failure to act on tender offers where a majority of stockholders have tendered their shares. Finally, Prospect Capital Management may withhold votes for directors of non-U.S. issuers where there is insufficient information about the nominees disclosed in the proxy statement.

*Appointment of auditors.* Prospect Capital Management believes that the Company remains in the best position to choose the auditors and will generally support management's recommendation.



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*Changes in capital structure.* Changes in a company's charter, articles of incorporation or by-laws may be required by state or U.S. Federal regulation. In general, Prospect Capital Management will cast its votes in accordance with the Company's management on such proposal. However, the Proxy Voting Committee will review and analyze on a case-by-case basis any proposals regarding changes in corporate structure that are not required by state or U.S. Federal regulation.

*Corporate restructurings, mergers and acquisitions.* Prospect Capital Management believes proxy votes dealing with corporate reorganizations are an extension of the investment decision. Accordingly, the Proxy Voting Committee will analyze such proposals on a case-by-case basis.

*Proposals affecting the rights of stockholders.* Prospect Capital Management will generally vote in favor of proposals that give stockholders a greater voice in the affairs of the Company and oppose any measure that seeks to limit those rights. However, when analyzing such proposals, Prospect Capital Management will weigh the financial impact of the proposal against the impairment of the rights of stockholders.

*Corporate governance.* Prospect Capital Management recognizes the importance of good corporate governance in ensuring that management and the Board of Directors fulfill their obligations to the stockholders. Prospect Capital Management favors proposals promoting transparency and accountability within a company.

*Anti-takeover measures.* The Proxy Voting Committee will evaluate, on a case-by-case basis, proposals regarding anti-takeover measures to determine the measure's likely effect on stockholder value dilution.

*Stock splits.* Prospect Capital Management will generally vote with the management of the Company on stock split matters.

*Limited liability of directors.* Prospect Capital Management will generally vote with management on matters that would affect the limited liability of directors.

*Social and corporate responsibility.* The Proxy Voting Committee may review and analyze on a case-by-case basis proposals relating to social, political and environmental issues to determine whether they will have a financial impact on stockholder value. Prospect Capital Management may abstain from voting on social proposals that do not have a readily determinable financial impact on stockholder value.

*Proxy voting procedures.* Prospect Capital Management will generally vote proxies in accordance with these guidelines. In circumstances in which (1) Prospect Capital Management has determined to consider the matter on a case-by-case basis (as is stated in these guidelines), (2) the subject matter of the vote is not covered by these guidelines, (3) a material conflict of interest is present, or (4) Prospect Capital Management might find it necessary to vote contrary to its general guidelines to maximize stockholder value and vote in its clients' best interests, the Proxy Voting Committee will vote the proxy.

*Proxy voting committee.* Prospect Capital Management has formed a proxy voting committee to establish general proxy policies and consider specific proxy voting matters as necessary. In addition, members of the committee may contact the management of the Company and interested stockholder groups as necessary to discuss proxy issues. Members of the committee will include relevant senior personnel. The committee may also evaluate proxies where we face a potential conflict of interest (as discussed below). Finally, the committee monitors adherence to guidelines, and reviews the policies contained in this statement from time to time.

*Conflicts of interest.* Prospect Capital Management recognizes that there may be a potential conflict of interest when it votes a proxy solicited by an issuer that is its advisory client or a client or customer of one of our affiliates or with whom it has another business or personal relationship that may affect how it votes on the issuer's proxy. Prospect Capital Management believes that adherence to these policies and procedures ensures that proxies are voted with only its clients' best interests in mind. To ensure that its votes are not the product of a conflict of interests, Prospect Capital Management requires that: (i) anyone involved in the decision making process (including members of the Proxy Voting Committee) disclose to the chairman of the Proxy Voting Committee any potential conflict that he or she is aware of and any contact that he or she has had with any interested party regarding a proxy vote; and (ii) employees involved in the decision making process or vote administration are prohibited from revealing how Prospect Capital Management intends to vote on a proposal in order to reduce any attempted influence from interested parties.



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*Proxy voting.* Each account's custodian will forward all relevant proxy materials to Prospect Capital Management, either electronically or in physical form to the address of record that Prospect Capital Management has provided to the custodian.

*Proxy recordkeeping.* Prospect Capital Management must retain the following documents pertaining to proxy voting:

- copies of its proxy voting policies and procedures;
- copies of all proxy statements;
- records of all votes cast by Prospect Capital Management;
- copies of all documents created by Prospect Capital Management that were material to making a decision how to vote proxies or that memorializes the basis for that decision; and
- copies of all written client requests for information with regard to how Prospect Capital Management voted proxies on behalf of the client as well as any written responses provided.

All of the above-referenced records will be maintained and preserved for a period of not less than five years from the end of the fiscal year during which the last entry was made. The first two years of records must be maintained at our office.

*Proxy voting records.* Clients may obtain information about how Prospect Capital Management voted proxies on their behalf by making a written request for proxy voting information to: Compliance Officer, Prospect Capital Management LLC, 10 East 40th Street, 44th Floor, New York, NY 10016.

*Sarbanes-Oxley Act of 2002*

The Sarbanes-Oxley Act of 2002 imposes a variety of regulatory requirements on publicly-held companies. In addition to our Chief Executive and Chief Financial Officers' required certifications as to the accuracy of our financial reporting, we are also required to disclose the effectiveness of our disclosure controls and procedures as well as report on our assessment of our internal controls over financial reporting, the latter of which must be audited by our independent registered public accounting firm.

The Sarbanes-Oxley Act also requires us to continually review our policies and procedures to ensure that we remain in compliance with all rules promulgated under the Act.

*Available Information*

We file with or submit to the SEC annual, quarterly and current periodic reports, proxy statements and other information meeting the informational requirements of the Securities Exchange Act of 1934, or the Exchange Act. This information is available free of charge by contacting us at 10 East 40th Street, 44th floor, New York, NY 10016 or by telephone at (212) 448-0702. You may inspect and copy these reports, proxy statements and other information, as well as the registration statement and related exhibits and schedules, at the Public Reference Room of the SEC at 100 F Street NE, Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at (202) 551-8090. The SEC maintains an Internet site that contains reports, proxy and information statements and other information filed electronically by us with the SEC which are available on the SEC's Internet site at <http://www.sec.gov>. Copies of these reports, proxy and information statements and other information may be obtained, after paying a duplicating fee, by electronic request at the following E-mail address: [publicinfo@sec.gov](mailto:publicinfo@sec.gov), or by writing the SEC's Public Reference Section, Washington, D.C. 20549-0102.

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**Item 1A. Risk Factors.**

Investing in our Securities involves a high degree of risk. You should carefully consider the risks described below, together with all of the other information included in this report, before you decide whether to make an investment in our Securities. The risks set forth below are not the only risks we face. If any of the adverse events or conditions described below occurs, our business, financial condition and results of operations could be materially adversely affected. In such case, our NAV, and the trading price of our common stock could decline, or the value of our preferred stock, debt securities, and warrants, if any are outstanding, may decline, and you may lose all or part of your investment.

**Forward Looking Information**

Our annual report on Form 10-K for the year ended June 30, 2009, any of our quarterly reports on Form 10-Q or current reports on Form 8-K, or any other oral or written statements made in press releases or otherwise by or on behalf of Prospect Capital Corporation may contain forward looking statements within the meaning of the Section 21E of the Securities and Exchange Act of 1934, as amended, which involve certain risks and uncertainties. Forward looking statements predict or describe our future operations, business plans, business and investment strategies and portfolio management and the performance of our investments and our investment management business. These forward looking statements are identified by their use of such terms and phrases as intends, intend, intended, go, estimate, estimates, expects, expect, expected, project, projected, projections, plans, seeks, a should, could, may, will, designed to, foreseeable future, believe, believes and scheduled and similar. actual results or outcomes may differ materially from those anticipated. Readers are cautioned not to place undue reliance on these forward looking statements, which speak only as of the date the statement was made. We undertake no obligation to publicly update or revise any forward looking statements, whether as a result of new information, future events or otherwise.

Our actual results may differ significantly from any results expressed or implied by these forward looking statements. Some, but not all, of the factors that might cause such a difference include, but are not limited to:

- our future operating results;
- our business prospects and the prospects of our portfolio companies;
- the impact of investments that we expect to make;
- our contractual arrangements and 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 ability of our portfolio companies to achieve their objectives;
- difficulty in obtaining financing or raising capital, especially in the current credit and equity environment;
- the level and volatility of prevailing interest rates and credit spreads, magnified by the current turmoil in the credit markets;
- adverse developments in the availability of desirable loan and investment opportunities whether they are due to competition, regulation or otherwise;
- a compression of the yield on our investments and the cost of our liabilities, as well as the level of leverage available to us;
  
- our regulatory structure and tax treatment, including our ability to operate as a business development company and a regulated investment company;
- the adequacy of our cash resources and working capital;
- the timing of cash flows, if any, from the operations of our portfolio companies;

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the ability of our investment adviser to locate suitable investments for us and to monitor and administer our investments.;

authoritative generally accepted accounting principles or policy changes from such standard-setting bodies as the Financial Accounting Standards Board, the Securities and Exchange Commission, Internal Revenue Service, the New York Stock Exchange, and other authorities that we are subject to, as well as their counterparts in any foreign jurisdictions where we might do business; and

the risk factors set forth below.

**Risks Relating To Our Business**

*Our financial condition and results of operations will depend on our ability to manage our future growth effectively.*

Prospect Capital Management has been registered as an investment adviser since March 31, 2004, and we have been organized as a closed-end investment company since April 13, 2004. Our ability to achieve our investment objective depends on our ability to grow, which depends, in turn, on our Investment Adviser's ability to continue to identify, analyze, invest in and monitor companies that meet our investment criteria. Accomplishing this result on a cost-effective basis is largely a function of our Investment Adviser's structuring of investments, its ability to provide competent, attentive and efficient services to us and our access to financing on acceptable terms. As we continue to grow, Prospect Capital Management will need to continue to hire, train, supervise and manage new employees. Failure to manage our future growth effectively could have a materially adverse effect on our business, financial condition and results of operations.

*We are dependent upon Prospect Capital Management's key management personnel for our future success.*

We depend on the due diligence, skill and network of business contacts of the senior management of our Investment Adviser. We also depend, to a significant extent, on our Investment Adviser's access to the investment professionals and the information and deal flow generated by these investment professionals in the course of their investment and portfolio management activities. The senior management team of the Investment Adviser evaluates, negotiates, structures, closes, monitors and services our investments. Our success depends to a significant extent on the continued service of the senior management team, particularly John F. Barry III and M. Grier Eliasek. The departure of any of the senior management team could have a materially adverse effect on our ability to achieve our investment objective. In addition, we can offer no assurance that Prospect Capital Management will remain our investment adviser or that we will continue to have access to its investment professionals or its information and deal flow.

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

A large number of entities compete with us to make the types of investments that we make in target companies. We compete with other business development companies, public and private funds, commercial and investment banks and commercial financing companies. Additionally, because competition for investment opportunities generally has increased among alternative investment vehicles, such as hedge funds, those entities have begun to invest in areas they have not traditionally invested in, including investments in middle-market companies. As a result of these new entrants, competition for investment opportunities at middle-market companies has intensified, a trend we expect to continue.

Many of our existing and potential competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources that are not available to us. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more or fuller relationships with borrowers and sponsors than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a business development company. We cannot assure you that the competitive pressures we face will not have a materially adverse effect on our business, financial condition and results of operations. Also, as a result of existing and increasing competition and our competitors ability to provide a total package solution, we may not be able to take advantage of attractive investment opportunities from time to time, and we can offer no assurance that we will be able to identify and make investments that are consistent with our investment objective.





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We do not seek to compete primarily based on the interest rates that we offer, and we believe that some of our competitors make loans with interest rates that are comparable to or lower than the rates we offer. We may lose investment opportunities if we do not match our competitors' pricing, terms and structure. If we match our competitors' pricing, terms and structure, we may experience decreased net interest income and increased risk of credit loss.

*Most of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty as to the value of our portfolio investments.*

A large percentage of our portfolio investments consist of securities of privately held companies. Hence, market quotations are generally not readily available for determining the fair values of such investments. The determination of fair value, and thus the amount of unrealized losses we may incur in any year, is to a degree subjective, and the Investment Adviser has a conflict of interest in making the determination. We value these securities quarterly at fair value as determined in good faith by our Board of Directors based on input from our Investment Adviser, a third party independent valuation firm and our audit committee. Our Board of Directors utilizes the services of an independent valuation firm to aid it in determining the fair value of any securities. The types of factors that may be considered in determining the fair values of our investments include the nature and realizable value of any collateral, the portfolio company's ability to make payments and its earnings, the markets in which the portfolio company does business, comparison to publicly traded companies, discounted cash flow, current market interest rates and other relevant factors. Because such valuations, and particularly valuations of private securities and private companies, are inherently uncertain, the valuations may fluctuate significantly over short periods of time due to changes in current market conditions. The determinations of fair value by our Board of Directors may differ materially from the values that would have been used if an active market and market quotations existed for these investments. Our net asset value could be adversely affected if the determinations regarding the fair value of our investments were materially higher than the values that we ultimately realize upon the disposal of such securities.

*Senior securities, including debt, expose us to additional risks, including the typical risks associated with leverage.*

We currently use our revolving credit facility to leverage our portfolio and we expect in the future to borrow from and issue senior debt securities to banks and other lenders and may securitize certain of our portfolio investments.

With certain limited exceptions, as a BDC we are only allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, is at least 200% after such borrowing. The amount of leverage that we employ will depend on our Investment Adviser's and our Board of Directors' assessment of market conditions and other factors at the time of any proposed borrowing. There is no assurance that a leveraging strategy will be successful. Leverage involves risks and special considerations for stockholders, including:

- A likelihood of greater volatility in the net asset value and market price of our common stock;
- Diminished operating flexibility as a result of asset coverage or investment portfolio composition requirements required by lenders or investors that are more stringent than those imposed by the 1940 Act;

- The possibility that investments will have to be liquidated at less than full value or at inopportune times to comply with debt covenants or to pay interest or dividends on the leverage;
- Increased operating expenses due to the cost of leverage, including issuance and servicing costs;
- Convertible or exchangeable securities issued in the future may have rights, preferences and privileges more favorable than those of our common stock; and
- Subordination to lenders' superior claims on our assets as a result of which lenders will be able to receive proceeds available in the case of our liquidation before any proceeds are distributed to our stockholders.

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For example, the amount we may borrow under our revolving credit facility is determined, in part, by the fair value of our investments. If the fair value of our investments declines, we may be forced to sell investments at a loss to maintain compliance with our borrowing limits. Other debt facilities we may enter into in the future may contain similar provisions. Any such forced sales would reduce our net asset value and also make it difficult for the net asset value to recover.

Our Investment Adviser and our Board of Directors in their best judgment nevertheless may determine to use leverage if they expect that the benefits to our stockholders of maintaining the leveraged position will outweigh the risks.

*Changes in interest rates may affect our cost of capital and net investment income.*

A significant portion of the debt investments we make bears interest at fixed rates and the value of these investments could be negatively affected by increases in market interest rates. In addition, as the interest rate on our revolving credit facility is at a variable rate based on an index, an increase in interest rates would make it more expensive to use debt to finance our investments. As a result, a significant increase in market interest rates could both reduce the value of our portfolio investments and increase our cost of capital, which would reduce our net investment income.

*We need to raise additional capital to grow because we must distribute most of our income.*

We need additional capital to fund growth in our investments. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to our shareholders to maintain our RIC status. As a result, such earnings are not available to fund investment originations. We have sought additional capital by borrowing from financial institutions and may issue debt securities or additional equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, we could be limited in our ability to grow, which may have an adverse effect on the value of our common stock. In addition, as a business development company, we are generally required to maintain a ratio of total assets to total borrowings of at least 200%, which may restrict our ability to borrow in certain circumstances.

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

We generally make investments in private companies. Substantially all of these securities are subject to legal and other restrictions on resale or are otherwise less liquid than publicly traded securities. The illiquidity of our investments may make it difficult for us to sell such investments if the need arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded our investments. In addition, we may face other restrictions on our ability to liquidate an investment in a portfolio company to the extent that we or our Investment Adviser has material non-public information regarding such portfolio company.

*We may experience fluctuations in our quarterly results.*

We could experience fluctuations in our quarterly operating results due to a number of factors, including the interest or dividend rates payable on the debt or equity securities we hold, the default rate on debt securities, the level of our expenses, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets, the seasonality of the energy industry, weather patterns, changes in energy prices and general economic conditions. As a result of these factors, results for any period should not be relied upon as being indicative of performance in future periods.

*Our most recent net asset value was calculated on June 30, 2010 and our NAV when calculated effective August 30, 2010 may be higher or lower.*

Our most recently estimated NAV per share is \$10.22 on an as adjusted basis solely to give effect to our issuance of common shares on July 30, 2010 in connection with our dividend reinvestment plan, and our sale of 3,814,528 shares of common stock during the period from July 1, 2010 through August 24, 2010 pursuant to the March 17, 2010 and July 19, 2010 equity distribution agreements, versus \$10.29 determined by us as of June 30, 2010. NAV as of August 30, 2010 may be higher or lower than \$10.22 based on potential changes in valuations and earnings for the quarter then ended. Our Board of Directors has not yet determined the fair value of portfolio investments at any date subsequent to June 30, 2010. Our Board of Directors determines the fair value of our portfolio investments on a quarterly basis in connection with the preparation of quarterly financial statements and based on input from an independent valuation firm, our Investment Advisor and the audit committee of our Board of Directors.



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*Potential conflicts of interest could impact our investment returns.*

Our executive officers and directors, and the executive officers of our Investment Adviser, Prospect Capital Management, may serve as officers, directors or principals of entities that operate in the same or related lines of business as we do or of investment funds managed by our affiliates. Accordingly, they may have obligations to investors in those entities, the fulfillment of which might not be in our best interests or those of our stockholders. Nevertheless, it is possible that new investment opportunities that meet our investment objective may come to the attention of one of these entities in connection with another investment advisory client or program, and, if so, such opportunity might not be offered, or otherwise made available, to us. However, as an investment adviser, Prospect Capital Management has a fiduciary obligation to act in the best interests of its clients, including us. To that end, if Prospect Capital Management or its affiliates manage any additional investment vehicles or client accounts in the future, Prospect Capital Management will endeavor to allocate investment opportunities in a fair and equitable manner over time so as not to discriminate unfairly against any client. If Prospect Capital Management chooses to establish another investment fund in the future, when the investment professionals of Prospect Capital Management identify an investment, they will have to choose which investment fund should make the investment.

In the course of our investing activities, under the Investment Advisory Agreement we pay base management and incentive fees to Prospect Capital Management, and reimburse Prospect Capital Management for certain expenses it incurs. As a result of the Investment Advisory Agreement, there may be times when the senior management team of Prospect Capital Management has interests that differ from those of our stockholders, giving rise to a conflict.

Prospect Capital Management receives a quarterly income incentive fee based, in part, on our pre-incentive fee net investment income, if any, for the immediately preceding calendar quarter. This income incentive fee is subject to a fixed quarterly hurdle rate before providing an income incentive fee return to the Investment Adviser. This fixed hurdle rate was determined when then current interest rates were relatively low on a historical basis. Thus, if interest rates rise, it would become easier for our investment income to exceed the hurdle rate and, as a result, more likely that our Investment Adviser will receive an income incentive fee than if interest rates on our investments remained constant or decreased. Subject to the receipt of any requisite stockholder approval under the 1940 Act, our Board of Directors may adjust the hurdle rate by amending the Investment Advisory Agreement.

The income incentive fee payable by us is computed and paid on income that may include interest that has been accrued but not yet received in cash. If a portfolio company defaults on a loan that has a deferred interest feature, it is possible that interest accrued under such loan that has previously been included in the calculation of the income incentive fee will become uncollectible. If this happens, our Investment Adviser is not required to reimburse us for any such income incentive fee payments. If we do not have sufficient liquid assets to pay this incentive fee or distributions to stockholders on such accrued income, we may be required to liquidate assets in order to do so. This fee structure could give rise to a conflict of interest for our Investment Adviser to the extent that it may encourage the Investment Adviser to favor debt financings that provide for deferred interest, rather than current cash payments of interest.

We have entered into a royalty-free license agreement with Prospect Capital Management. Under this agreement, Prospect Capital Management agrees to grant us a non-exclusive license to use the name Prospect Capital. Under the license agreement, we have the right to use the Prospect Capital name for so long as Prospect Capital Management or one of its affiliates remains our Investment Adviser. In addition, we rent office space from Prospect Administration, an affiliate of Prospect Capital Management, and pay Prospect Administration our allocable portion of overhead and other expenses incurred by Prospect Administration in performing its obligations as Administrator under the Administration Agreement, including rent and our allocable portion of the costs of our chief financial officer and chief compliance officer and their respective staffs. This may create conflicts of interest that our Board of Directors monitors.

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*Our incentive fee could induce Prospect Capital Management to make speculative investments.*

The incentive fee payable by us to Prospect Capital Management may create an incentive for our Investment Adviser to make investments on our behalf that are more speculative or involve more risk than would be the case in the absence of such compensation arrangement. The way in which the incentive fee payable is determined (calculated as a percentage of the return on invested capital) may encourage the Investment Adviser to use leverage to increase the return on our investments. Increased use of leverage and this increased risk of replacement of that leverage at maturity would increase the likelihood of default, which would disfavor holders of our common stock. Similarly, because the Investment Adviser will receive an incentive fee based, in part, upon net capital gains realized on our investments, the Investment Adviser may invest more than would otherwise be appropriate in companies whose securities are likely to yield capital gains, as compared to income producing securities. Such a practice could result in our investing in more speculative securities than would otherwise be the case, which could result in higher investment losses, particularly during economic downturns.

The incentive fee payable by us to Prospect Capital Management could create an incentive for our Investment Adviser to invest on our behalf in instruments, such as zero coupon bonds, that have a deferred interest feature. Under these investments, we would accrue interest income over the life of the investment but would not receive payments in cash on the investment until the end of the term. Our net investment income used to calculate the income incentive fee, however, includes accrued interest. For example, accrued interest, if any, on our investments in zero coupon bonds will be included in the calculation of our incentive fee, even though we will not receive any cash interest payments in respect of payment on the bond until its maturity date. Thus, a portion of this incentive fee would be based on income that we may not have yet received in cash in the event of default may never receive.

*Changes in laws or regulations governing our operations may adversely affect our business.*

We and our portfolio companies are subject to regulation by laws at the local, state and U.S. Federal levels. These laws and regulations, as well as their interpretation, may be changed from time to time. Accordingly, changes in these laws or regulations could have a materially adverse effect on our business. For additional information regarding the regulations we are subject to, see [Business Regulation as a Business Development Company](#).

*Recent developments may increase the risks associated with our business and an investment in us.*

The U.S. financial markets have been experiencing a high level of volatility, disruption and distress, which was exacerbated by the failure of several major financial institutions in the last few months of 2008. In addition, the U.S. economy has been in a recession, the aftermath of which may be severe and prolonged. Similar conditions have occurred in the financial markets and economies of numerous other countries and could worsen, both in the U.S. and globally. These conditions have raised the level of many of the risks described in this document and could have an adverse effect on our portfolio companies as well as on our business, financial condition, results of operations, dividend payments, credit facility, access to capital, valuation of our assets, NAV and our stock price.

**Risks Relating To Our Operation As A Business Development Company**

*Our Investment Adviser and its senior management team have limited experience managing a business development company under the 1940 Act.*

The 1940 Act imposes numerous constraints on the operations of business development companies. For example, business development companies are required to invest at least 70% of their total assets in securities of certain privately held, thinly traded or distressed U.S. companies, cash, cash equivalents, U.S. government securities and other high quality debt investments that mature in one year or less. Our Investment Adviser's and its senior management team's limited experience in managing a portfolio of assets under such constraints may hinder their ability to take advantage of attractive investment opportunities and, as a result, achieve our investment objective. In addition, our investment strategies differ in some ways from those of other investment funds that have been managed in the past by investment professionals.

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

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

*If we fail to qualify as a RIC, we will have to pay corporate-level taxes on our income, and our income available for distribution would be reduced.*

To maintain our qualification for federal income tax purposes as a RIC under Subchapter M of the Code, and obtain RIC tax treatment, we must meet certain source of income, asset diversification and annual distribution requirements.

The source of income requirement is satisfied if we derive at least 90% of our annual gross income from interest, dividends, payments with respect to certain securities loans, gains from the sale or other disposition of securities or options thereon or foreign currencies, or other income derived with respect to our business of investing in such securities or currencies, and net income from interests in qualified publicly traded partnerships, as defined in the Code.

The annual distribution requirement for a RIC is satisfied if we distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to our stockholders on an annual basis. Because we use debt financing, we are subject to certain asset coverage ratio requirements under the 1940 Act and financial covenants that could, under certain circumstances, restrict us from making distributions necessary to qualify for RIC tax treatment. If we are unable to obtain cash from other sources, we may fail to qualify for RIC tax treatment and, thus, may be subject to corporate-level income tax.

To maintain our qualification as a RIC, we must also meet certain asset diversification requirements at the end of each calendar quarter. Failure to meet these tests may result in our having to dispose of certain investments quickly in order to prevent the loss of RIC status. Because most of our investments are in private companies, any such dispositions could be made at disadvantageous prices and may result in substantial losses.

If we fail to qualify as a RIC for any reason or become subject to corporate income tax, the resulting corporate taxes could substantially reduce our net assets, the amount of income available for distribution, and the actual amount of our distributions. Such a failure would have a materially adverse effect on us and our stockholders. For additional information regarding asset coverage ratio and RIC requirements, see *Business Tax Considerations* and *Business Regulation as a Business Development Company*.

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

We have incurred indebtedness under our revolving credit facility and, in the future, may issue preferred stock and/or borrow additional money from banks or other financial institutions, which we refer to collectively as senior securities, up to the maximum amount permitted by the 1940 Act. Under the provisions of the 1940 Act, we are permitted, as a BDC, to incur indebtedness or issue senior securities only in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after each issuance of senior securities. If the value of our assets declines, we may be unable to satisfy this test, which would prohibit us from paying dividends and could prohibit us from qualifying as a RIC. If we cannot satisfy this test, we may be required to sell a portion of our investments or sell additional shares of common stock at a time when such sales may be disadvantageous in order to repay a portion of our indebtedness. In addition, issuance of additional common stock could dilute the percentage ownership of our current stockholders in us.

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As a BDC regulated under provisions of the 1940 Act, we are not generally able to issue and sell our common stock at a price below the current net asset value per share. If our common stock trades at a discount to net asset value, this restriction could adversely affect our ability to raise capital. We may, however, sell our common stock, or warrants, options or rights to acquire our common stock, at a price below the current net asset value of our common stock in certain circumstances, including if (i)(1) the holders of a majority of our shares (or, if less, at least 67% of a quorum consisting of a majority of our shares) and a similar majority of the holders of our shares who are not affiliated persons of us approve the sale of our common stock at a price that is less than the current net asset value, and (2) a majority of our Directors who have no financial interest in the transaction and a majority of our independent Directors (a) determine that such sale is in our and our stockholders' best interests and (b) in consultation with any underwriter or underwriters of the offering, make a good faith determination as of a time either immediately prior to the first solicitation by us or on our behalf of firm commitments to purchase such shares, or immediately prior to the issuance of such shares, that the price at which such shares are to be sold is not less than a price which closely approximates the market value of such shares, less any distributing commission or discount or if (ii) a majority of the number of the beneficial holders of our common stock entitled to vote at our annual meeting, without regard to whether a majority of such shares are voted in favor of the proposal, approve the sale of our common stock at a price that is less than the current net asset value per share. At our 2008 annual meeting of stockholders held on February 12, 2009, and our 2009 annual meeting of stockholders held on December 11, 2009, we obtained the first method of approval from our shareholders. See *If we sell common stock at a discount to our net asset value per share, stockholders who do not participate in such sale will experience immediate dilution in an amount that may be material* discussed below.

To generate cash for funding new investments, we pledged a substantial portion of our portfolio investments under our revolving credit facility. These assets are not available to secure other sources of funding or for securitization. Our ability to obtain additional secured or unsecured financing on attractive terms in the future is uncertain.

Alternatively, we may securitize our future loans to generate cash for funding new investments. To securitize loans, we may create a wholly owned subsidiary and contribute a pool of loans to such subsidiary. This could include the sale of interests in the loans by the subsidiary on a non-recourse basis to purchasers who we would expect to be willing to accept a lower interest rate to invest in investment grade loan pools. We would retain a portion of the equity in the securitized pool of loans. An inability to successfully securitize our loan portfolio could limit our ability to grow our business and fully execute our business strategy, and could decrease our earnings, if any. Moreover, the successful securitization of our loan portfolio exposes us to a risk of loss for the equity we retain in the securitized pool of loans and might expose us to losses because the residual loans in which we do not sell interests may tend to be those that are riskier and more likely to generate losses. A successful securitization may also impose financial and operating covenants that restrict our business activities and may include limitations that could hinder our ability to finance additional loans and investments or to make the distributions required to maintain our status as a RIC under Subchapter M of the Code. The 1940 Act may also impose restrictions on the structure of any securitizations.

*Our common stock may trade at a discount to our net asset value per share.*

Common stock of BDCs, like that of closed-end investment companies, frequently trades at a discount to current net asset value, which could adversely affect the ability to raise capital. In the past, our common stock has traded at a discount to our net asset value. However, we have been able to periodically raise capital pursuant to authority granted by our stockholders at our 2008 and 2009 annual meetings to sell an unlimited number of shares of our common stock at any level of discount from net asset value during the 12 month period following such approval. The risk that our common stock may continue to trade at a discount to our net asset value is separate and distinct from the risk that our net asset value per share may decline.

*If we sell common stock at a discount to our net asset value per share, stockholders who do not participate in such sale will experience immediate dilution in an amount that may be material.*

At our annual meeting of stockholders held on December 11, 2009, our stockholders approved our ability to sell an unlimited number of shares of our common stock at any level of discount from net asset value per share during the 12 month period following the December 11, 2009 approval in accordance with the exception described above in Regulations governing our operation as a business development company affect our ability to raise, and the way in which we raise, additional capital. The issuance or sale by us of shares of our common stock at a discount to net asset

value poses a risk of dilution to our stockholders. In particular, stockholders who do not purchase additional shares at or below the discounted price in proportion to their current ownership will experience an immediate decrease in net asset value per share (as well as in the aggregate net asset value of their shares if they do not participate at all). These stockholders will also experience a disproportionately greater decrease in their participation in our earnings and assets and their voting power than the increase we experience in our assets, potential earning power and voting interests from such issuance or sale. They may also experience a reduction in the market price of our common stock. For additional information and hypothetical examples of these risks, see [Sales of Common Stock Below Net Asset Value](#) and the prospectus supplement pursuant to which such sale is made.



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

For U.S. Federal income tax purposes, we include in income certain amounts that we have not yet received in cash, such as original issue discount, which may arise if we receive warrants in connection with the making of a loan or possibly in other circumstances, or payment-in-kind interest, which represents contractual interest added to the loan balance and due at the end of the loan term. Such original issue discount, which could be significant relative to our overall investment activities, or increases in loan balances as a result of payment-in-kind arrangements, are included in our taxable income before we receive any corresponding cash payments. We also may be required to include in taxable income certain other amounts that we do not receive in cash. While we focus primarily on investments that will generate a current cash return, our investment portfolio currently includes, and we may continue to invest in, securities that do not pay some or all of their return in periodic current cash distributions.

The income incentive fee payable by us is computed and paid on income that may include interest that has been accrued but not yet received in cash. If a portfolio company defaults on a loan that is structured to provide accrued interest, it is possible that accrued interest previously used in the calculation of the income incentive fee will become uncollectible.

Since in some cases we may recognize taxable income before or without receiving cash representing such income, we may have difficulty meeting the tax requirement to distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to maintain RIC tax treatment. Accordingly, we may have to sell some of our investments at times we would not consider advantageous, raise additional debt or equity capital or reduce new investment originations to meet these distribution requirements. If we are not able to obtain cash from other sources, we may fail to qualify for RIC treatment and thus become subject to corporate-level income tax. See Regulation Senior Securities and Material U.S. Federal Income Tax Considerations .  
*Our ability to enter into transactions with our affiliates is restricted.*

We are prohibited under the 1940 Act from knowingly participating in certain transactions with our affiliates without the prior approval of our independent directors. Any person that owns, directly or indirectly, 5% or more of our outstanding voting securities is our affiliate for purposes of the 1940 Act and we are generally prohibited from buying or selling any security or other property from or to such affiliate, absent the prior approval of our independent directors. The 1940 Act also prohibits joint transactions with an affiliate, which could include investments in the same portfolio company (whether at the same or different times), without prior approval of our independent directors. We are prohibited from buying or selling any security or other property from or to our Investment Adviser and its affiliates and persons with whom we are in a control relationship, or entering into joint transactions with any such person, absent the prior approval of the SEC.

*The Company may be unable to realize the benefits anticipated by the merger with Patriot or may take longer than anticipated to achieve such benefits.*

On December 2, 2009, we completed our previously announced acquisition of Patriot under the Agreement and Plan of Merger, dated as of August 3, 2009, by and among, us and Patriot. The realization of certain benefits anticipated as a result of the merger will depend in part on the integration of Patriot's investment portfolio with the Company and the successful inclusion of Patriot's investment portfolio in the Company's financing operations. There can be no assurance that Patriot's business can be operated profitably or integrated successfully into the Company's operations in a timely fashion or at all. The dedication of management resources to such integration may detract attention from the day-to-day business of the Company and there can be no assurance that there will not be substantial costs associated with the transition process or that there will not be other material adverse effects as a result of these integration efforts. Such effects, including but not limited to, incurring unexpected costs or delays in connection with such integration and failure of Patriot's investment portfolio to perform as expected, could have a material adverse effect on the financial results of the Company.

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### **Risks Relating To Our Investments**

*We may not realize gains or income from our investments.*

We seek to generate both current income and capital appreciation. However, the securities we invest in may not appreciate and, in fact, may decline in value, and the issuers of debt securities we invest in may default on interest and/or principal payments. Accordingly, we may not be able to realize gains from our investments, and any gains that we do realize may not be sufficient to offset any losses we experience. See **Business** **Our Investment Objective and Policies** .

Our portfolio is concentrated in a limited number of portfolio companies in the energy industry, which subject us to a risk of significant loss if any of these companies defaults on its obligations under any of the securities that we hold or if the energy industry experiences a downturn.

As of June 30, 2010, we had invested in a number of companies in the energy and energy related industries. A consequence of this lack of diversification is that the aggregate returns we realize may be significantly and adversely affected if a small number of such investments perform poorly or if we need to write down the value of any one investment. Beyond our income tax diversification requirements, we do not have fixed guidelines for diversification, and our investments are concentrated in relatively few portfolio companies. In addition, to date we have concentrated on making investments in the energy industry. While we expect to be less focused on the energy and energy related industries in the future, we anticipate that we will continue to have significant holdings in the energy and energy related industries. As a result, a downturn in the energy industry could materially and adversely affect us.

*The energy industry is subject to many risks.*

We have a significant concentration in the energy industry. Our definition of energy, as used in the context of the energy industry, is broad, and different sectors in the energy industry may be subject to variable risks and economic pressures. As a result, it is difficult to anticipate the impact of changing economic and political conditions on our portfolio companies and, as a result, our financial results. The revenues, income (or losses) and valuations of energy companies can fluctuate suddenly and dramatically due to any one or more of the following factors:

**Commodity Pricing Risk.** Energy companies in general are directly affected by energy commodity prices, such as the market prices of crude oil, natural gas and wholesale electricity, especially for those that own the underlying energy commodity. In addition, the volatility of commodity prices can affect other energy companies due to the impact of prices on the volume of commodities transported, processed, stored or distributed and on the cost of fuel for power generation companies. The volatility of commodity prices can also affect energy companies ability to access the capital markets in light of market perception that their performance may be directly tied to commodity prices. Historically, energy commodity prices have been cyclical and exhibited significant volatility. Although we generally prefer risk controls, including appropriate commodity and other hedges, by certain of our portfolio companies, if available, some of our portfolio companies may not engage in hedging transactions to minimize their exposure to commodity price risk. For those companies that engage in such hedging transactions, they remain subject to market risks, including market liquidity and counterparty creditworthiness. In addition, such companies may also still have exposure to market prices if such companies do not produce volumes or other contractual obligations in accordance with such hedging contracts.

**Regulatory Risk.** The profitability of energy companies could be adversely affected by changes in the regulatory environment. The businesses of energy companies are heavily regulated by federal, state and local governments in diverse ways, such as the way in which energy assets are constructed, maintained and operated and the prices energy companies may charge for their products and services. Such regulation can change over time in scope and intensity. For example, a particular by-product of an energy process may be declared hazardous by a regulatory agency, which can unexpectedly increase production costs. Moreover, many state and federal environmental laws provide for civil penalties as well as regulatory remediation, thus adding to the potential liability an energy company may face. In addition, the deregulation of energy markets and the unresolved regulatory issues related to some power markets such as California create uncertainty in

the regulatory environment as rules and regulations may be adopted on a transitional basis. We cannot assure you that the deregulation of energy markets will continue and if it continues, whether its impact on energy companies' profitability will be positive.

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**Production Risk.** The profitability of energy companies may be materially impacted by the volume of crude oil, natural gas or other energy commodities available for transporting, processing, storing, distributing or power generation. A significant decrease in the production of natural gas, crude oil, coal or other energy commodities, due to the decline of production from existing facilities, import supply disruption, depressed commodity prices, political events, OPEC actions or otherwise, could reduce revenue and operating income or increase operating costs of energy companies and, therefore, their ability to pay debt or dividends.

**Demand Risk.** A sustained decline in demand for crude oil, natural gas, refined petroleum products and electricity could materially affect revenues and cash flows of energy companies. Factors that could lead to a decrease in market demand include a recession or other adverse economic conditions, an increase in the market price of the underlying commodity, higher taxes or other regulatory actions that increase costs, or a shift in consumer demand for such products.

**Depletion and Exploration Risk.** A portion of any one energy company's assets may be dedicated to natural gas, crude oil and/or coal reserves and other commodities that naturally deplete over time. Depletion could have a materially adverse impact on such company's ability to maintain its revenue. Further, estimates of energy reserves may not be accurate and, even if accurate, reserves may not be fully utilized at reasonable costs. Exploration of energy resources, especially of oil and gas, is inherently risky and requires large amounts of capital.

**Weather Risk.** Unseasonable extreme weather patterns could result in significant volatility in demand for energy and power. In addition, hurricanes, storms, tornados, floods, rain, and other significant weather events could disrupt supply and other operations at our portfolio companies as well as customers or suppliers to such companies. This volatility may create fluctuations in earnings of energy companies.

**Operational Risk.** Energy companies are subject to various operational risks, such as failed drilling or well development, unscheduled outages, underestimated cost projections, unanticipated operation and maintenance expenses, failure to obtain the necessary permits to operate and failure of third-party contractors (for example, energy producers and shippers) to perform their contractual obligations. In addition, energy companies employ a variety of means of increasing cash flow, including increasing utilization of existing facilities, expanding operations through new construction, expanding operations through acquisitions, or securing additional long-term contracts. Thus, some energy companies may be subject to construction risk, acquisition risk or other risk factors arising from their specific business strategies.

**Competition Risk.** The progress in deregulating energy markets has created more competition in the energy industry. This competition is reflected in risks associated with marketing and selling energy in the evolving energy market and a competitor's development of a lower-cost energy or power source, or of a lower cost means of operations, and other risks arising from competition.

**Valuation Risk.** Since mid-2001, excess power generation capacity in certain regions of the United States has caused substantial decreases in the market capitalization of many energy companies. While such prices have recovered to some extent, we can offer no assurance that such decreases in market capitalization will not recur, or that any future decreases in energy company valuations will be insubstantial or temporary in nature.

**Terrorism Risk.** Since the September 11th attacks, the United States government has issued public warnings indicating that energy assets, specifically those related to pipeline infrastructure, production facilities and transmission and distribution facilities, might be specific targets of terrorist activity. The continued threat of terrorism and related military activity will likely increase volatility for prices of natural gas and oil and could affect the market for products and services of energy companies. In addition, any future terrorist attack or armed conflict in the United States or elsewhere may undermine economic conditions in the United States in general.

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**Financing Risk.** Some of our portfolio companies rely on the capital markets to raise money to pay their existing obligations. Their ability to access the capital markets on attractive terms or at all may be affected by any of the risks associated with energy companies described above, by general economic and market conditions or by other factors. This may in turn affect their ability to satisfy their obligations with us.

**Climate Change.** There is evidence of global climate change. Climate change creates physical and financial risk and some of our portfolio companies may be adversely affected by climate change. For example, customers of energy companies needs vary with weather conditions, primarily temperature and humidity. To the extent weather conditions are affected by climate change, energy use could increase or decrease depending on the duration and magnitude of any changes. Increased energy use due to weather changes may require additional investments by our portfolio companies in more pipelines and other infrastructure to serve increased demand. A decrease in energy use due to weather changes may affect our portfolio companies financial condition, through decreased revenues. Extreme weather conditions in general require more system backup, adding to costs, and can contribute to increased system stresses, including service interruptions. Energy companies could also be affected by the potential for lawsuits against or taxes or other regulatory costs imposed on greenhouse gas emitters, based on links drawn between greenhouse gas emissions and climate change.

*Our investments in prospective portfolio companies may be risky and we could lose all or part of our investment.*

Some of our portfolio companies have relatively short or no operating histories. These companies are and will be subject to all of the business risk and uncertainties associated with any new business enterprise, including the risk that these companies may not reach their investment objective and the value of our investment in them may decline substantially or fall to zero.

In addition, investment in the middle market companies that we are targeting involves a number of other significant risks, including:

- these companies may have limited financial resources and may be unable to meet their obligations under their securities that we hold, which may be accompanied by a deterioration in the value of their securities or of any collateral with respect to any securities and a reduction in the likelihood of our realizing on any guarantees we may have obtained in connection with our investment;
- they may have shorter operating histories, narrower product lines and smaller market shares than larger businesses, which tend to render them more vulnerable to competitors' actions and market conditions, as well as general economic downturns;

- because many of these companies are privately held companies, public information is generally not available about these companies. As a result, we will depend on the ability of our Investment Adviser to obtain adequate information to evaluate these companies in making investment decisions. If our Investment Adviser is unable to uncover all material information about these companies, it may not make a fully informed investment decision, and we may lose money on our investments;

- they are more likely to depend on the management talents and efforts of a small group of persons; therefore, the death, disability, resignation or termination of one or more of these persons could have a materially adverse impact on our portfolio company and, in turn, on us;

- they may have less predictable operating results, may from time to time be parties to litigation, may be engaged in changing businesses with products subject to a risk of obsolescence and may require substantial additional capital to support their operations, finance expansion or maintain their competitive position;
- they have difficulty accessing the capital markets to meet future capital needs; and

- increased taxes, regulatory expense or the costs of changes to the way they conduct business due to the effects of climate change may adversely affect their business, financial structure or prospects.

In addition, our executive officers, directors and our Investment Adviser could, in the ordinary course of business, be named as defendants in litigation arising from proposed investments or from our investments in the portfolio companies.



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

The U.S. financial markets have been experiencing a high level of volatility, disruption and distress, which was exacerbated by the failure of several major financial institutions in the last few months of 2008. In addition, the U.S. economy has been in a recession, the aftermath of which may be severe and prolonged. Similar conditions have occurred in the financial markets and economies of numerous other countries and could worsen, both in the U.S. and globally. Our portfolio companies will generally be affected by the conditions and overall strength of the national, regional and local economies, including interest rate fluctuations, changes in the capital markets and changes in the prices of their primary commodities and products. These factors also impact the amount of residential, industrial and commercial growth in the energy industry. Additionally, these factors could adversely impact the customer base and customer collections of our portfolio companies.

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

A portfolio company's failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of its loans and foreclosure on its secured assets, which could trigger cross-defaults under other agreements and jeopardize a portfolio company's ability to meet its obligations under the debt or equity securities that we hold. We may incur expenses to the extent necessary to seek recovery upon default or to negotiate new terms, which may include the waiver of certain financial covenants, with a defaulting portfolio company. In addition, if one of our portfolio companies were to go bankrupt, even though we may have structured our interest as senior debt or preferred equity, depending on the facts and circumstances, including the extent to which we actually provided managerial assistance to that portfolio company, a bankruptcy court might re-characterize our debt or equity holding and subordinate all or a portion of our claim to those of other creditors.

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

We make investments in private companies. A portion of these investments may be subject to legal and other restrictions on resale, transfer, pledge or other disposition or will otherwise be less liquid than publicly traded securities. The illiquidity of our investments may make it difficult for us to sell such investments if the need arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded our investments. In addition, we face other restrictions on our ability to liquidate an investment in a business entity to the extent that we or our Investment Adviser has or could be deemed to have material non-public information regarding such business entity.

*We may have limited access to information about privately held companies in which we invest.*

We invest primarily in privately-held companies. Generally, little public information exists about these companies, and we are required to rely on the ability of our Investment Adviser's investment professionals to obtain adequate information to evaluate the potential returns from investing in these companies. These companies and their financial information are not subject to the Sarbanes-Oxley Act and other rules that govern public companies. If we are unable to uncover all material information about these companies, we may not make a fully informed investment decision, and we may lose money on our investment.

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*We may not be in a position to control a portfolio investment when we are a debt or minority equity investor and its management may make decisions that could decrease the value of our investment.*

We make both debt and minority equity investments in portfolio companies. As a result, we are subject to the risk that a portfolio company may make business decisions with which we disagree, and the management of such company, as representatives of the holders of their common equity, may take risks or otherwise act in ways that do not serve our interests. As a result, a portfolio company may make decisions that could decrease the value of our portfolio holdings. *Our portfolio companies may incur debt or issue equity securities that rank equally with, or senior to, our investments in such companies.*

We may invest in mezzanine debt and dividend-paying equity securities issued by our portfolio companies. Our portfolio companies usually have, or may be permitted to incur, other debt, or issue other equity securities, that rank equally with, or senior to, the securities in which we invest. By their terms, such instruments may provide that the holders are entitled to receive payment of dividends, interest or principal on or before the dates on which we are entitled to receive payments in respect of the securities in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization or bankruptcy of a portfolio company, holders of securities ranking senior to our investment in that portfolio company would typically be entitled to receive payment in full before we receive any distribution in respect of our investment. After repaying the senior security holders, the portfolio company may not have any remaining assets to use for repaying its obligation to us. In the case of securities ranking equally with securities in which we invest, we would have to share on an equal basis any distributions with other security holders in the event of an insolvency, liquidation, dissolution, reorganization or bankruptcy of the relevant portfolio company.

*We may not be able to fully realize the value of the collateral securing our debt investments.*

Although a substantial amount of our debt investments are protected by holding security interests in the assets of the portfolio companies, we may not be able to fully realize the value of the collateral securing our investments due to one or more of the following factors:

- our debt investments are primarily made in the form of mezzanine loans, therefore our liens on the collateral, if any, are subordinated to those of the senior secured debt of the portfolio companies, if any. As a result, we may not be able to control remedies with respect to the collateral;

- the collateral may not be valuable enough to satisfy all of the obligations under our secured loan, particularly after giving effect to the repayment of secured debt of the portfolio company that ranks senior to our loan;

- bankruptcy laws may limit our ability to realize value from the collateral and may delay the realization process;

- our rights in the collateral may be adversely affected by the failure to perfect security interests in the collateral;

- the need to obtain regulatory and contractual consents could impair or impede how effectively the collateral would be liquidated and could affect the value received; and

- some or all of the collateral may be illiquid and may have no readily ascertainable market value. The liquidity and value of the collateral could be impaired as a result of changing economic conditions, competition, and other factors, including the availability of suitable buyers.

*Our investments in foreign securities may involve significant risks in addition to the risks inherent in U.S. investments.*

Our investment strategy contemplates potential investments in securities of foreign companies. Investing in foreign companies may expose us to additional risks not typically associated with investing in U.S. companies. These risks include changes in exchange control regulations, political and social instability, expropriation, imposition of foreign taxes, less liquid markets and less available information than is generally the case in the United States, higher transaction costs, less government supervision of exchanges, brokers and issuers, less developed bankruptcy laws, difficulty in enforcing contractual obligations, lack of uniform accounting and auditing standards and greater price volatility.

Although currently most of our investments are, and we expect that most of our investments will be, U.S. dollar-denominated, investments that are denominated in a foreign currency will be subject to the risk that the value of a particular currency will change in relation to one or more other currencies. Among the factors that may affect



currency values are trade balances, the level of short-term interest rates, differences in relative values of similar assets in different currencies, long-term opportunities for investment and capital appreciation, and political developments.

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*We may expose ourselves to risks if we engage in hedging transactions.*

We may employ hedging techniques to minimize certain investment risks, such as fluctuations in interest and currency exchange rates, but we can offer no assurance that such strategies will be effective. If we engage in hedging transactions, we may expose ourselves to risks associated with such transactions. We may utilize instruments such as forward contracts, currency options and interest rate swaps, caps, collars and floors to seek to hedge against fluctuations in the relative values of our portfolio positions from changes in currency exchange rates and market interest rates. Hedging against a decline in the values of our portfolio positions does not eliminate the possibility of fluctuations in the values of such positions or prevent losses if the values of such positions decline. However, such hedging can establish other positions designed to gain from those same developments, thereby offsetting the decline in the value of such portfolio positions. Such hedging transactions may also limit the opportunity for gain if the values of the portfolio positions should increase. Moreover, it may not be possible to hedge against an exchange rate or interest rate fluctuation that is so generally anticipated that we are not able to enter into a hedging transaction at an acceptable price.

The success of our hedging transactions depends on our ability to correctly predict movements, currencies and interest rates. Therefore, while we may enter into such transactions to seek to reduce currency exchange rate and interest rate risks, unanticipated changes in currency exchange rates or interest rates may result in poorer overall investment performance than if we had not engaged in any such hedging transactions. The degree of correlation between price movements of the instruments used in a hedging strategy and price movements in the portfolio positions being hedged may vary. Moreover, for a variety of reasons, we may not seek to establish a perfect correlation between such hedging instruments and the portfolio holdings being hedged. Any such imperfect correlation may prevent us from achieving the intended hedge and expose us to risk of loss. In addition, it may not be possible to hedge fully or perfectly against currency fluctuations affecting the value of securities denominated in non-U.S. currencies.

*Our Board of Directors may change our operating policies and strategies without prior notice or stockholder approval, the effects of which may be adverse to us and could impair the value of our stockholders' investment.*

Our Board of Directors has the authority to modify or waive our current operating policies and our strategies without prior notice and without stockholder approval. We cannot predict the effect any changes to our current operating policies and strategies would have on our business, financial condition, and value of our common stock. However, the effects might be adverse, which could negatively impact our ability to pay dividends and cause stockholders to lose all or part of their investment.

**Risks Relating To Our Securities**

*Investing in our securities may involve a high degree of risk.*

The investments we make in accordance with our investment objective may result in a higher amount of risk than alternative investment options and volatility or loss of principal. Our investments in portfolio companies may be speculative and aggressive, and therefore, an investment in our shares may not be suitable for someone with low risk tolerance.

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*The market price of our securities may fluctuate significantly.*

The market price and liquidity of the market for our securities may be significantly affected by numerous factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include:

- significant volatility in the market price and trading volume of securities of business development companies or other companies in the energy industry, which are not necessarily related to the operating performance of these companies;
- changes in regulatory policies or tax guidelines, particularly with respect to RICs or business development companies;
- loss of RIC qualification;
- changes in earnings or variations in operating results;
- changes in the value of our portfolio of investments;
- any shortfall in revenue or net income or any increase in losses from levels expected by investors or securities analysts;
- departure of one or more of Prospect Capital Management's key personnel;
- operating performance of companies comparable to us;
- changes in prevailing interest rates;
- litigation matters;
- general economic trends and other external factors; and
- loss of a major funding source.

*Sales of substantial amounts of our securities in the public market may have an adverse effect on the market price of our securities.*

As of August 30, 2010, we have 75,733,865 shares of common stock outstanding. Sales of substantial amounts of our securities or the availability of such securities for sale could adversely affect the prevailing market price for our securities. If this occurs and continues it could impair our ability to raise additional capital through the sale of securities should we desire to do so.

*There is a risk that you may not receive distributions or that our distributions may not grow over time.*

We have made and intend to continue to make distributions on a quarterly basis to our stockholders out of assets legally available for distribution. We cannot assure you that we will achieve investment results or maintain a tax status that will allow or require any specified level of cash distributions or year-to-year increases in cash distributions. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions.

*Provisions of the Maryland General Corporation Law and of our charter and bylaws could deter takeover attempts and have an adverse impact on the price of our common stock.*

Our charter and bylaws and the Maryland General Corporation Law contain provisions that may have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for our stockholders or otherwise be in their best interest. These provisions may prevent shareholders from being able to sell shares of its common stock at a premium over the current of prevailing market prices.

Our charter provides for the classification of our Board of Directors into three classes of directors, serving staggered three-year terms, which may render a change of control or removal of our incumbent management more difficult. Furthermore, any and all vacancies on our Board of Directors will be filled generally only by the affirmative vote of a majority of the remaining directors in office, even if the remaining directors do not constitute a quorum, and any director elected to fill a vacancy will serve for the remainder of the full term until a successor is elected and qualifies.

Our Board of Directors is authorized to create and issue new series of shares, to classify or reclassify any unissued shares of stock into one or more classes or series, including preferred stock and, without stockholder approval, to amend our charter to increase or decrease the number of shares of common stock that we have authority to issue, which could have the effect of diluting a stockholder's ownership interest. Prior to the issuance of shares of common stock of each class or series, including any reclassified series, our Board of Directors is required by our governing documents to set the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to

dividends or other distributions, qualifications and terms or conditions of redemption for each class or series of shares of stock.

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Our charter and bylaws also provide that our Board of Directors has the exclusive power to adopt, alter or repeal any provision of our bylaws, and to make new bylaws. The Maryland General Corporation Law also contains certain provisions that may limit the ability of a third party to acquire control of us, such as:

The Maryland Business Combination Act, which, subject to certain limitations, prohibits certain business combinations between us and an interested stockholder (defined generally as any person who beneficially owns 10% or more of the voting power of the common stock or an affiliate thereof) for five years after the most recent date on which the stockholder becomes an interested stockholder and, thereafter, imposes special minimum price provisions and special stockholder voting requirements on these combinations; and The Maryland Control Share Acquisition Act, which provides that control shares of a Maryland corporation (defined as shares of common stock which, when aggregated with other shares of common stock controlled by the stockholder, entitles the stockholder to exercise one of three increasing ranges of voting power in electing directors, as described more fully below) acquired in a control share acquisition (defined as the direct or indirect acquisition of ownership or control of control shares ) have no voting rights except to the extent approved by stockholders by the affirmative vote of at least two-thirds of all the votes entitled to be cast on the matter, excluding all interested shares of common stock.

The provisions of the Maryland Business Combination Act will not apply, however, if our Board of Directors adopts a resolution that any business combination between us and any other person will be exempt from the provisions of the Maryland Business Combination Act. Although our Board of Directors has adopted such a resolution, there can be no assurance that this resolution will not be altered or repealed in whole or in part at any time. If the resolution is altered or repealed, the provisions of the Maryland Business Combination Act may discourage others from trying to acquire control of us.

As permitted by Maryland law, our bylaws contain a provision exempting from the Maryland Control Share Acquisition Act any and all acquisitions by any person of our common stock. Although our bylaws include such a provision, such a provision may also be amended or eliminated by our Board of Directors at any time in the future, provided that we will notify the Division of Investment Management at the SEC prior to amending or eliminating this provision.

*We may in the future choose to pay dividends in our own stock, in which case our shareholders may be required to pay tax in excess of the cash they receive.*

We may distribute taxable dividends that are payable in part in our stock. Under IRS Revenue Procedure 2010-12, which extended and modified Revenue Procedure 2009-15, up to 90% of any such taxable dividend for 2009, 2010, and 2011 could be payable in our stock. The IRS has also issued (and where Revenue Procedure 2009-15 or 2010-12 is not currently applicable, the IRS continues to issue) private letter rulings on cash/stock dividends paid by regulated investment companies and real estate investment trusts using a 20% cash standard (instead of the 10% cash standard of Revenue Procedures 2009-15 and 2010-12) if certain requirements are satisfied. Taxable stockholders receiving such dividends would be required to include the full amount of the dividend as ordinary income (or as long-term capital gain to the extent such distribution is properly designated as a capital gain dividend) to the extent of its current and accumulated earnings and profits for United States federal income tax purposes. As a result, a U.S. stockholder may be required to pay tax with respect to such dividends in excess of any cash received. If a U.S. stockholder sells the stock it receives as a dividend in order to pay this tax, it may be subject to transaction fees (e.g. broker fees or transfer agent fees) and the sales proceeds may be less than the amount included in income with respect to the dividend, depending on the market price of our stock at the time of the sale. Furthermore, with respect to non-U.S. stockholders, we may be required to withhold U.S. tax with respect to such dividends, including in respect of all or a portion of such dividend that is payable in stock. In addition, if a significant number of our stockholders determine to sell shares of its stock in order to pay taxes owed on dividends, it may put downward pressure on the trading price of our stock. It is unclear whether and to what extent we will be able to pay dividends in cash and our stock (whether pursuant to Revenue Procedure 2009-15 or 2010-12, a private letter ruling, or otherwise).



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**Item 1B. Unresolved Staff Comments.**

Not applicable

**Item 2. Properties.**

We do not own any real estate or other physical properties materially important to our operation. Our principal executive offices are located at 10 East 40th Street, New York, New York 10016, where we occupy our office space pursuant to our Administration Agreement with Prospect Administration. The office facilities, which are shared with our Investment Adviser and Administrator, consist of approximately 8,987 square feet, of which 3,087 square feet were added subsequent to June 30, 2010, and are leased through October 2014. We believe that our office facilities are suitable and adequate for our business as currently conducted.

**Item 3. Legal Proceedings.**

From time to time, we may become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to intellectual property, employment, tax, regulation, contract or other matters. The resolution of such of these matters as may arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources.

On December 6, 2004, Dallas Gas Partners, L.P. ( DGP ) served us with a complaint filed November 30, 2004 in the U.S. District for the Southern District of Texas, Galveston Division. DGP alleges that DGP was defrauded and that we breached our fiduciary duty to DGP and tortiously interfered with DGP s contract to purchase Gas Solutions, Ltd. (a subsidiary of our portfolio company, GSHI) in connection with our alleged agreement in September 2004 to loan DGP funds with which DGP intended to buy Gas Solutions, Ltd. for approximately \$26 million. The complaint sought relief not limited to \$100 million. On November 30, 2005, U.S. Magistrate Judge John R. Froeschner of the U.S. District Court for the Southern District of Texas, Galveston Division, issued a recommendation that the court grant our Motion for Summary Judgment dismissing all claims by DGP. On February 21, 2006, U.S. District Judge Samuel Kent of the U.S. District Court for the Southern District of Texas, Galveston Division issued an order granting our Motion for Summary Judgment dismissing all claims by DGP, against us. On May 16, 2007, the Court also granted us summary judgment on DGP s liability to us on our counterclaim for DGP s breach of a release and covenant not to sue. On January 4, 2008, the Court, Judge Melinda Harmon presiding, granted our motion to dismiss all DGP s claims asserted against certain of our officers and affiliates. On August 20, 2008, Judge Harmon entered a Final Judgment dismissing all of DGP s claims. DGP appealed to the U.S. Court of Appeals for the Fifth Circuit, which affirmed the Final Judgment on June 24, 2009. DGP then moved for rehearing on July 8, 2009, which the Fifth Circuit denied on August 6, 2009. Our damage claims against DGP remain pending.

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In May 2006, based in part on unfavorable due diligence and the absence of investment committee approval, we declined to extend a loan for \$10 million to a potential borrower ( plaintiff ). Plaintiff was subsequently sued by its own attorney in a local Texas court for plaintiff 's failure to pay fees owed to its attorney. In December 2006, plaintiff filed a cross-action against us and certain affiliates (the defendants ) in the same local Texas court, alleging, among other things, tortious interference with contract and fraud. We petitioned the United States District Court for the Southern District of New York (the District Court ) to compel arbitration and to enjoin the Texas action. In February 2007, our motions were granted. Plaintiff appealed that decision. On July 24, 2008, the Second Circuit Court of Appeals affirmed the judgment of the District Court. The arbitration commenced in July 2007 and concluded in late November 2007. Post-hearing briefings were completed in February 2008. On April 14, 2008, the arbitrator rendered an award in our favor, rejecting all of plaintiff 's claims. On April 18, 2008, we filed a petition before the District Court to confirm the award. On October 8, 2008, the District Court granted the Company 's petition to confirm the award, confirmed the awards and subsequently entered judgment thereon in favor of the Company in the amount of \$2.3 million. After filing a defective notice of appeal to the United States Court of Appeals for the Second Circuit on November 5, 2008, plaintiff 's counsel resubmitted a new notice of appeal on January 9, 2009. The plaintiff subsequently requested that the Company agree to stipulate to the withdrawal of plaintiff 's appeal to the Second Circuit. Such a stipulation was filed with the Second Circuit on or about April 14, 2009. Based on this stipulation, the Second Circuit issued a mandate terminating the appeal, which was transmitted to the District Court on April 23, 2009. Post-judgment discovery against plaintiff is continuing and we have filed a motion for sanctions against plaintiff 's counsel. Argument for the motion for sanctions was held on November 19, 2009 and a decision from the court is pending. On March 9, 2010, Judge Leonard Sands granted our motion for sanctions against plaintiff 's counsel. On July 14, 2010, Arnold & Itkin filed a notice of appeal appealing the judgment and the Court 's March 9, 2010 Memorandum and Order.

**Item 4. Removed and reserved.**



**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

Our common stock is quoted on the NASDAQ Global Market under the symbol PSEC. The following table sets forth, for the periods indicated, our net asset value per share of common stock and the high and low closing prices per share of our common stock as reported on the NASDAQ Global Market. Our common stock historically has traded at prices both above and below its net asset value. There can be no assurance, however, that such premium or discount, as applicable, to net asset value will be maintained.

Year Ended	Net Asset Value Per Share <sup>(1)</sup>	High	Low	Premium (Discount) of High Sales Price to Net Asset Value	Premium (Discount) of Low Sales Price to Net Asset Value
June 30, 2010					
First quarter	\$ 11.11	\$ 10.99	\$ 8.82	(1.1%)	(20.6%)
Second quarter	\$ 10.06	\$ 12.31	\$ 9.93	22.4%	(1.3%)
Third quarter	\$ 10.09	\$ 13.20	\$ 10.45	30.8%	3.6%
Fourth quarter	\$ 10.29	\$ 12.20	\$ 9.65	18.6%	(6.2%)
June 30, 2009					
First quarter	\$ 14.63	\$ 14.24	\$ 11.12	(2.7%)	(24.0%)
Second quarter	\$ 14.43	\$ 13.08	\$ 6.29	(9.4%)	(56.4%)
Third quarter	\$ 14.19	\$ 12.89	\$ 6.38	(9.2%)	(55.0%)
Fourth quarter	\$ 12.40	\$ 10.48	\$ 7.95	(15.5%)	(35.9%)
June 30, 2008					
First quarter	\$ 15.08	\$ 18.68	\$ 14.16	23.9%	(6.1%)
Second quarter	\$ 14.58	\$ 17.17	\$ 11.22	17.8%	(23.0%)
Third quarter	\$ 14.15	\$ 16.00	\$ 13.55	13.1%	(4.2%)
Fourth quarter	\$ 14.55	\$ 16.12	\$ 13.18	10.8%	(9.4%)

(1) Net asset value per share is determined as of the last day in the relevant quarter and therefore may not reflect the net asset value per share on the date of the high or low sales price. The net asset values shown are based

on outstanding  
shares at the end  
of each period.

On August 20, 2010, the last reported sales price of our common stock was \$9.43 per share. As of August 20, 2010, we had approximately 56 stockholders of record, and we had approximately 53,829 beneficial owners whose shares are held in the names of brokers, dealers and clearing agencies.

**Distributions**

Through March 2010, we made quarterly distributions to our stockholders out of assets legally available for distribution. In June 2010, we changed our distribution policy from a quarterly payment to a monthly payment and intend to continue with monthly distributions. Our distributions, if any, will be determined by our Board of Directors. Certain amounts of the monthly distributions may from time to time be paid out of our capital rather than from earnings for the quarter as a result of our deliberate planning or by accounting reclassifications.

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In order to maintain RIC tax treatment, we must distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, out of the assets legally available for distribution. In order to avoid certain excise taxes imposed on RICs, we are required to distribute with respect to each calendar year by January 31 of the following year an amount at least equal to the sum of

98% of our ordinary income for the calendar year,

98% of our capital gains in excess of capital losses for the one-year period ending on October 31 of the calendar year, and

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

In December 2008, our Board of Directors elected to retain excess profits generated in the quarter ended September 30, 2008 and pay a 4% excise tax on such retained earnings. We paid \$533,000 for the excise tax with the filing of our tax return in March 2009.

In addition, although we currently intend to distribute realized net capital gains (which we define as net long-term capital gains in excess of short-term capital losses), if any, at least annually, out of the assets legally available for such distributions, we may decide in the future to retain such capital gains for investment. In such event, the consequences of our retention of net capital gains are as described under Material U.S. Federal Income Tax Considerations. We can offer no assurance that we will achieve results that will permit the payment of any cash distributions and, if we issue senior securities, we may be prohibited from making distributions if doing so causes us to fail to maintain the asset coverage ratios stipulated by the 1940 Act or if distributions are limited by the terms of any of our borrowings.

We maintain an opt out dividend reinvestment plan for our common stockholders. As a result, if we declare a dividend, then stockholders cash dividends will be automatically reinvested in additional shares of our common stock, unless they specifically opt out of the dividend reinvestment plan so as to receive cash dividends. See Dividend Reinvestment Plan. To the extent prudent and practicable, we intend to declare and pay dividends on a quarterly basis. With respect to the dividends paid to stockholders, income from origination, structuring, closing, commitment and other upfront fees associated with investments in portfolio companies were treated as taxable income and accordingly, distributed to stockholders. During the fiscal year ended June 30, 2010, we declared total dividends of approximately \$96.4 million.

Tax characteristics of all distributions will be reported to stockholders, as appropriate, on Form 1099-DIV after the end of the year. Our ability to pay distributions could be affected by future business performance, liquidity, capital needs, alternative investment opportunities and loan covenants.

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The following table reflects the dividends per share that we have declared on our common stock to date:

<b>Declaration Date</b>	<b>Record Date</b>	<b>Pay Date</b>	<b>Rate</b>	<b>Amount (in thousands)</b>
6/18/2010	8/31/2010	9/30/2010	\$ 0.10050	\$ 7,611
6/18/2010	7/30/2010	8/31/2010	0.10025	7,330
6/18/2010	6/30/2010	7/30/2010	0.10000	6,909
3/18/2010	3/31/2010	4/23/2010	0.41000	26,403
12/17/2009	12/31/2009	1/25/2010	0.40875	25,894
9/28/2009	10/8/2009	10/19/2009	0.40750	22,279
6/23/2009	7/8/2009	7/20/2009	0.40625	19,548
3/24/2009	3/31/2009	4/20/2009	0.40500	12,671
12/19/2008	12/31/2008	1/19/2009	0.40375	11,966
9/16/2008	9/30/2008	10/16/2008	0.40250	11,882
6/19/2008	6/30/2008	7/16/2008	0.40125	11,845
3/6/2008	3/31/2008	4/16/2008	0.40000	10,468
12/8/2007	12/28/2007	1/7/2008	0.39500	9,370
9/6/2007	9/19/2007	9/28/2007	0.39250	7,830
6/14/2007	6/22/2007	6/29/2007	0.39000	7,753
3/14/2007	3/23/2007	3/30/2007	0.38750	7,667
12/15/2006	12/29/2006	1/5/2007	0.38500	7,264
7/31/2006	9/22/2006	9/29/2006	0.38000	4,858
6/14/2006	6/23/2006	6/30/2006	0.34000	2,401
3/15/2006	3/24/2006	3/31/2006	0.30000	2,117
12/12/2005	12/22/2005	12/29/2005	0.28000	1,975
9/15/2005	9/22/2005	9/29/2005	0.20000	1,411
4/21/2005	6/10/2005	6/30/2005	0.15000	1,058
2/9/2005	3/11/2005	3/31/2005	0.12500	882
11/11/2004	12/10/2004	12/30/2004	0.10000	706
Since Inception				\$ 230,098

**Dividend Reinvestment**

We maintain an opt out dividend reinvestment and cash purchase plan for our registered stockholders. Under the plan, if shares of our common stock are registered, dividends will be automatically reinvested in additional shares of common stock unless you opt out of the plan. Stockholders are advised to consult with their brokers or financial institutions, as appropriate, with respect to the administration of their dividends and related instructions.

Assuming that we maintain our status as a RIC under Subchapter M of the Code, we intend to make distributions to our stockholders on a quarterly basis of substantially all of our net operating income. We may also make distributions of net realized capital gains, as appropriate.

Tax characteristics of all dividends will be reported to stockholders, as appropriate, on Form 1099-DIV after the end of the year. Our Board of Directors presently intends to declare and pay quarterly dividends on the common stock. Our ability to pay dividends could be affected by future business performance, liquidity, capital needs, alternative investment opportunities and loan covenants.

Stock dividends distributed pursuant to this dividend reinvestment plan may come in the form of the issuance of new shares or the distribution of pre-existing shares re-acquired from the open market. How the stock to be distributed as part of this plan is made available is a determination made by our Board of Directors.



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During the year ended June 30, 2010, we distributed 1,016,513 shares of common stock in accordance with this dividend reinvestment plan. All of the shares issued were distributed from new issues.

The following table reflects dividend reinvestments distributed through the issuance of new shares:

<b>Record Date</b>	<b>Shares Issued</b>	<b>Aggregate Offering Price (in thousands)</b>	<b>% of Dividend</b>
June 30, 2010	83,875	\$ 822	11.9%
March 31, 2010	248,731	2,962	11.2%
December 31, 2009	236,985	2,896	11.2%
October 8, 2009	233,523	2,456	11.0%
July 8, 2009	297,274	2,901	14.8%
March 31, 2009	214,456	1,827	14.4%
December 31, 2008	148,200	1,774	14.8%
September 30, 2008	117,549	1,506	12.7%
March 31, 2008	99,241	1,510	14.4%
September 19, 2007	72,073	1,243	15.9%
June 22, 2007	69,834	1,190	15.3%
March 23, 2007	93,843	1,595	20.8%
December 29, 2006	108,047	1,850	25.5%
September 22, 2006	80,818	1,273	26.2%
June 23, 2006	7,932	130	5.4%
March 24, 2006	6,841	111	5.2%

The following table reflects dividend reinvestments distributed from re-acquired shares:

<b>Record Date</b>	<b>Shares Purchased</b>	<b>Aggregate Amount Distributed (in thousands)</b>	<b>% of Dividend</b>
June 30, 2008	133,156	\$ 1,635	13.8%
December 28, 2007	111,335	1,541	16.4%
December 22, 2005	6,192	95	4.8%
September 22, 2005	7,848	105	7.4%
June 10, 2005	10,885	138	13.0%
March 11, 2005	8,986	117	13.2%
December 10, 2004	7,540	92	13.0%

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**Stock Performance Graph**

This graph compares the return on our common stock with that of the Standard & Poor's 500 Stock Index and the NASDAQ Financial 100 Index, for the period July 1, 2005 through June 30, 2010. The graph assumes that, on July 1, 2005, a person invested \$100 in each of our common stock, the S&P 500 Index, and the NASDAQ Financial 100 Index. The graph measures total shareholder return, which takes into account both changes in stock price and dividends. It assumes that dividends paid are invested in like securities.

The graph and other information furnished under this Part II, Item 5 of this annual report on Form 10-K shall not be deemed to be soliciting material or to be filed with the SEC or subject to Regulation 14A or 14C, or to the liabilities of Section 18 of the 1934 Act. The stock price performance included in the above graph is not necessarily indicative of future stock performance.

**Sales of unregistered securities**

We did not sell any securities during the period covered by this report that were not registered under the Securities Act.

**Table of Contents****Item 6. Selected Financial Data.**

The following selected financial data is derived from our financial statements which have been audited by BDO USA LLP, our independent registered public accounting firm. The financial data should be read in conjunction with our financial statements and related notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included below in this annual report.

	<b>For the Year/Period Ended June 30,</b>				
	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>
	(in thousands except data relating to shares, per share and number of portfolio companies)				
<b>Performance Data:</b>					
Interest income	\$ 86,518	\$ 62,926	\$ 59,033	\$ 30,084	\$ 13,268
Dividend income	15,366	22,793	12,033	6,153	3,601
Other income	11,751	14,762	8,336	4,444	
<b>Total investment income</b>	<b>113,635</b>	<b>100,481</b>	<b>79,402</b>	<b>40,681</b>	<b>16,869</b>
<b>Interest and credit facility expenses</b>	<b>(8,382)</b>	<b>(6,161)</b>	<b>(6,318)</b>	<b>(1,903)</b>	<b>(642)</b>
Investment advisory expense	(30,542)	(26,705)	(20,199)	(11,226)	(3,868)
Other expenses	(8,260)	(8,452)	(7,772)	(4,421)	(3,801)
<b>Total expenses</b>	<b>(47,184)</b>	<b>(41,318)</b>	<b>(34,289)</b>	<b>(17,550)</b>	<b>(8,311)</b>
<b>Net investment income</b>	<b>66,451</b>	<b>59,163</b>	<b>45,113</b>	<b>23,131</b>	<b>8,558</b>
<b>Realized and unrealized (losses) gains</b>	<b>(47,565)</b>	<b>(24,059)</b>	<b>(17,522)</b>	<b>(6,403)</b>	<b>4,338</b>
<b>Net increase in net assets from operations</b>	<b>\$ 18,886</b>	<b>\$ 35,104</b>	<b>\$ 27,591</b>	<b>\$ 16,728</b>	<b>\$ 12,896</b>
<b>Per Share Data:</b>					
Net increase in net assets from operations <sup>(1)</sup>	\$ 0.32	\$ 1.11	\$ 1.17	\$ 1.06	\$ 1.83
Distributions declared per share	\$ (1.33)	\$ (1.62)	\$ (1.59)	\$ (1.54)	\$ (1.12)
Average weighted shares outstanding for the period	59,429,222	31,559,905	23,626,642	15,724,095	7,056,846
<b>Assets and Liabilities Data:</b>					
Investments	\$ 748,483	\$ 547,168	\$ 497,530	\$ 328,222	\$ 133,969
Other assets	84,212	119,857	44,248	48,280	4,511
<b>Total assets</b>	<b>832,695</b>	<b>667,025</b>	<b>541,778</b>	<b>376,502</b>	<b>138,480</b>



Amount drawn on credit facility	100,300	124,800	91,167		28,500
Amount owed to related parties	9,115	6,713	6,641	4,838	745
Other liabilities	12,595	2,916	14,347	71,616	965
Total liabilities	122,010	134,429	112,155	76,454	30,210
Net assets	\$ 710,685	\$ 532,596	\$ 429,623	\$ 300,048	\$ 108,270

**Investment Activity Data:**

No. of portfolio companies at period end	58	30	29 <sup>(2)</sup>	24 <sup>(2)</sup>	15
Acquisitions	\$ 157,662	\$ 98,305	\$ 311,947	\$ 167,255	\$ 83,625
Sales, repayments, and other disposals	\$ 136,221	\$ 27,007	\$ 127,212	\$ 38,407	\$ 9,954
Weighted-Average Yield at end of period <sup>(3)</sup>	14.2%	13.7%	15.5%	17.1%	17.0%

(1) Per share data is based on average weighted shares for the period

(2) Includes a net profits interest in Charlevoix Energy Trading LLC ( Charlevoix ), remaining after loan was paid

(3) Includes dividends from certain equity investments

**Table of Contents****Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.** *(All figures in this item are in thousands except per share and other data)*

The following discussion should be read in conjunction with our financial statements and related notes and other financial information appearing elsewhere in this annual report. In addition to historical information, the following discussion and other parts of this annual report contain forward-looking information that involves risks and uncertainties. Our actual results could differ materially from those anticipated by such forward-looking information due to the factors discussed under Part I, Item 1A Risk Factors and Note about Forward-Looking Statements appearing elsewhere herein.

**Overview**

We are a financial services company that primarily lends to and invests in middle market privately-held companies. We are a closed-end investment company that has filed an election to be treated as a business development company under the Investment Company Act of 1940, or the 1940 Act. We invest primarily in senior and subordinated debt and equity of companies in need of capital for acquisitions, divestitures, growth, development, project financing and recapitalization. We work with the management teams or financial sponsors to seek investments with historical cash flows, asset collateral or contracted pro-forma cash flows.

We seek to be a long-term investor with our portfolio companies. From our July 27, 2004 inception to the fiscal year ended June 30, 2007, we invested primarily in industries related to the industrial/energy economy. Since then, we have widened our strategy to focus in other sectors of the economy and continue to diversify our portfolio holdings.

The aggregate value of our portfolio investments was \$748,483 and \$547,168 as of June 30, 2010 and June 30, 2009, respectively. During the fiscal year ended June 30, 2010, our net cost of investments increased by \$197,335, or 37.1%, primarily as a result of the acquisition of Patriot Capital Funding, Inc. ( Patriot ) and our investment in three new and several follow-on investments while we sold one investment and we received repayment on eight other investments.

Compared to the end of last fiscal year (ended June 30, 2009), net assets increased by \$178,089 or 33.4% during the year ended June 30, 2010, from \$532,596 to \$710,685. This increase resulted from the issuance of new shares of our common stock (less offering costs) in the amount of \$156,221, equity issued in conjunction with the Patriot acquisition of \$92,800, dividend reinvestments of \$11,216, and another \$18,886 from operations. These increases, in turn, were offset by \$101,034 in dividend distributions to our stockholders. The \$18,886 increase in net assets resulting from operations is net of the following: net investment income of \$66,451, realized loss on investments of \$51,545, and a net increase in net assets due to changes in net unrealized appreciation of investments of \$3,980.

**Patriot Acquisition**

On December 2, 2009, we acquired the outstanding shares of Patriot Capital Funding, Inc. ( Patriot ) common stock for \$201,083. Under the terms of the merger agreement, Patriot common shareholders received 0.363992 shares of our common stock for each share of Patriot common stock, resulting in 8,444,068 shares of common stock being issued by us. In connection with the transaction, we repaid all the outstanding borrowings of Patriot, in compliance with the merger agreement.

On December 2, 2009, Patriot made a final dividend equal to its undistributed net ordinary income and capital gains of \$0.38 per share. In accordance with a recent IRS revenue procedure, the dividend was paid 10% in cash and 90% in newly issued shares of Patriot's common stock. The exchange ratio was adjusted to give effect to the tax distribution.

The merger has been accounted for as an acquisition of Patriot by Prospect Capital Corporation ( Prospect ) in accordance with acquisition method of accounting as detailed in ASC 805, *Business Combinations* ( ASC 805 ). The fair value of the consideration paid was allocated to the assets acquired and liabilities assumed based on their fair values as the date of acquisition. As described in more detail in ASC 805, goodwill, if any, would have been recognized as of the acquisition date, if the consideration transferred exceeded the fair value of identifiable net assets acquired. As of the acquisition date, the fair value of the identifiable net assets acquired exceeded the fair value of the consideration transferred, and we recognized the excess as a gain. A preliminary gain of \$5,714 was recorded by Prospect in the quarter ended December 31, 2009 related to the acquisition of Patriot, which was revised in the fourth quarter of Fiscal 2010, to \$7,708, when we settled severance accruals related to certain members of Patriot's top management. Under ASC 805, the adjustment to our preliminary estimates is reflected in the three and six months ended December 31, 2009 (See Note 13 to our consolidated financial statements.). The acquisition of Patriot was

negotiated in July 2009 with the purchase agreement being signed on August 3, 2009. Between July 2009 and December 2, 2009, our valuation of certain of the investments acquired from Patriot increased due to market improvement, which resulted in the recognition of the gain at closing.

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The purchase price has been allocated to the assets acquired and the liabilities assumed based on their estimated fair values as summarized in the following table:

Cash (to repay Patriot debt)	\$ 107,313
Cash (to fund purchase of restricted stock from former Patriot employees)	970
Common stock issued <sup>(1)</sup>	92,800
 Total purchase price	 201,083
 Assets acquired:	
Investments <sup>(2)</sup>	207,126
Cash and cash equivalents	1,697
Other assets	3,859
 Assets acquired	 212,682
Other liabilities assumed	(3,891)
 Net assets acquired	 208,791
 Preliminary gain on Patriot acquisition <sup>(3)</sup>	 \$ 7,708

(1) The value of the shares of common stock exchanged with the Patriot common shareholders was based upon the closing price of our common stock on December 2, 2009, the price immediately prior to the closing of the transaction.

(2) The fair value of Patriot's investments were determined by the Board of Directors in conjunction with an independent

valuation agent. This valuation resulted in a purchase price which was \$98,150 below the amortized cost of such investments. For those assets which are performing, Prospect will record the accretion to par value in interest income over the remaining term of the investment.

- (3) The preliminary gain has been determined based upon the estimated value of certain liabilities which are not yet settled. Any changes to such accruals will be recorded in future periods as an adjustment to such gain. We do not believe such adjustments will be material.

During the period from the acquisition of Patriot on December 2, 2009 to June 30, 2010, we recognized \$18,795 of interest income due to purchase discount accretion from the assets acquired from Patriot. Included in this amount is \$14,216 resulting from the acceleration of purchase discounts from the early repayments of four loans, two revolving lines of credit, sale of one investment position and restructuring of five loans.

#### **Market Conditions**

While the economy continues to show signs of recovery from the deteriorating credit markets of 2008 and 2009, there is still a level of uncertainty and volatility in the capital markets. The growth and improvement in the capital markets that began during the second half of 2009 carried over into the first quarter of 2010. While encouraged by the signs of improvement, we operate in a challenging environment that is still recovering from a recession and financial services industry negatively affected by the deterioration of credit quality in subprime residential mortgages that spread rapidly to other credit markets. Market liquidity and credit quality conditions continue to remain weaker today than three

years ago.

We believe that Prospect is well positioned to navigate through these adverse market conditions. As a business development company, we are limited to a maximum 1 to 1 debt to equity ratio, and as of June 30, 2010, we had \$180,678 available under our credit facility, of which \$100,300 was outstanding. Further, as we make additional investments that are eligible to be pledged under the credit facility, we will generate additional credit facility availability. The revolving period for our credit facility continues until June 13, 2012, with an amortization running to June 13, 2013, with interest distributions to us allowed.

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We also continue to generate liquidity through public and private stock offerings. On July 7, 2009, we completed a public stock offering for 5,175,000 shares of our common stock at \$9.00 per share, raising \$46,575 of gross proceeds. On August 20, 2009 and September 24, 2009, we issued 3,449,686 shares and 2,807,111 shares, respectively, of our common stock at \$8.50 and \$9.00 per share, respectively, in private stock offerings, raising \$29,322, and \$25,264 of gross proceeds, respectively. Concurrent with the sale of these shares, we entered into a registration rights agreement in which we granted the purchasers certain registration rights with respect to the shares. Under the terms and conditions of the registration rights agreement, we filed with the SEC a post-effective amendment to the registration statement on Form N-2 on November 6, 2009. Such amendment was declared effective by the SEC on November 9, 2009.

On March 4, 2010, our Registration Statement on Form N-2 was declared effective by the SEC. Under this Shelf Registration Statement, we can issue up to \$439,622 of additional equity securities as of June 30, 2010.

On March 17, 2010, we established an at-the-market program through which we sold shares of our common stock. An at-the-market offering is a registered offering by a publicly traded issuer of its listed equity securities selling shares directly into the market at market prices. We engaged two broker-dealers to act as agents and sell our common stock directly into the market over a period of time. We paid a 2% commission to the broker-dealer on shares sold. Through this program we issued 8,000,000 shares of our common stock at an average price of \$10.90 per share, raising \$87,177 of gross proceeds, from March 23, 2010 through July 21, 2010.

On July 19, 2010, we established a new at-the-market program, as we had sold all the shares authorized in the original at-the-market program, through which we may sell, from time to time and at our discretion, 6,000,000 shares of our common stock. We engaged three broker-dealers to act as potential agents and sell our common stock directly into the market over a period of time. We currently pay a 2% commission to the broker-dealer on shares sold. Through this program we issued 3,814,528 shares of our common stock at an average price of \$9.71 per share, raising \$37,052 of gross proceeds, from July 22, 2010 through August 24, 2010.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reported period. Changes in the economic environment, financial markets and any other parameters used in determining these estimates could cause actual results to differ.

**Fourth Quarter Highlights***Investment Transactions*

On April 7, 2010, we purchased \$12,296 of second lien notes in Seaton Corporation, a human resources services company. The second lien notes bear interest in cash at the greater of 12.5% or Libor plus 9.0% and have a final maturity on March 14, 2011.

On May 26, 2010, we purchased \$15,000 in senior notes issued by an affiliate of SkillSoft PLC, a leading Software as a Service provider of on-demand, e-learning, and performance support solutions. The senior notes bear interest in cash at 11.125% and has a final maturity on June 1, 2018.

On June 2, 2010, we made a secured second lien debt investment of \$20,000 in Hoffmaster, Inc., which primarily serves the foodservice and consumer market segments. The secured second lien debt bears interest in cash at 13.50% and has a final maturity on June 2, 2017.

On June 24, 2010, we closed a \$25,500 senior secured credit facility for EXL Acquisition Corp., a leading manufacturer and marketer of consumable lab testing equipment and supplies. The senior secured credit facility is composed of a Term A Loan and a Term B Loan. The Term A Loan bears interest in cash at [the greater of Libor plus 5.5% or, the greater of the (i) Prime Rate, (ii) the Federal Funds Rate plus 0.5% or (iii) 4.25% plus 4.5%] and has a final maturity on June 24, 2015. The Term B Loan bears interest in cash at 12.0% and interest in kind at 2.0% and has a final maturity on December 24, 2015.

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*Equity Issuance*

From April 1, 2010 to July 16, 2010, we completed the sale of the remaining 7,188,500 shares of our common stock pursuant to the March 17, 2010 equity distribution agreements, resulting in net proceeds of approximately \$75,231 after deducting related expenses including commissions.

On April 23, 2010, we issued 248,731 shares of our common stock in connection with the dividend reinvestment plan.

*Dividend*

On June 18, 2010, we announced a change in dividend policy from quarterly to monthly dividends and declared monthly dividends in the following amounts and with the following dates:

\$0.10 per share for June 2010 to holders of record on June 30, 2010 with a payment date of July 30, 2010;

\$0.10025 per share for July 2010 to holders of record on July 30, 2010 with a payment date of August 31, 2010; and

\$0.10050 per share for August 2010 to holders of record on August 31, 2010 with a payment date of September 30, 2010.

*Credit Facility*

On June 14, 2010, we closed an extension and expansion of our revolving credit facility with a syndicate of lenders. The lenders have commitments of \$210,000 under the new credit facility as of June 14, 2010. The new credit facility includes an accordion feature which allows the facility to be increased to up to \$300,000 of commitments in the aggregate to the extent additional or existing lenders commit to increase the commitments. We will seek to add additional lenders in order to reach the maximum size; although no assurance can be given we will be able to do so. As we make additional investments which are eligible to be pledged under the credit facility, we will generate additional availability to the extent such investments are eligible to be placed into the borrowing base. The revolving period of the credit facility extends through June 2012, with an additional one year amortization period (with distributions allowed) after the completion of the revolving period. During such one year amortization period, all principal payments on the pledged assets will be applied to reduce the balance. At the end of the one year amortization period, the remaining balance will become due if required by the lenders. Interest on borrowings under the credit facility is one-month Libor plus 325 basis points, subject to a minimum Libor floor of 100 basis points. Additionally, the lenders charge a fee on the unused portion of the credit facility equal to either 75 basis points if at least half of the credit facility is used or 100 basis points otherwise. The credit facility will be used, together with our equity capital, to make additional long-term investments.

The new credit facility contains restrictions pertaining to the geographic and industry concentrations of funded loans, maximum size of funded loans, interest rate payment frequency of funded loans, maturity dates of funded loans and minimum equity requirements. The new credit facility also contains certain requirements relating to portfolio performance, including required minimum portfolio yield and limitations on delinquencies and charge-offs, violation of which could result in the early termination of the new credit facility. The new credit facility also requires the maintenance of a minimum liquidity requirement.

**Recent Developments**

On July 14, 2010, we closed a \$37,400 first lien senior secured credit facility to support the acquisition by H.I.G. Capital of a leading consumer credit enhancement services company.

On July 23, 2010, we made a secured debt investment of \$21,000 in SonicWALL, Inc., a global leader in network security and data protection for small, mid-sized, and large enterprise organizations.

On July 30, 2010, we issued 83,875 shares of our common stock in connection with the dividend reinvestment plan.



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On July 30, 2010, we invested \$52,420 of combined debt and equity in AIRMALL USA Inc., a leading developer and manager of airport retail operations.

On July 30, 2010, we recapitalized our debt investment in Northwestern Management Services, LLC, a leading dental practice management company in the Southeast Florida market, providing \$10,774 of additional funding to fund the acquisition of six dental practices.

During the period from July 1, 2010 to July 21, 2010, we issued 2,748,600 shares of our common stock at an average price of \$9.75 per share, and raised \$26,799 of gross proceeds, under our at-the-market program. Net proceeds were \$26,262 after 2% commission to the broker-dealer on shares sold.

During the period from July 22, 2010 to August 24, 2010, we issued 3,814,528 shares of our common stock at an average price of \$9.71 per share, and raised \$37,052 of gross proceeds, under our at-the-market program. Net proceeds were \$36,335 after 2% commission to the broker-dealer on shares sold.

On August 26, 2010, we declared monthly dividends in the following amounts and with the following dates:

\$0.100625 per share for September 2010 to holders of record on September 30, 2010 with a payment date of October 29, 2010;

\$0.100750 per share for October 2010 to holders of record on October 29, 2010 with a payment date of November 30, 2010.

On August 26, 2010, Regional Management Corporation repaid the \$25,814 loan receivable to us.

*Critical Accounting Policies and Estimates*

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ). The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Changes in the economic environment, financial markets and any other parameters used in determining such estimates could cause actual results to differ materially. In addition to the discussion below, our critical accounting policies are further described in the notes to the financial statements.

*Basis of Consolidation*

Under the 1940 Act rules, the regulations pursuant to Article 6 of Regulation S-X, and the American Institute of Certified Public Accountants Audit and Accounting Guide for Investment Companies, we are precluded from consolidating any entity other than another investment company or an operating company which provides substantially all of its services and benefits to us. June 30, 2010 and June 30, 2009 financial statements include our accounts and the accounts of Prospect Capital Funding, LLC, our only wholly-owned, closely-managed subsidiary that is also an investment company. All intercompany balances and transactions have been eliminated in consolidation.

*Investment Classification*

We are a non-diversified company within the meaning of the 1940 Act. We classify our investments by level of control. As defined in the 1940 Act, control investments are those where there is the ability or power to exercise a controlling influence over the management or policies of a company. Control is generally deemed to exist when a company or individual possesses or has the right to acquire within 60 days or less, a beneficial ownership of 25% or more of the voting securities of an investee company. Affiliated investments and affiliated companies are defined by a lesser degree of influence and are deemed to exist through the possession outright or via the right to acquire within 60 days or less, beneficial ownership of 5% or more of the outstanding voting securities of another person.

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Investments are recognized when we assume an obligation to acquire a financial instrument and assume the risks for gains or losses related to that instrument. Investments are derecognized when we assume an obligation to sell a financial instrument and forego the risks for gains or losses related to that instrument. Specifically, we record all security transactions on a trade date basis. Investments in other, non-security financial instruments are recorded on the basis of subscription date or redemption date, as applicable. Amounts for investments recognized or derecognized but not yet settled are reported as Receivables for investments sold and Payables for investments purchased, respectively, in the Consolidated Statements of Assets and Liabilities.

*Investment Valuation*

Our Board of Directors has established procedures for the valuation of our investment portfolio. These procedures are detailed below.

Investments for which market quotations are readily available are valued at such market quotations.

For most of our investments, market quotations are not available. With respect to investments for which market quotations are not readily available or when such market quotations are deemed not to represent fair value, our Board of Directors has approved a multi-step valuation process each quarter, as described below:

- 1) Each portfolio company or investment is reviewed by our investment professionals with the independent valuation firm engaged by our Board of Directors;
- 2) the independent valuation firm conducts independent appraisals and makes their own independent assessment;
- 3) the audit committee of our Board of Directors reviews and discusses the preliminary valuation of our Investment Adviser and that of the independent valuation firm; and
- 4) the Board of Directors discusses the valuations and determines the fair value of each investment in our portfolio in good faith based on the input of our Investment Adviser, the independent valuation firm and the audit committee.

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Codification ( ASC or Codification ) 820, *Fair Value Measurements and Disclosures* ( ASC 820 ). ASC 820 defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. We adopted ASC 820 on a prospective basis beginning in the quarter ended September 30, 2008.

ASC 820 classifies the inputs used to measure these fair values into the following hierarchy:

- Level 1:** Quoted prices in active markets for identical assets or liabilities, accessible by us at the measurement date.
- Level 2:** Quoted prices for similar assets or liabilities in active markets, or quoted prices for identical or similar assets or liabilities in markets that are not active, or other observable inputs other than quoted prices.
- Level 3:** Unobservable inputs for the asset or liability.

In all cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined 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 considers factors specific to each investment.

The changes to GAAP from the application of ASC 820 relate to the definition of fair value, framework for measuring fair value, and the expanded disclosures about fair value measurements. ASC 820 applies to fair value measurements already required or permitted by other standards.

In accordance with ASC 820, the fair value of our investments is defined as the price that we would receive upon selling an investment in an orderly transaction to an independent buyer in the principal or most advantageous market in which that investment is transacted.

In April 2009, the FASB issued ASC 820-10-65, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ( ASC 820-10-65 ). This update provides further clarification for ASC 820 in markets that are not active and provides additional guidance for determining when the volume of trading level of activity for an asset or liability has significantly decreased and for identifying circumstances that indicate a transaction is not orderly. ASC 820-10-65 is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of ASC 820-10-65 for year ended June 30, 2010, did not have any effect on our net asset value, financial position or results of operations as there was no change to the fair value measurement principles set forth in ASC 820.



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In January 2010, the FASB issued Accounting Standards Update 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* (ASC 2010-06). ASU 2010-06 amends ASC 820-10 and clarifies and provides additional disclosure requirements related to recurring and non-recurring fair value measurements and employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009. Our management does not believe that the adoption of the amended guidance in ASC 820-10 will have a significant effect on our financial statements.

*Federal and State Income Taxes*

We have elected to be treated as a regulated investment company and intend to continue to comply with the requirements of the Internal Revenue Code of 1986 (the Code), applicable to regulated investment companies. We are required to distribute at least 90% of our investment company taxable income and intend to distribute (or retain through a deemed distribution) all of our investment company taxable income and net capital gain to stockholders; therefore, we have made no provision for income taxes. The character of income and gains that we will distribute is determined in accordance with income tax regulations that may differ from GAAP. Book and tax basis differences relating to stockholder dividends and distributions and other permanent book and tax differences are reclassified to paid-in capital.

If we do not distribute (or are not deemed to have distributed) at least 98% of our annual taxable income in the calendar year earned, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such taxable income for the year. To the extent that we determine that our estimated current year annual taxable income will be in excess of estimated current year dividend distributions from such taxable income, we accrue excise taxes, if any, on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

We adopted FASB ASC 740, *Income Taxes* (ASC 740). 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 our tax returns to determine whether the tax positions are more-likely-than-not of being sustained by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. Adoption of ASC 740 was applied to all open tax years as of July 1, 2007. The adoption of ASC 740 did not have an effect on our net asset value, financial condition or results of operations as there was no liability for unrecognized tax benefits and no change to our beginning net asset value. As of June 30, 2010 and for the year then ended, we did not have a liability for any unrecognized tax benefits. 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 on-going analysis of tax laws, regulations and interpretations thereof.

*Revenue Recognition*

Realized gains or losses on the sale of investments are calculated using the specific identification method. Interest income, adjusted for amortization of premium and accretion of discount, is recorded on an accrual basis. Origination, closing and/or commitment fees associated with investments in portfolio companies are accreted into interest income over the respective terms of the applicable loans. Upon the prepayment of a loan or debt security, any prepayment penalties and unamortized loan origination, closing and commitment fees are recorded as interest income. Loans are placed on non-accrual status when principal or interest payments are past due 90 days or more or when there is reasonable doubt that principal or interest will be collected. Unpaid accrued interest is generally reversed when a loan is placed on non-accrual status. Interest payments received on non-accrual loans may be recognized as income or applied to principal depending upon management's judgment. Non-accrual loans are restored to accrual status when past due principal and interest is paid and in management's judgment, are likely to remain current. As of June 30, 2010, approximately 5.6% of our net assets are in non-accrual status.

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Dividend income is recorded on the ex-dividend date.

Structuring fees and similar fees are recognized as income as earned, usually when paid. Structuring fees, excess deal deposits, net profits interests and overriding royalty interests are included in other income.

*Dividends and Distributions*

Dividends and distributions to common stockholders are recorded on the ex-dividend date. The amount, if any, to be paid as a dividend or distribution is approved by our Board of Directors each quarter and is generally based upon our management's estimate of our earnings for the quarter. Net realized capital gains, if any, are distributed at least annually.

*Financing Costs*

We record origination expenses related to our credit facility as deferred financing costs. These expenses are deferred and amortized as part of interest expense using the effective interest method over the stated life of the facility.

We record registration expenses related to shelf filings as prepaid assets. These expenses consist principally of Securities and Exchange Commission ( SEC ) registration fees, legal fees and accounting fees incurred. These prepaid assets will be charged to capital upon the receipt of an equity offering proceeds or charged to expense if no offering completed.

*Guarantees and Indemnification Agreements*

We follow FASB ASC 460, *Guarantees* ( ASC 460 ). ASC 460 elaborates on the disclosure requirements of a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires a guarantor to recognize, at the inception of a guarantee, for those guarantees that are covered by ASC 460, the fair value of the obligation undertaken in issuing certain guarantees. ASC 460 did not have a material effect on the financial statements. Refer to Note 3 and Note 11 to our consolidated financial statements for further discussion of guarantees and indemnification agreements.

*Per Share Information*

Net increase or decrease in net assets resulting from operations per common share are calculated using the weighted average number of common shares outstanding for the period presented. Diluted net increase or decrease in net assets resulting from operations per share are not presented as there are no potentially dilutive securities outstanding.

*Reclassifications*

Certain reclassifications have been made in the presentation of prior consolidated financial statements to conform to the presentation as of and for the twelve months ended June 30, 2010.

*Recent Accounting Pronouncements*

In May 2009, the FASB issued ASC 855, *Subsequent Events* ( ASC 855 ). ASC 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The standard, which includes a new required disclosure of the date through which an entity has evaluated subsequent events, is effective for interim or annual periods ending after June 15, 2009. We evaluated all events or transactions that occurred after June 30, 2010 up through the date we issued the accompanying financial statements. During this period, we did not have any material recognizable subsequent events other than those disclosed in our financial statements.

In June 2009, the FASB issued ASC 105, *Generally Accepted Accounting Principles* ( ASC 105 ), which establishes the FASB Codification which supersedes all existing accounting standard documents and will become the single source of authoritative non-governmental U.S. GAAP. All other accounting literature not included in the Codification will be considered non-authoritative. The Codification did not change GAAP but reorganizes the literature. ASC 105 is effective for interim and annual periods ending after September 15, 2009. We have conformed our financial statements and related Notes to the new Codification.

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In June 2009, the FASB issued ASC 860, *Accounting for Transfers of Financial Assets – an amendment to FAS 140* ( ASC 860 ). ASC 860 improves the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets: the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor’s continuing involvement, if any, in transferred financial assets. ASC 860 is effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Our management does not believe that the adoption of the amended guidance in ASC 860 will have a significant effect on our financial statements.

In June 2009, the FASB issued ASC 810, *Consolidation* ( ASC 810 ). ASC 810 is intended to (1) address the effects on certain provisions of FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, as a result of the elimination of the qualifying special-purpose entity concept in ASC 860, and (2) constituent concerns about the application of certain key provisions of Interpretation 46(R), including those in which the accounting and disclosures under the Interpretation do not always provided timely and useful information about an enterprise’s involvement in a variable interest entity. ASC 810 is effective as of the beginning of our first annual reporting period that begins after November 15, 2009. Our management does not believe that the adoption of the amended guidance in ASC 860 will have a significant effect on our financial statements.

In August 2009, the FASB issued Accounting Standards Update ( ASU ) 2009-05, *Measuring Liabilities at Fair Value, to amend FASB Accounting Standards Codification ASC 820, Fair Value Measurements and Disclosures* ( ASC 820 ), to clarify how entities should estimate the fair value of liabilities. ASC 820, as amended, includes clarifying guidance for circumstances in which a quoted price in an active market is not available, the effect of the existence of liability transfer restrictions, and the effect of quoted prices for the identical liability, including when the identical liability is traded as an asset. We adopted ASU 2009-05 effective October 1, 2009. The amended guidance in ASC 820 does not have a significant effect on our financial statements for the year ended June 30, 2010.

In September 2009, the FASB issued ASU 2009-12, *Measuring Fair Value of Certain Investments* ( ASU 2009-12 ). This update provides further amendments to ASC 820 to offer investors a practical expedient for measuring the fair value of investments in certain entities that calculate net asset value per share. Specifically, measurement using net asset value per share is reasonable for investments within the scope of ASU 2009-12. We adopted ASU 2009-12 effective October 1, 2009. The amended guidance in ASC 820 does not have a significant effect on our financial statements for the year ended June 30, 2010.

In January 2010, the FASB issued Accounting Standards Update 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* ( ASC 2010-06 ). ASU 2010-06 amends ASC 820-10 and clarifies and provides additional disclosure requirements related to recurring and non-recurring fair value measurements and employers’ disclosures about postretirement benefit plan assets. ASU 2010-06 is effective December 15, 2009, except for the disclosure about purchase, sales, issuances and settlements in the roll forward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. Our management does not believe that the adoption of the amended guidance in ASC 820-10 will have a significant effect on our financial statements.

In February 2010, the FASB issued Accounting Standards Update 2010-09, *Subsequent Events (Topic 855) Amendments to Certain Recognition and Disclosure Requirements* ( ASU 2010-09 ), which amends ASC Subtopic 855-10. ASU 2010-09 requires an entity that is an SEC filer to evaluate subsequent events through the date that the financial statements are issued and removes the requirement that an SEC filer disclose the date through which subsequent events have been evaluated. ASC 2010-09 was effective upon issuance. The adoption of this standard had no effect on our results of operation or our financial position.

In February 2010, the FASB issued Accounting Standards Update 2010-10, *Consolidation (Topic 810) Amendments for Certain Investments Funds* ( ASU 2010-10 ), which defers the application of the consolidation guidance in ASC 810 for certain investments funds. The disclosure requirements continue to apply to all entities. ASU 2010-10 is effective as of the beginning of the first annual period that begins after November 15, 2009 and for interim periods within that first annual period. Our management does not believe that the adoption of the amended guidance in ASU 2010-10 will have a significant effect on our financial statements.



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In August 2010, the FASB issued Accounting Standards Update 2010-21, *Accounting for Technical Amendments to Various SEC Rules and Schedules* ( ASU 2010-21 ). This Accounting Standards Update various SEC paragraphs pursuant to the issuance of Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules and Codification of Financial Reporting Policies. We are assessing the potential effect this guidance will have on our consolidated financial statements.

In August 2010, the FASB issued Accounting Standards Update 2010-22, *Accounting for Various Topics – Technical Corrections to SEC Paragraphs* ( ASU 2010-22 ). ASU 2010-22 amends various SEC paragraphs based on external comments received and the issuance of Staff Accounting Bulletin ( SAB ) 112, which amends or rescinds portions of certain SAB topics. We are assessing the potential effect this guidance will have on our consolidated financial statements.

**Investment Holdings**

As of June 30, 2010, we continue to pursue our investment strategy. Despite our name change to Prospect Capital Corporation and the termination of our policy to invest at least 80% of our net assets in energy companies in May 2007, we currently have a concentration of investments in companies in the energy and energy related industries. This concentration continues to decrease as we make investments outside of the energy and energy related industries. Some of the companies in which we invest have relatively short or no operating histories. These companies are and will be subject to all of the business risk and uncertainties associated with any new business enterprise, including the risk that these companies may not reach their investment objective or the value of our investment in them may decline substantially or fall to zero.

Our portfolio had an annualized current yield of 14.2% and 13.7% across all our long-term debt and certain equity investments as of June 30, 2010 and June 30, 2009, respectively. This yield includes interest from all of our long-term investments as well as dividends from GSHI for the year ended June 30, 2010 and GSHI and NRG for the year ended June 30, 2009. The 0.5% increase is primarily due to accretion of purchase discounts on the loans acquired from Patriot. This increase is partially offset by an increase in non-accrual loans. Monetization of other equity positions that we hold is not included in this yield calculation. In each of our portfolio companies, we hold equity positions, ranging from minority interests to majority stakes, which we expect over time to contribute to our investment returns. Some of these equity positions include features such as contractual minimum internal rates of returns, preferred distributions, flip structures and other features expected to generate additional investment returns, as well as contractual protections and preferences over junior equity, in addition to the yield and security offered by our cash flow and collateral debt protections.

We classify our investments by level of control. As defined in the 1940 Act, control investments are those where there is the ability or power to exercise a controlling influence over the management or policies of a company. Control is generally deemed to exist when a company or individual possesses or has the right to acquire within 60 days or less, a beneficial ownership of 25% or more of the voting securities of an investee company. Affiliated investments and affiliated companies are defined by a lesser degree of influence and are deemed to exist through the possession outright or via the right to acquire within 60 days or less, beneficial ownership of 5% or more of the outstanding voting securities of another person.

As of June 30, 2010, we own controlling interests in Ajax Rolled Ring & Machine ( Ajax ), AWCNC, LLC, Borga, Inc., C&J Cladding, LLC, Change Clean Energy Holdings, Inc. ( CCEHI ), Fischbein, LLC ( Fischbein ), Freedom Marine Services LLC ( Freedom Marine ), Gas Solutions Holdings, Inc. ( GSHI ), Integrated Contract Services, Inc. ( ICS ), Iron Horse Coiled Tubing, Inc. ( Iron Horse ), Manx Energy, Inc. ( Manx ), NRG Manufacturing, Inc. ( NRG ), Nupla Corporation, R-V Industries, Inc. ( R-V ), Sidump r Trailer Company, Inc. and Yatesville Coal Holdings, Inc. ( Yatesville ). We also own an affiliated interest in Biotronic NeuroNetwork ( Biotronic ), Boxercraft Incorporated ( Boxercraft ), KTPS Holdings, LLC ( KTPS ), Smart, LLC and Sport Helmets Holdings, LLC ( Sport Helmets ).



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The following is a summary of our investment portfolio by level of control:

Level of Control	June 30, 2010				June 30, 2009			
	Cost	Percent of Portfolio	Fair Value	Percent of Portfolio	Cost	Percent of Portfolio	Fair Value	Percent of Portfolio
Control	\$ 185,720	23.3%	\$ 195,958	24.0%	\$ 187,105	29.7%	\$ 206,332	31.9%
Affiliate	65,082	8.2%	73,740	9.0%	33,544	5.3%	32,254	5.0%
Non-control/Non-affiliate	477,957	59.9%	478,785	58.6%	310,775	49.3%	308,582	47.8%
Money Market Funds	68,871	8.6%	68,871	8.4%	98,735	15.7%	98,735	15.3%
Total Portfolio	\$ 797,630	100.0%	\$ 817,354	100.0%	\$ 630,159	100.0%	\$ 645,903	100.0%

The following is our investment portfolio presented by type of investment at June 30, 2010 and June 30, 2009, respectively:

Type of Investment	June 30, 2010				June 30, 2009			
	Cost	Percent of Portfolio	Fair Value	Percent of Portfolio	Cost	Percent of Portfolio	Fair Value	Percent of Portfolio
Money Market Funds	\$ 68,871	8.6%	\$ 68,871	8.4%	\$ 98,735	15.7%	\$ 98,735	15.3%
Revolving Line of Credit	4,754	0.6%	5,017	0.6%		%		%
Senior Secured Debt	313,755	39.4%	287,470	35.2%	232,534	36.9%	220,993	34.2%
Subordinated Secured Debt	333,453	41.8%	313,511	38.4%	251,292	39.9%	194,547	30.1%
Subordinated Unsecured Debt	30,209	3.8%	30,895	3.8%	15,065	2.4%	16,331	2.5%
Preferred Stock	16,969	2.1%	5,872	0.7%	10,432	1.6%	4,139	0.7%
Common Stock	20,243	2.5%	77,131	9.4%	16,310	2.6%	89,278	13.8%
Membership Interests	6,964	0.9%	17,730	2.2%	3,031	0.5%	7,270	1.1%
Overriding Royalty Interests		%	2,768	0.3%		%	3,483	0.5%
Net Profit Interests		%	1,020	0.1%		%	2,561	0.4%
Warrants	2,412	0.3%	7,069	0.9%	2,760	0.4%	8,566	1.4%
Total Portfolio	\$ 797,630	100.0%	\$ 817,354	100.0%	\$ 630,159	100.0%	\$ 645,903	100.0%

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The following is our investment portfolio presented by geographic location of the investment at June 30, 2010 and June 30, 2009, respectively:

<b>Geographic Location</b>	<b>June 30, 2010</b>				<b>June 30, 2009</b>			
	<b>Cost</b>	<b>Percent of Portfolio</b>	<b>Fair Value</b>	<b>Percent of Portfolio</b>	<b>Cost</b>	<b>Percent of Portfolio</b>	<b>Fair Value</b>	<b>Percent of Portfolio</b>
Canada	\$ 21,002	2.6%	\$ 12,054	1.5%	\$ 19,344	3.1%	\$ 12,606	2.0%
Ireland	14,903	1.9%	15,000	1.8%		%		%
Netherlands	1,397	0.2%	1,233	0.2%		%		%
Midwest US	170,869	21.5%	167,571	20.5%	77,681	12.3%	84,097	13.0%
Northeast US	61,813	7.7%	62,727	7.7%	44,875	7.1%	47,049	7.3%
Southeast US	193,420	24.2%	171,144	20.9%	164,652	26.1%	101,710	15.7%
Southwest US	179,641	22.6%	235,945	28.9%	178,993	28.4%	253,615	39.3%
Western US	85,714	10.7%	82,809	10.1%	45,879	7.3%	48,091	7.4%
Money Market Funds	68,871	8.6%	68,871	8.4%	98,735	15.7%	98,735	15.3%
<b>Total Portfolio</b>	<b>\$ 797,630</b>	<b>100.0%</b>	<b>\$ 817,354</b>	<b>100.0%</b>	<b>\$ 630,159</b>	<b>100.0%</b>	<b>\$ 645,903</b>	<b>100.0%</b>

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The following is our investment portfolio presented by industry sector of the investment at June 30, 2010 and June 30, 2009, respectively:

Industry	June 30, 2010			June 30, 2009			Percent of Portfolio	
	Cost	Percent of Portfolio	Fair Value	Percent of Portfolio	Cost	Fair Value		
Aerospace and Defense	\$ 56	%	\$ 38	%			%	
Automobile	19,017	2.4%	18,615	2.3%			%	
Biomass Power	2,383	0.3%		%	2,530	0.4%	2,530	0.4%
Business Services	12,060	1.5%	12,132	1.5%			%	
Chemical	1,397	0.2%	1,233	0.2%			%	
Construction Services		%		%	5,017	0.8%	2,408	0.4%
Contracting	16,652	2.1%	4,542	0.6%	16,652	2.6%	5,000	0.8%
Durable Consumer Products	20,000	2.5%	20,000	2.4%		%		%
Ecological	141	%	340	%		%		%
Electronics	25,777	3.2%	25,629	3.1%		%		%
Financial Services	25,814	3.2%	25,592	3.1%	25,424	4.0%	23,073	3.6%
Food Products	53,681	6.7%	60,882	7.4%	27,413	4.4%	29,416	4.6%
Gas Gathering and Processing	37,503	4.7%	93,096	11.4%	35,003	5.6%	85,187	13.2%
Healthcare	89,026	11.2%	93,593	11.5%	57,535	9.1%	60,293	9.3%
Home and Office Furnishings, Housewares and Durable	14,112	1.8%	17,232	2.1%		%		%
Insurance	5,811	0.7%	5,952	0.7%		%		%
Machinery	15,625	2.0%	17,776	2.2%		%		%
Manufacturing	74,961	9.4%	64,784	7.9%	90,978	14.4%	110,929	17.2%
Metal Services and Minerals	19,252	2.4%	33,620	4.1%	3,302	0.5%	7,133	1.1%
Mining, Steel, Iron and Non-Precious Metals and Coal Production	1,130	0.1%	808	0.1%	48,890	7.8%	13,097	2.0%
Oil and Gas Production	122,034	15.3%	96,988	11.9%	104,183	16.5%	104,806	16.2%
Oilfield Fabrication	30,429	3.8%	30,429	3.7%	34,247	5.4%	34,931	5.4%
Personal and Nondurable Consumer Products	14,387	1.8%	20,049	2.5%		%		%
Pharmaceuticals	11,955	1.5%	12,000	1.5%	11,949	2.0%	11,452	1.8%
Prepackaged Software	14,903	1.9%	15,000	1.8%		%		%
Printing and Publishing	5,222	0.7%	5,284	0.6%		%		%

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Production Services	21,002	2.6%	12,054	1.5%	19,344	3.1%	12,606	1.9%
Retail	14,669	1.8%	2,148	0.3%	14,623	2.3%	6,272	1.0%
Shipping Vessels	10,040	1.3%	3,583	0.4%	7,160	1.1%	7,381	1.1%
Specialty Minerals	15,814	2.1%	18,463	2.3%	15,814	2.5%	18,924	2.9%
Technical Services	11,387	1.4%	11,615	1.4%	11,360	1.8%	11,730	1.8%
Textiles and Leather	22,519	2.8%	25,006	3.1%		%		%
Money Market Funds	68,871	8.6%	68,871	8.4%	98,735	15.7%	98,735	15.3%
Total Portfolio	\$ 797,630	100.0%	\$ 817,354	100.0%	\$ 630,159	100.0%	\$ 645,903	100.0%

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**Investment Activity**

At June 30, 2010, approximately 105.3% of our net assets or about \$748,483 was invested in 58 long-term portfolio investments and 9.7% of our net assets invested in money market funds. Liabilities in excess of other assets offset the excess of these amounts over 100%.

**Long-Term Portfolio Investment Activity**

During the year ended June 30, 2010, we acquired \$207,126 of investments from Patriot, completed follow-on investments in existing portfolio companies totaling approximately \$150,111, and recorded PIK interest of \$7,551, resulting in gross investment originations with a cost basis of \$364,788. The more significant of these investments are described briefly in the following:

During the year ended June 30, 2010, we made follow-on secured debt investments of \$1,708 in Iron Horse in support of the build out of additional equipment and to fund working capital requirements. Effective January 1, 2010, we restructured our senior secured and bridge loans to Iron Horse. Our loans were replaced with three new tranches of senior secured debt.

During the year ended June 30, 2010, we provided additional fundings of \$3,376 to Yatesville to fund ongoing operations.

During the year ended June 30, 2010, we made follow-on secured subordinated debt investments of \$3,530 in Ajax.

On October 5, 2009 we purchased an additional secured debt investment of \$1,675 in Resco Products, Inc. ( Resco ) at a discount of \$670, increasing our cost basis by \$1,005 in this investment.

On December 2, 2009, we acquired portfolio investments with a face amount of \$289,030 for \$207,126 from Patriot.

On March 31, 2010, we made a follow-on secured debt investment of \$9,000 in H&M Oil & Gas ( H&M ) to fund ongoing operations including completion of several previously drilled oil wells.

On March 31, 2010, we made a \$36,322 investment in Shearer s Foods, Inc. ( Shearer s ) for which we received \$35,000 of junior secured debt and \$1,322 of membership interests.

On January 19, 2010, we restructured our debt investment in Appalachian Energy Holdings LLC ( AEH ) and Coalbed, LLC ( Coalbed ) under Manx, a newly formed entity. We funded \$2,800 at closing to Manx to provide working capital.

On April 7, 2010, we purchased \$12,296 of second lien notes in Seaton Corporation, a human resources services company. The second lien notes bear interest in cash at the greater of 12.5% or Libor plus 9.0% and have a final maturity on March 14, 2011.

On May 26, 2010, we purchased \$15,000 in senior notes issued by an affiliate of SkillSoft PLC, a leading Software as a Service provider of on-demand, e-learning, and performance support solutions. The senior notes bear interest in cash at 11.125% and has a final maturity on June 1, 2018.

On June 2, 2010, we made a secured second lien debt investment of \$20,000 in Hoffmaster, Inc. ( Hoffmaster ), which primarily serves the foodservice and consumer market segments. The secured second lien debt bears interest in cash at 13.50% and has a final maturity on June 2, 2017.

On June 24, 2010, we closed a \$25,500 senior secured credit facility for EXL Acquisition Corp. ( EXL ), a leading manufacturer and marketer of consumable lab testing equipment and supplies. The senior secured credit facility is composed of a Term A Loan and a Term B Loan. The Term A Loan bears interest in cash at [the greater of Libor plus 5.5% or, the greater of the (i) Prime Rate, (ii) the Federal Funds Rate plus 0.5% or (iii) 4.25% plus 4.5%] and has a final maturity on June 24, 2015. The Term B Loan bears interest in cash at 12.0% and interest in kind at 2.0% and has a final maturity on December 24, 2015.

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During the year ended June 30, 2010, we closed-out ten positions which are briefly described below.

On August 31, 2009, C&J Cladding, LLC repaid the \$3,150 loan receivable to us and we received an additional 5% prepayment penalty totaling \$158. We continue to hold warrants for common units in this investment.

On September 4, 2009, Peerless Manufacturing Co. repaid the \$20,000 loan receivable to us.

On December 4, 2009, CS Operating, LLC repaid the \$4,460 loan receivable to us.

On December 10, 2009, Resco repaid the \$11,425 loan receivable to us.

On December 17, 2009, ADAPCO, Inc. repaid the \$7,466 loan receivable to us. We continue to hold warrants for common stock in this investment.

On December 18, 2009, Quartermaster, Inc. repaid the \$11,274 loan receivable to us.

On December 31, 2009, we sold our investment in Aylward Enterprises, LLC for net amount of \$4,775.

On March 31, 2010, Shearer's repaid the \$18,000 loan receivable to us.

On April 9, 2010, Custom Direct repaid the \$3,603 loan receivable to us.

On May 11, 2010, Caleel and Hayden, LLC, repaid the \$12,659 loan receivable to us.

During the year ended June 30, 2010, we also received principal amortization payments of \$23,285 on several loans.

During the year ended June 30, 2010, we restructured our loans to Aircraft Fasteners International, LLC ( AFI ), EXL, LHC Holdings Corp. ( LHC ), Prince Mineral Company, Inc. ( Prince ) and R-O-M Corporation ( ROM ). The revised terms were more favorable than the original terms and increased the present value of the future cash flows. In accordance with ASC 320-20-35 the cost basis of the new loans were recorded at par value, which included \$8,099 of accelerated original purchase discount recognized as interest income.

On September 30, 2008, we settled our net profits interests ( NPIs ) in IEC Systems LP ( IEC ) and Advanced Rig Services LLC ( ARS ) with the companies for a combined \$12,576. IEC and ARS originally issued the NPIs to us when we loaned a combined \$25,600 to IEC and ARS on November 20, 2007. In conjunction with the NPI realization, we recognized other income of \$12,576 and simultaneously reinvested the \$12,576 as incremental senior secured debt in IEC and ARS. The incremental debt will amortize over the period ending November 20, 2010.

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The following is a quarter-by-quarter summary of our investment activity:

<b>Quarter-End</b>	<b>Acquisitions<sup>(1)</sup></b>	<b>Dispositions<sup>(2)</sup></b>
June 30, 2010	\$ 88,973	\$ 39,883
March 31, 2010	59,311	26,603
December 31, 2009 <sup>(3)</sup>	210,438	45,494
September 30, 2009	6,066	24,241
June 30, 2009	7,929	3,148
March 31, 2009	6,356	10,782
December 31, 2008	13,564	2,128
September 30, 2008	70,456	10,949
June 30, 2008	118,913	61,148
March 31, 2008	31,794	28,891
December 31, 2007	120,846	19,223
September 30, 2007	40,394	17,949
June 30, 2007	130,345	9,857
March 31, 2007	19,701	7,731
December 31, 2006	62,679	17,796
September 30, 2006	24,677	2,781
June 30, 2006	42,783	5,752
March 31, 2006	15,732	901
December 31, 2005		3,523
September 30, 2005	25,342	
June 30, 2005	17,544	
March 31, 2005	7,332	
December 31, 2004	23,771	32,083
September 30, 2004	30,371	
Since inception	\$ 1,175,317	\$ 370,863

(1) Includes new deals, additional fundings, refinancings and PIK interest

(2) Includes scheduled principal payments, prepayments and repayments

(3) The \$210,438 of acquisitions for the quarter ended

December 31,  
2009 includes  
\$207,126 of  
portfolio  
investments  
acquired from  
Patriot.



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**Investment Valuation**

In determining the fair value of our portfolio investments at June 30, 2010 the Audit Committee considered valuations from the independent valuation firm and from management having an aggregate range of \$726,588 to \$798,597, excluding money market investments.

In determining the range of value for debt instruments, management and the independent valuation firm generally shadow rated the investment and then based upon the range of ratings, determined appropriate yields to maturity for a loan rated as such. A discounted cash flow analysis was then prepared using the appropriate yield to maturity as the discount rate, yielding the ranges. For equity investments, the enterprise value was determined by applying EBITDA multiples for similar recent investment sales. For stressed equity investments, a liquidation analysis was prepared.

The Board of Directors looked at several factors in determining where within the range to value the asset including: recent operating and financial trends for the asset, independent ratings obtained from third parties and comparable multiples for recent sales of companies within the industry. The composite of all these analysis, applied to each investment, was a total valuation of \$748,483, excluding money market investments.

Our portfolio companies are generally lower middle market companies, outside of the financial sector, with less than \$50,000 of annual EBITDA. We believe our market has experienced less volatility than others because we believe there are more buy and hold investors who own these less liquid investments.

During the year ended June 30, 2010, there has been a general improvement in the markets in which we operate, and market rates of interest negotiated for middle market loans have decreased.

Control investments often offer increased risk and reward over straight debt investments. Operating results and changes in market multiples can result in significant changes in values from quarter to quarter. Significant downturns in operations can further result in our looking to recoveries on sales of assets rather than the enterprise value of the investment. A few of the control investments in our portfolio are discussed below.

*Ajax Rolled Ring & Machine, Inc.*

We acquired a controlling equity interest in Ajax in a recapitalization of the company that was closed on April 4, 2008. We funded \$22,000 of senior secured term debt, \$11,500 of subordinated term debt and \$6,300 of equity as of that closing. During the fiscal year ended June 30, 2010, we funded an additional \$3,530 of secured subordinated debt to refinance a third-party revolver provider and provide working capital. As of June 30, 2010, we control 78.1% of the fully-diluted common and preferred equity.

Ajax forges seamless steel rings sold to various customers. The rings are used in a range of industrial applications, including in construction equipment and wind power turbines. Ajax's business is cyclical, and the business experienced a significant decline in the first half of 2009 in light of the global macroeconomic crisis. The second half of 2009 and to-date 2010 show steady improvement versus the first half of 2009. At June 30, 2010, Ajax had a backlog of new business that would indicate continued improvement for 2010.

The Board of Directors decreased the fair value of our investment in Ajax to \$30,904 as of June 30, 2010, a reduction of \$13,006 from its amortized cost, compared to the \$7,581 unrealized depreciation recorded at June 30, 2009.

*Change Clean Energy Holdings Inc. and Change Clean Energy, Inc., f/k/a Worcester Energy Partners, Inc.*

Change Clean Energy, Inc. ( CCEI ) is an investment, that we originated in September 2005, which owns and operated a biomass energy plant. In March 2009, CCEI ceased operations, as the business became uneconomic based on the cost of materials and the price being received for the electricity generated. During that quarter, we instituted foreclosure proceedings against the co-borrowers of our debt. In anticipation of such proceedings, CCEHI was established. On March 11, 2009, the foreclosure was completed and the assets were assigned to a wholly owned subsidiary of CCEHI. During the year ended June 30, 2010, we provided additional funding of \$296 to CCEHI to fund ongoing operations. CCEI currently has no material operations. At June 30, 2009 we determined that the impairment at both CCEI and CCEHI was other than temporary and recognized a realized loss of \$41,134, which was the amount by which the amortized cost exceeded the fair value. At June 30, 2010, our Board of Directors, under recommendation from senior management, has set the value of the CCEHI investment with no value, a reduction of \$2,383 from its amortized cost after the recognized depreciation.



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*Gas Solutions Holdings, Inc.*

GSHI is an investment that we completed in September 2004 in which we own 100% of the equity. GSHI is a midstream gathering and processing business located in east Texas. GSHI has improved its operations and we have experienced an increase in revenue, gross margin, and EBITDA (the later two metrics on both an absolute and a percentage of revenues basis) over the past five years.

During the past two years, we have held discussions with multiple interested purchasers for Gas Solutions. While we wish to unlock the value in Gas Solutions, we do not wish to enter into any agreement at any time that does not recognize the long term value we see in Gas Solutions. As a well-hedged midstream asset, which we expect to generate recurring cash flows to us, Gas Solutions is a valuable asset that we wish to sell at a value-maximizing price, or not at all. In addition, a sale of the assets, rather than the stock of GSHI, might result in a significant tax liability at the GSHI level which would need to be paid prior to any distribution to us.

In February 2010, we hired Robert Bourne as President and CEO of Gas Solutions. Mr. Bourne has over 30 years of experience in the midstream sector, including gathering and processing, gas purchasing, storing and trading; producer services; and business development mergers and acquisitions. He served most recently at Energy Transfer, where he managed Houston Pipeline, among other activities. Mr. Bourne is focusing on our upside plant projects and seeking new opportunities to help Gas Solutions grow beyond its existing footprint.

In April 2010, Gas Solutions purchased a series of propane puts with strike prices of \$1.00 per gallon and \$0.95 per gallon covering the periods May 1, 2010, through April 30, 2011, and May 1, 2011, through April 30, 2012, respectively. Gas Solutions hedged approximately 85% of its current exposure to natural gas liquids based on current plant volumes. These hedges will reduce the volatility on earnings associated with lower prices of natural gas liquids without limiting the upside from higher prices, helping GSHI to continue to generate sufficient cash flow to make interest and dividend payments.

In determining the value of GSHI, we have utilized two valuation techniques to determine the value of the investment. Our Board of Directors has determined the value to be \$93,096 for our debt and equity positions at June 30, 2010 based upon a combination of a discounted cash flow analysis and a public comparables analysis. At June 30, 2010 and June 30, 2009, GSHI was valued \$55,593 and \$50,184 above its amortized cost, respectively.

*Integrated Contract Services, Inc.*

ICS is an investment that we completed in April 2007. Prior to January 2009, ICS owned the assets of ESA Environmental Specialists, Inc. ( ESA ) and 100% of the stock of The Healing Staff ( THS ). ESA originally defaulted under our contract governing our investment in ESA, prompting us to commence foreclosure actions with respect to certain ESA assets in respect of which we have a priority lien. In response to our actions, ESA filed voluntarily for reorganization under the bankruptcy code on August 1, 2007. On September 20, 2007, the U.S. Bankruptcy Court approved a Section 363 Asset Sale from ESA to us. To complete this transaction, we contributed our ESA debt to a newly-formed entity, ICS, and provided funds for working capital on October 9, 2007. In return for the ESA debt, we received senior secured debt in ICS of equal amount to our ESA debt, preferred stock of ICS, and 49% of the ICS common stock. ICS subsequently ceased operations and assigned the collateral back to us. ICS is in default of both payment and financial covenants. During September and October 2007, we provided \$1,170 to THS for working capital.

In January 2009, we foreclosed on the real and personal property of ICS. Through this foreclosure process, we gained 100% ownership of THS and certain ESA assets. Based upon an analysis of the liquidation value of the ESA assets and the enterprise value of THS, our Board of Directors determined the fair value of our investment in ICS to be \$4,542 at June 30, 2010, a reduction of \$12,110 from its amortized cost, compared to the \$11,652 unrealized loss recorded at June 30, 2009.

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*Iron Horse Coiled Tubing, Inc.*

Iron Horse is an investment that we completed in April 2006. Iron Horse had been a provider of coiled tubing subcontractor services prior to making a strategic decision in late 2007 to directly service natural gas and oil producers in the Western Canadian Sedimentary Basin ( WCSB ) as a fracturing services provider. As a result of the business transition, the Company's 2008 financial performance declined significantly from 2007 levels. Iron Horse completed its transition from a subcontractor to a direct service provider in 2009, but natural gas prices declined to trough levels due to the recession and heightened natural gas inventory levels. Since November 2009, Iron Horse has experienced increased activity in the WCSB and is now completing wells for several large producers in the WCSB.

Prior to December 31, 2007, we owned 8.5% of the common stock in Iron Horse. On December 31, 2007, we received an additional 50.3% of the common stock in Iron Horse, which increased our total ownership to 58.8%. Through a series of subsequent loans that were used to construct equipment and facilitate the transition from a subcontractor to a direct service provider, we secured an additional 21.0% of the common stock in Iron Horse in September 2008, which increased our total ownership to 79.8% of the common stock in Iron Horse.

Effective January 1, 2010, we restructured our senior secured and bridge loans to Iron Horse and we reorganized Iron Horse's management structure. Our loans were replaced with three new tranches of senior secured debt and our total ownership of Iron Horse decreased to 70.4%. Our equity ownership will incrementally decrease as debt tranches are repaid upon maturity. There was no change to fair value at the time of restructuring, and we continue to fully reserve any income accrued for Iron Horse.

The Board of Directors wrote-down the fair value of our investment in Iron Horse to \$12,054 as of June 30, 2010, a reduction of \$8,948 from its amortized cost, compared to the \$6,738 unrealized depreciation recorded at June 30, 2009.

*Manx Energy, Inc.*

On January 19, 2010, we modified the terms of our senior secured debt in AEH and Coalbed in conjunction with the formation of Manx Energy, a new entity consisting of the assets of AEH, Coalbed and Kinley Exploration. The assets of the three companies were combined under new common management. We funded \$2,800 at closing to Manx to provide for working capital. A portion of our loans to AEH and Coalbed was exchanged for Manx preferred equity, while our AEH equity interest was converted into Manx common stock. There was no change to fair value at the time of restructuring, and we continue to fully reserve any income accrued for Manx.

The Board of Directors wrote-down the fair value of our investment in Manx to \$4,686 as of June 30, 2010, a reduction of \$13,584 from its amortized cost, compared to the \$5,380 unrealized depreciation, for AEH and Coalbed combined, recorded at June 30, 2009.

*Yatesville Coal Holdings, Inc.*

All of our coal holdings have been consolidated under the Yatesville entity. Yatesville delivered improved operating results after the consolidation of the coal holdings, but the company mined its permitted reserves in December 2008 and has not produced meaningful revenues since then. We continue to evaluate strategies for Yatesville, such as soliciting indications of interest regarding a transaction involving part or all of recoverable reserves. During the year ended June 30, 2010, we provided additional funding of \$3,376 to Yatesville to fund ongoing operations, including new permitting. During the quarter ended December 31, 2009, we discontinued operations at Yatesville. At December 31, 2009, our Board of Directors determined that, consistent with the decision to discontinue operations, the impairment of Yatesville was other than temporary, and we recorded a realized loss of \$51,228, which was the amount that the amortized cost exceeded the fair value at December 31, 2009. As of June 30, 2010, our Board of Directors set the value of the remaining Yatesville investment at \$809, which represents the residual value of recoverable reserves, a reduction of \$12,288 from its value as of June 30, 2009.

Equity positions in the portfolio are susceptible to potentially significant changes in value, both increases as well as decreases, due to changes in operating results. Four control investments have experienced such volatility - Fischbein and GSHI with improved operating results and NRG and R-V with declining operating results. Nine of the remaining controlled investments have experienced operating challenges and have been valued at significant discounts to the original investment.



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The affiliate investments continue to report strong operating results, with valuations increasing significantly for two investments subsequent to the acquisition of Patriot Boxercraft and Sport Helmets.

With the non-control/non-affiliate investments, generally, there is less volatility related to our total investments because our equity positions tend to be smaller than with our control/affiliate investments, and debt investments are generally not as susceptible to large swings in value as equity investments. For debt investments, the fair value is limited on the high side to each loan's par value, plus any prepayment premia that could be imposed. Many of the debt investments in this category have not experienced a significant change in value, as they were previously valued at or near par value. The exception to this categorization relates to investments which were acquired in the Patriot Acquisition, many of which were acquired at significant discounts to par value, and any changes in operating results or interest rates can have a significant effect on the value of such investments. AFI, Copernicus Group, Impact Products, LLC, Mac & Massey Holdings, LLC and Prince experienced meaningful increases in valuations. AFI, Deb Shops, Inc. ( Deb Shops ), H&M and Wind River Resources Corp. and Wind River II Corp. ( Wind River ) experienced decreases in valuations due to declines in their operating results. Shearer's completed a significant acquisition, which is driving the operating results and the increase in the value of the investment. For one investment, Miller Petroleum, Inc., we have held warrants in the company, and there has been a significant increase in the price per share of the company's stock, driving the increase in the value of our investment. The remaining investments did not experience significant changes in operations or valuation.

During the year ended June 30, 2010, we restructured our loans to AFI, EXL, LHC, Prince and ROM. The revised terms were more favorable than the original terms and increased the present value of the future cash flows. The cost bases of the new loans were recorded at par value, which included \$8,099 of accelerated original purchase discount recognized as interest income.

**Capitalization**

Our investment activities are capital intensive and the availability and cost of capital is a critical component of our business. We capitalize our business with a combination of debt and equity. Our debt is currently consists of a revolving credit facility availing us of the ability to borrow debt subject to borrowing base determinations and our equity capital is currently comprised entirely of common equity.

On June 25, 2009, we completed a first closing on an expanded \$250,000 syndicated revolving credit facility (the Facility ). The Facility included an accordion feature which allowed the Facility to accept up to an aggregate total of \$250,000 of commitments for which we had \$210,000 of commitments from six lenders when the Facility was renegotiated. The revolving period of the Facility extended through June 2010, with an additional one year amortization period after the completion of the revolving period.

On June 11, 2010, we closed an extension and expansion of our revolving credit facility with a syndicate of lenders. The lenders have commitments of \$210 million under the new credit facility as of June 11, 2010. The new credit facility includes an accordion feature which allows the facility to be increased to up to \$300 million of commitments in the aggregate to the extent additional or existing lenders commit to increase the commitments. We will seek to add additional lenders in order to reach the maximum size; although no assurance can be given we will be able to do so. As we make additional investments which are eligible to be pledged under the credit facility, we will generate additional availability to the extent such investments are eligible to be placed into the borrowing base. The revolving period of the credit facility extends through June 2012, with an additional one year amortization period (with distributions allowed) after the completion of the revolving period. During such one year amortization period, all principal payments on the pledged assets will be applied to reduce the balance. At the end of the one year amortization period, the remaining balance will become due if required by the lenders.

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As of June 30, 2010 and 2009, we had \$180,678 and \$125,746 available to us for borrowing under our credit facility, of which \$100,300 and \$124,800 was outstanding, respectively. Interest on borrowings under the credit facility was one-month Libor plus 250 basis points prior to June 25, 2009, increasing to one-month Libor plus 400 basis points, subject to a minimum Libor floor of 200 basis points for the period from June 26, 2009 to June 10, 2010 and thereafter. The maintenance of this facility requires us to pay a fee for the amount not drawn upon. Prior to June 25, 2009, this fee was assessed at the rate of 37.5 basis points per annum of the amount of that unused portion. For the period from June 26, 2010 to June 10, 2010, this rate increased to 100 basis points per annum. After June 11, 2010, the lenders charge a fee on the unused portion of the credit facility equal to either 75 basis points if at least half of the credit facility is used or 100 basis points otherwise. The following table shows the facility amounts and outstanding borrowings at June 30, 2010 and June 30, 2009:

	June 30, 2010		June 30, 2009	
	Facility Amount	Amount Outstanding	Facility Amount	Amount Outstanding
Revolving Credit Facility	\$ 210,000	\$ 100,300	\$ 175,000	\$ 124,800

	Payments Due By Period		
	Less Than 1 Year	1-3 Years	More Than 3 Years
Revolving Credit Facility	\$	\$ 100,300	\$

Concurrent with the extension of our revolving credit facility, we wrote off \$759 of the unamortized debt issue costs associated with the original credit facility, in accordance with ASC 470-50, *Debt Modifications and Extinguishments*. During the year ended June 30, 2009, we completed three stock offerings and raised \$100,304 of additional equity by issuing 12,942,500 shares of our common stock below net asset value diluting shareholder value by \$2.06 per share. The following table shows the calculation of net asset value per share as of June 30, 2010 and June 30, 2009:

	As of June 30, 2010	As of June 30, 2009
Net Assets	\$ 710,685	\$ 532,596
Shares of common stock outstanding	69,086,862	42,943,084
Net asset value per share	\$ 10.29(1)	\$ 12.40

(1) Our most recently estimated NAV per share is \$10.22 on an as adjusted basis solely to give effect to our issuance of common shares on July 30, 2010 in connection with our dividend

reinvestment plan, and issuances during the period from July 1, 2010 to August 24, 2010 under the ATM Program, versus \$10.29 determined by us as of June 30, 2010. NAV as of August 30, 2010 may be higher or lower than \$10.22 based on potential changes in valuations. Our Board of Directors has not yet determined the fair value of portfolio investments subsequent to June 30, 2010. Our Board of Directors determines the fair value of our portfolio investments on a quarterly basis in connection with the preparation of quarterly financial statements and based on input from an independent valuation firm, our Investment Advisor and the audit committee of our Board of Directors.



At June 30, 2010, we had 69,086,862 shares of our common stock outstanding.

**Results of Operations**

Net increase in net assets resulting from operations for the years ended June 30, 2010, 2009 and 2008 was \$18,886, \$35,104 and \$27,591, respectively, representing \$0.32, \$1.11 and \$1.17 per weighted average share, respectively. During the year ended June 30, 2010, we experienced net unrealized and realized losses of \$47,565 or approximately \$0.80 per weighted average share primarily from the write-downs of our investments in Freedom Marine, H&M, Iron Horse, NRG, R-V and Yatesville. During the year ended June 30, 2009, we experienced net unrealized and realized losses of \$24,059 or approximately \$0.76 per weighted average share primarily from the write-downs of our investments in CCEI and Yatesville. During the year ended June 30, 2008, we experienced net unrealized and realized losses of \$17,522 or approximately \$0.74 per weighted average share primarily from the sales of our investments in Advantage Oilfield Group and Central Illinois Energy at a loss.

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During the last quarter of the fiscal year ended June 30, 2009 and the fiscal year ended June 30, 2010, we have raised a significant amount of equity capital, which was used in part to fund the Patriot Acquisition, but has not yet been fully invested. As a result, our use of the credit facility has been less during the fiscal year ended June 30, 2010 and the excess cash on hand tends to depress our earnings per share. We continue to deploy our debt and equity raised into new investments.

To further illustrate the effects, for the fiscal year ended June 30, 2010 compared to the fiscal year ended June 30, 2009, weighted average shares outstanding have increased from 31,559,905 to 59,429,222, or 88.31%, while the average debt principal of investments increased from \$525,144 to \$633,275, or 20.1%. Partially offsetting this effect on EPS is the increase in the weighted interest rate earned on debt investments from 12.0% for the fiscal year ended June 30, 2009 to 13.7% for the fiscal year ended June 30, 2010.

While we seek to maximize gains and minimize losses, our investments in portfolio companies can expose our capital to risks greater than those we may anticipate. These companies are typically not issuing securities rated investment grade, have limited resources, have limited operating history, have concentrated product lines or customers, are generally private companies with limited operating information available and are likely to depend on a small core of management talents. Changes in any of these factors can have a significant impact on the value of the portfolio company.

**Investment Income**

We generate revenue in the form of interest income on the debt securities that we own, dividend income on any common or preferred stock that we own, and amortized loan origination fees on the structuring of new deals. Our investments, if in the form of debt securities, will typically have a term of one to ten years and bear interest at a fixed or floating rate. To the extent achievable, we will seek to collateralize our investments by obtaining security interests in our portfolio companies' assets. We also may acquire minority or majority equity interests in our portfolio companies, which may pay cash or in-kind dividends on a recurring or otherwise negotiated basis. In addition, we may generate revenue in other forms including prepayment penalties and possibly consulting fees. Any such fees generated in connection with our investments are recognized as earned.

Investment income, which consists of interest income, including accretion of loan origination fees and prepayment penalty fees, dividend income and other income, including settlement of net profits interests, overriding royalty interests and structuring fees, was \$113,635, \$100,481, and \$79,402 for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. The primary driver of the increase from Fiscal 2009 to Fiscal 2010 is the acquisition of additional assets from Patriot and other new investments which increased interest income for the second half of the year. This increase is partially offset by a decline in dividend income from GSHI. Drivers of the increase from fiscal 2008 to fiscal 2009 include increased assets generating increased interest and dividend income along with increased income from royalty and settlement of net profits interests. The following table describes the various components of investment income and the related levels of debt investments:

	<b>Year Ended June 30, 2010</b>	<b>Year Ended June 30, 2009</b>	<b>Year Ended June 30, 2008</b>
Interest income	\$ 86,518	\$ 62,926	\$ 59,033
Dividend income	15,366	22,793	12,033
Other income	11,751	14,762	8,336
<b>Total investment income</b>	<b>\$ 113,635</b>	<b>\$ 100,481</b>	<b>\$ 79,402</b>
Average debt principal of investments	\$ 633,275	\$ 525,144	\$ 397,913
Weighted-average interest rate earned	13.7%	12.0%	14.8%



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Total investment income has increased from \$79,402 for the year ended June 30, 2008 to \$100,481 for the year ended June 30, 2009 to \$113,635 for the year ended June 30, 2010. Investment income has been increasing as we continue to deploy the additional capital, raised in both debt and equity offerings, in revenue-producing assets.

Average interest income producing assets have increased from \$397,913 for the year ended June 30, 2008 to \$525,144 for the year ended June 30, 2009 to \$633,275 for the year ended June 30, 2010. The average yield on interest bearing assets increased from 12.0% for the year ended June 30, 2009 to 13.7% for the year ended June 30, 2010. This increase is primarily the result of higher interest rates earned on the assets acquired in the Patriot acquisition (including discount accretion). Average yields on interest bearing assets decreased from 14.8% for the year ended June 30, 2008 to 12.0% for the year ended June 30, 2009. This decrease was the result of our increasing our asset mix in financings with private equity sponsors. We believe that such financings offer less risk, and consequently lower yields, due, in part, to lesser risk to our capital resulting from larger equity at risk underneath our capital. Holding these types of investments has allowed us to more effectively utilize our credit facility to finance such assets at an average rate of 5.8%, 3.8 and 5.7% for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. Additionally, during the years ended June 30, 2010 and June 30, 2009, interest of \$19,764 and \$18,746, respectively, was foregone on non-accrual debt investments compared to \$3,449 of foregone interest for the year ended June 30, 2008. Without these adjustments, the weighted average interest rates earned on debt investments would have been 17.3%, 15.6% and 15.7% for the years ended June 30, 2010, 2009 and 2008, respectively.

Investment income is also generated from dividends and other income. Dividend income grew significantly from \$12,033 for the year ended June 30, 2008 to \$22,793 for the year ended June 30, 2009 and declined to \$15,366 for the year ended June 30, 2010. Dividend income is mostly attributable to dividends received from our investment in GSHI, which were \$20,500 and \$14,500 during the years ended June 30, 2009 and June 30, 2010, respectively.

Other income has come primarily from structuring fees, overriding royalty interests, and settlement of net profits interests. Income from other sources grew from \$8,336 for the year ended June 30, 2008 to \$14,762 for the year ended June 30, 2009 and decreased to \$11,751 for the year ended June 30, 2010. During the year ended June 30, 2008 we received royalty income and settlement of net profits interest of \$2,984 in the aggregate related to Ken-Tex Energy Corp, and \$4,751 of structuring fees related to Ajax, H&M and various other portfolio investments. During the year ended June 30, 2009, structuring fees of \$1,274 were received primarily related to Biotronic and GSHI, a decrease of \$3,477 from the year ended June 30, 2008. The increase in other income for the year ended June 30, 2009 is largely due to the settlement of our net profit interests in IEC/ARS for \$12,576. During the year ended June 30, 2010 we recognized a \$7,708 gain on the Patriot acquisition and received \$2,388 of structuring and amendment fees primarily related to EXL, H&M, Hoffmaster and Shearers, an overall decrease of \$3,011 in other income from the year ended June 30, 2009.

**Operating Expenses**

Our primary operating expenses consist of investment advisory fees (base and incentive fees), credit facility costs, legal and professional fees and other operating and overhead-related expenses. These expenses include our allocable portion of overhead under the Administration Agreement with Prospect Administration under which Prospect Administration provides administrative services and facilities for us. Our investment advisory fees compensate our Investment Adviser for its work in identifying, evaluating, negotiating, closing and monitoring our investments. We bear all other costs and expenses of our operations and transactions in accordance with our Administration Agreement with Prospect Administration. Operating expenses were \$47,184, \$41,318 and \$34,289 for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively.

The base investment advisory expenses were \$13,929, \$11,915 and \$8,921 for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. These increases are directly related to our growth in total assets. \$16,613, \$14,970 and \$11,278 in income incentive fees were earned for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. The increases have occurred as net interest income has increased due primarily to an increase in the asset base. No capital gains incentive fee has yet been incurred pursuant to the Investment Advisory Agreement.



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During the years ended June 30, 2010, June 30, 2009 and June 30, 2008, we incurred \$8,392, \$6,161 and \$6,318, respectively, of expenses related to our credit facilities. These expenses are related directly to the leveraging capacity put into place for each of those years and the levels of indebtedness actually undertaken in those years. The table below describes the various credit facility expenses and the related indicators of leveraging capacity and indebtedness.

	Year Ended June 30, 2010	Year Ended June 30, 2009	Year Ended June 30, 2008
Interest expense	\$ 1,338	\$ 5,075	\$ 5,104
Amortization of deferred financing costs	5,297	759	726
Commitment and other fees	1,747	327	488
Total	\$ 8,382	\$ 6,161	\$ 6,318
Weighted average debt outstanding	\$ 23,147	\$ 132,013	\$ 90,032
Weighted average interest rate	5.78%	3.84%	5.67%
Facility amount at beginning of year	\$ 175,000	\$ 200,000	\$ 200,000

The increase in our interest rate incurred for the year ended June 30, 2010 is primarily due to an increase of 150 basis points in our borrowing rate effective June 25, 2009 and the concurrent introduction of a Libor floor at 200 basis points. This increase was partially amended on June 11, 2010 with the closing of our current facility. The borrowing rate and Libor floor decreased by 75 basis points and 100 basis points, respectively. The decrease in our interest rate incurred for the year ended June 30, 2009 is primarily due to a decrease in average LIBOR of approximately 1.44% in comparison to 4.08% for the year ended June 30, 2008. This decrease was partially offset by an increase of 125 basis points in the then effective borrowing rate at November 14, 2008.

As our asset base has grown and we have added complexity to our capital raising activities, due, in part, to our assumption of the sub-administration role from Vastardis, we have commensurately increased the size of our administrative and financial staff, accounting for a significant increase in the overhead allocation from Prospect Administration. Over the last two years, Prospect Administration has added several additional staff members, including a senior finance professional, a controller, three corporate counsels and other finance professionals. As our portfolio continues to grow, we expect to continue to increase the size of our administrative and financial staff on a basis that provides increasing returns to scale. However, initial investments in administrative and financial staff may not provide returns to scale immediately, perhaps not until the portfolio increases to a greater size. Other allocated expenses from Prospect Administration have, as expected, increased alongside with the increase in staffing and asset base.

Total operating expenses, net of management fees and interest costs ( Other Operating Expenses ), were \$8,280, \$8,452 and \$7,772 for the years ended June 30, 2010, 2009 and 2008, respectively. The decrease in Other Operating Expenses during the year ended June 30, 2010 when compared to the year ended June 30, 2009 is primarily the result operating efficiencies realized upon the termination of the sub-administration agreement and no excise taxes being paid in 2010 offset by the costs incurred in connection with merger discussions with Allied Capital Corporation expensed in the 2010 period. At December 31, 2008, we elected to retain a portion of our annual taxable income and accrued \$533 for the excise tax that was paid with the filing of the return. Legal costs continue to decrease significantly from \$2,503 for the year ended June 30, 2008 to \$947 for the year ended June 30, 2009 to \$702 for the year ended June 30, 2010 as there were reduced costs for litigation.

**Net Investment Income, Net Realized Gains (Loss), Increase (Decrease) in Net Assets from Net Changes in Unrealized Appreciation/Depreciation and Net Increase in Net Assets Resulting from Operations**

Our net investment income was \$66,451, \$59,163 and \$45,113 for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. Net investment income represents the difference between investment income and

operating expenses and is directly impacted by the items described above.

Net realized (losses) gains were (\$51,545), (\$39,078) and (\$16,222) for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. The net realized loss during the year ended June 30, 2010 was due primarily to the determination that Yatesville was other than temporarily impaired and recognized a realized loss for the amount by which the amortized cost exceeded the current fair value. On June 30, 2009, we determined that the impairment of the CCEHI investment was other than temporarily impaired and recognized a realized loss for the amount by which the amortized cost exceeded the current fair value. This loss was partially offset by realized gains from sales of the Arctic warrants and Deep Down common stock. The net realized loss of \$16,222 sustained in the year ended June 30, 2008 was due mainly to the sale of Charlevoix and Advantage Oilfield Group Ltd. ( AOG ).

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Increase (decrease) in net assets from changes in unrealized appreciation/depreciation was \$3,980, \$15,019 and (\$1,300) for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. For the year ended June 30, 2010, the net unrealized appreciation was driven by \$25,184 of write-ups in our investments in Fischbein, GSHI, Prince, Shearer s, and Regional Management Corporation, and by the disposition of previously written-down investment in Yatesville mentioned above with an unrealized net appreciation of \$35,471, which, in turn, were offset by \$56,954 of write-downs in our investments in Deb Shops, Freedom Marine, H&M, Manx, NRG, R-V and Wind River. For the year ended June 30, 2009, the net unrealized appreciation was driven by significant write-ups of our investments in AGC, GSHI, NRG, R-V, Shearer s and Stryker, and by the disposition of previously written-down investment in CCEI mentioned above, which, in turn, were offset by significant write-downs our investments in Ajax, AEH, Conquest Cherokee, LLC, Deb Shops, Iron Horse and Yatesville as well as the elimination of the unrealized appreciation resulting from the sale of Deep Down mentioned above. For the year ended June 30, 2008, \$1,300 of the decrease in net assets from the net change in unrealized appreciation/depreciation was driven by significant write-downs in our investments in ICS, Worcester Energy Partners, Inc., and Yatesville partially offset by the write-up for our investment in GSHI and by the disposition of previously written-down investments in AOG and ESA.

**Financial Condition, Liquidity and Capital Resources**

Our cash flows provided by (used in) operating activities totaled \$54,838, (\$74,000) and (\$204,025) for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. Investing activities used \$106,586 for the acquisition of Patriot for the year ended June 30, 2010. There were no investing activities for the years ended June 30, 2009 and June 30, 2008. Financing activities provided cash flows of \$42,887, \$83,387 and \$204,580 for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. Dividends paid were \$82,908, \$43,257 and \$24,915 for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively.

Our primary uses of funds have been to continue to invest in our investments in portfolio companies, to add new companies to our investment portfolio, acquire Patriot, repay outstanding borrowings and to make cash distributions to holders of our common stock.

We have and may continue to fund a portion of our cash needs through borrowings from banks, issuances of senior securities or secondary offerings. We may also securitize a portion of our investments in mezzanine or senior secured loans or other assets. Our objective is to put in place such borrowings in order to enable us to expand our portfolio. At June 30, 2010, we had \$100,300 outstanding borrowings on our \$210,000 revolving credit facility.

On March 4, 2010, our Registration Statement on Form N-2 was declared effective by the SEC. Under this Shelf Registration Statement, we can issue up to \$439,622 of additional equity securities as of June 30, 2010.

We also continue to generate liquidity through public and private stock offerings. On July 7, 2009 we completed a public stock offering for 5,175,000 shares of our common stock at \$9.00 per share, raising \$46,575 of gross proceeds. On August 20, 2009 and September 24, 2009, we issued 3,449,686 shares and 2,807,111 shares, respectively, of our common stock at \$8.50 and \$9.00 per share, respectively, in private stock offerings, raising \$29,322, and \$25,264 of gross proceeds, respectively. Concurrent with the sale of these shares, we entered into a registration rights agreement in which we granted the purchasers certain registration rights with respect to the shares. Under the terms and conditions of the registration rights agreement, we filed with the SEC a post-effective amendment to the registration statement on Form N-2 on November 6, 2009. Such amendment was declared effective by the SEC on November 9, 2009.

On December 2, 2009 we acquired the outstanding shares of Patriot common stock for approximately \$201,083. Under the terms of the merger agreement, Patriot common shareholders received 0.363992 shares of our common stock for each share of Patriot common stock, resulting in 8,444,068 shares of common stock being issued by us. In connection with the transaction, we repaid all the outstanding borrowings of Patriot, in compliance with the merger agreement.



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On March 17, 2010, we established an at-the-market program through which we may sell, from time to time and at our discretion, 8,000,000 shares of our common stock. Through this program we issued 5,251,400 shares of our common stock at an average price of \$11.50 per share, raising \$60,378 of gross proceeds, from March 23, 2010 through June 30, 2010.

**Off-Balance Sheet Arrangements**

At June 30, 2010, we did not have any off-balance sheet liabilities or other contractual obligations that are reasonably likely to have a current or future material effect on our financial condition, other than those which originate from 1) the investment advisory and management agreement and the administration agreement and 2) the portfolio companies.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**

We are subject to financial market risks, including changes in interest rates and equity price risk. Some of the loans in our portfolio have floating interest rates.

We may hedge against interest rate fluctuations by using standard hedging instruments such as futures, options and forward contracts subject to the requirements of the 1940 Act. While hedging activities may insulate us against adverse changes in interest rates, they may also limit our ability to participate in the benefits of higher interest rates with respect to our portfolio of investments. During the twelve months ended June 30, 2010, we did not engage in hedging activities.

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**Item 8. Financial Statements and Supplementary Data.**

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**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders

Prospect Capital Corporation

New York, New York

We have audited the accompanying consolidated statements of assets and liabilities of Prospect Capital Corporation, including the schedule of investments, as of June 30, 2010 and 2009, and the related consolidated statements of operations, changes in net assets, and cash flows for each of the three years in the period ended June 30, 2010, and the financial highlights for each of the periods presented. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Prospect Capital Corporation at June 30, 2010 and 2009, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2010, and the financial highlights for each of the periods presented in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Prospect Capital Corporation's internal control over financial reporting as of June 30, 2010, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated August 30, 2010 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

BDO USA, LLP

New York, New York

August 30, 2010

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES  
(in thousands, except share and per share data)**

	<b>June 30, 2010</b>	<b>June 30, 2009</b>
<b>Assets (Note 11)</b>		
Investments at fair value (net cost of \$728,759 and \$531,424, respectively, Note 4)		
Control investments (net cost of \$185,720 and \$187,105, respectively)	\$ 195,958	\$ 206,332
Affiliate investments (net cost of \$65,082 and \$33,544, respectively)	73,740	32,254
Non-control/Non-affiliate investments (net cost of \$477,957 and \$310,775, respectively)	478,785	308,582
Total investments at fair value	748,483	547,168
Investments in money market funds	68,871	98,735
Cash	1,081	9,942
Receivables for:		
Interest, net	5,356	3,562
Dividends	1	28
Other	419	571
Prepaid expenses	371	68
Deferred financing costs	7,579	6,951
Other assets	534	
<b>Total Assets</b>	<b>832,695</b>	<b>667,025</b>
<b>Liabilities</b>		
Credit facility payable (Note 11)	100,300	124,800
Dividends payable	6,909	
Due to Prospect Administration (Note 8)	294	842
Due to Prospect Capital Management (Note 8)	8,821	5,871
Accrued expenses	4,981	2,381
Other liabilities	705	535
<b>Total Liabilities</b>	<b>122,010</b>	<b>134,429</b>
<b>Net Assets</b>	<b>\$ 710,685</b>	<b>\$ 532,596</b>
<b>Components of Net Assets</b>		
Common stock, par value \$0.001 per share (100,000,000 and 100,000,000 common shares authorized, respectively; 69,086,862 and 42,943,084 issued and outstanding, respectively) (Note 6)	\$ 69	\$ 43
Paid-in capital in excess of par (Note 6)	805,918	545,707
(Over) undistributed net investment income	(10,431)	24,152
Accumulated realized losses on investments	(104,595)	(53,050)

Unrealized appreciation on investments	19,724	15,744
<b>Net Assets</b>	<b>\$ 710,685</b>	<b>\$ 532,596</b>
<b>Net Asset Value Per Share</b>	<b>\$ 10.29</b>	<b>\$ 12.40</b>

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands, except share and per share data)**

	<b>June 30, 2010</b>	<b>Year Ended June 30, 2009</b>	<b>June 30, 2008</b>
<b>Investment Income</b>			
Interest income: (Note 4)			
Control investments (Net of foreign withholding tax of \$19, \$166, and \$230, respectively)	\$ 17,218	\$ 19,281	\$ 21,709
Affiliate investments (Net of foreign withholding tax of \$-, \$-, and \$70, respectively)	7,957	3,039	1,858
Non-control/Non-affiliate investments	61,343	40,606	35,466
<b>Total interest income</b>	<b>86,518</b>	<b>62,926</b>	<b>59,033</b>
<b>Dividend income</b>			
Control investments	14,860	22,468	11,327
Non-control/Non-affiliate investments	474		
Money market funds	32	325	706
<b>Total dividend income</b>	<b>15,366</b>	<b>22,793</b>	<b>12,033</b>
<b>Other income: (Note 5)</b>			
Control investments	261	1,249	1,123
Affiliate investments	169		
Non-control/Non-affiliate investments	3,613	13,513	7,213
Gain on Patriot acquisition (Note 2)	7,708		
<b>Total other income</b>	<b>11,751</b>	<b>14,762</b>	<b>8,336</b>
<b>Total Investment Income</b>	<b>113,635</b>	<b>100,481</b>	<b>79,402</b>
<b>Operating Expenses</b>			
Investment advisory fees:			
Base management fee (Note 8)	13,929	11,915	8,921
Income incentive fee (Note 8)	16,613	14,790	11,278
<b>Total investment advisory fees</b>	<b>30,542</b>	<b>26,705</b>	<b>20,199</b>
Interest and credit facility expenses	8,382	6,161	6,318
Sub-administration fees		846	859
Legal fees	702	947	2,503
Valuation services	734	705	577

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Audit, compliance and tax related fees	981	1,015	470
Allocation of overhead from Prospect Administration (Note 8)	3,361	2,856	2,139
Insurance expense	254	246	256
Directors fees	255	269	253
Potential merger expenses (Note 12)	852		
Other general and administrative expenses	1,121	1,035	715
Excise taxes		533	
<b>Total Operating Expenses</b>	47,184	41,318	34,289
<b>Net Investment Income</b>	66,451	59,163	45,113
Net realized loss on investments (Note 4)	(51,545)	(39,078)	(16,222)
Net change in unrealized appreciation (depreciation) on investments (Note 4)	3,980	15,019	(1,300)
<b>Net Increase in Net Assets Resulting from Operations</b>	\$ 18,886	\$ 35,104	\$ 27,591
Net increase in net assets resulting from operations per share: (Note 7 and Note 9)	\$ 0.32	\$ 1.11	\$ 1.17
Weighted average shares of common stock outstanding:	59,429,222	31,559,905	23,626,642

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS**  
(in thousands, except share data)

	<b>June 30, 2010</b>	<b>Year Ended June 30, 2009</b>	<b>June 30, 2008</b>
<b>Increase in Net Assets from Operations:</b>			
Net investment income	\$ 66,451	\$ 59,163	\$ 45,113
Net loss on investments	(51,545)	(39,078)	(16,222)
Net change in unrealized appreciation (depreciation) on investments	3,980	15,019	(1,300)
<b>Net Increase in Net Assets Resulting from Operations</b>	<b>18,886</b>	<b>35,104</b>	<b>27,591</b>
<b>Dividends to Shareholders</b>	<b>(101,034)</b>	<b>(36,519)</b>	<b>(39,513)</b>
<b>Capital Share Transactions:</b>			
Net proceeds from capital shares sold	158,002	100,304	140,249
Less: Offering costs of public share offerings	(1,781)	(1,023)	(1,505)
Fair value of equity issued in conjunction with Patriot acquisition	92,800		
Reinvestment of dividends	11,216	5,107	2,753
<b>Net Increase in Net Assets Resulting from Capital Share Transactions</b>	<b>260,237</b>	<b>104,388</b>	<b>141,497</b>
<b>Total Increase in Net Assets:</b>	<b>178,089</b>	<b>102,973</b>	<b>129,575</b>
Net assets at beginning of year	532,596	429,623	300,048
<b>Net Assets at End of Year</b>	<b>\$ 710,685</b>	<b>\$ 532,596</b>	<b>\$ 429,623</b>
<b>Capital Share Activity:</b>			
Shares sold	16,683,197	12,942,500	9,400,000
Shares issued for Patriot acquisition	8,444,068		
Shares issued through reinvestment of dividends	1,016,513	480,205	171,314
Net increase in capital share activity	26,143,778	13,422,705	9,571,314
Shares outstanding at beginning of year	42,943,084	29,520,379	19,949,065
<b>Shares Outstanding at End of Year</b>	<b>69,086,862</b>	<b>42,943,084</b>	<b>29,520,379</b>

See notes to consolidated financial statements.





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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands, except share data)

	<b>June 30,</b>	<b>Year Ended</b>	<b>June 30,</b>
	<b>2010</b>	<b>June 30,</b>	<b>2008</b>
		<b>2009</b>	
<b>Cash Flows from Operating Activities:</b>			
Net increase in net assets resulting from operations	\$ 18,886	\$ 35,104	\$ 27,591
Net realized loss on investments	51,545	39,078	16,239
Net change in unrealized (appreciation) depreciation on investments	(3,980)	(15,019)	1,300
Accretion of original issue discount on investments	(20,313)	(2,399)	(2,095)
Amortization of deferred financing costs	5,297	759	727
Gain on Patriot acquisition (Note 2)	(7,708)		
Change in operating assets and liabilities:			
Payments for purchases of investments and payment-in-kind interest	(157,662)	(98,305)	(311,947)
Proceeds from sale of investments and collection of investment principal	136,221	27,007	127,212
Purchases of cash equivalents	(199,997)	(39,999)	(274,949)
Sales of cash equivalents	199,997	39,999	274,932
Net decrease (increase) of investments in money market funds	29,864	(65,735)	8,760
Decrease (increase) in interest receivable, net	530	532	(1,955)
Decrease (increase) in dividends receivable	27	4,220	(3,985)
Decrease (increase) in loan principal receivable		71	(71)
Decrease in receivable for structuring fees			1,625
Decrease (increase) in other receivables	152	(4)	(296)
(Increase) decrease in prepaid expenses	(268)	205	198
Decrease in due from Prospect Administration	1,500		
Increase in other assets	(534)		
Decrease in payables for securities purchased			(70,000)
(Decrease) increase in due to Prospect Administration	(548)	147	365
Increase (decrease) in due to Prospect Capital Management	2,950	(75)	1,438
(Decrease) increase in accrued expenses	(1,291)	1,277	(208)
Increase (decrease) in other liabilities	170	(863)	1,094
<b>Net Cash Provided By Operating Activities:</b>	<b>54,838</b>	<b>(74,000)</b>	<b>(204,025)</b>
<b>Cash Flows from Investing Activities:</b>			
Acquisition of Patriot, net of cash acquired (Note 2)	(106,586)		
<b>Net Cash Used In Investing Activities:</b>	<b>(106,586)</b>		
<b>Cash Flows from Financing Activities:</b>			
Borrowings under credit facility	244,100	100,157	238,492
Payments under credit facility	(268,600)	(66,524)	(147,325)
Financing costs paid and deferred	(5,925)	(6,270)	(416)

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Net proceeds from issuance of common stock	158,001	100,304	140,249
Offering costs from issuance of common stock	(1,781)	(1,023)	(1,505)
Dividends paid	(82,908)	(43,257)	(24,915)
<b>Net Cash Provided By Financing Activities:</b>	42,887	83,387	204,580
<b>Total (Decrease) Increase in Cash</b>	(8,861)	9,387	555
Cash balance at beginning of year	9,942	555	
<b>Cash Balance at End of Year</b>	\$ 1,081	\$ 9,942	\$ 555
<b>Cash Paid For Interest</b>	\$ 1,444	\$ 5,014	\$ 4,942
<b>Non-Cash Financing Activity:</b>			
Amount of shares issued in connection with dividend reinvestment plan	\$ 11,216	\$ 5,107	\$ 2,753
Fair value of shares issued in conjunction with the Patriot Acquisition	\$ 92,800	\$	\$

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULE OF INVESTMENTS**

**June 30, 2010 and June 30, 2009**

**(in thousands, except share data)**

Portfolio Company	Locale / Industry	Investments <sup>(1)</sup>	Principal Value	June 30, 2010		% of Net Assets
				Cost	Fair Value <sup>(2)</sup>	
<b>LEVEL 3 PORTFOLIO INVESTMENTS:</b>						
<b>Control Investments (25.00% or greater of voting control)</b>						
Ajax Rolled Ring & Machine, Inc.	South Carolina / Manufacturing	Senior Secured Note Tranche A (10.50%, due 4/01/2013) <sup>(3), (4)</sup>	\$ 21,047	\$ 21,047	\$ 21,047	3.0%
		Subordinated Secured Note Tranche B (11.50% plus 6.00% PIK, due 4/01/2013) <sup>(3), (4)</sup>	16,306	16,306	9,857	1.3%
		Subordinated Secured Note Tranche B (15.00%, due 10/30/2010)	500	500		0.0%
		Convertible Preferred Stock Series A (6,142.6 shares)		6,057		0.0%
		Unrestricted Common Stock (6 shares)				0.0%
			<b>43,910</b>	<b>30,904</b>	<b>4.3%</b>	
AWCNC, LLC <sup>(20)</sup>	North Carolina / Machinery	Members Units Class A (1,800,000 units)				0.0%
		Members Units Class B-1 (1 unit)				0.0%
		Members Units Class B-2 (7,999,999 units)				0.0%
						<b>0.0%</b>
Borga, Inc.	California / Manufacturing	Revolving Line of Credit \$1,000 Commitment (4.75%)	1,000	945	850	0.1%

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		plus 3.25% default interest, in non-accrual status effective 03/02/2010, past due) <sup>(4), (26)</sup>				
		Senior Secured Term Loan B (8.25% plus 3.25% default interest, in non-accrual status effective 03/02/2010, past due) <sup>(4)</sup>	1,612	1,500	1,282	0.2%
		Senior Secured Term Loan C (12.00% plus 4.00% PIK plus 3.00% default interest, in non-accrual status effective 03/02/2010, past due)	8,624	707		0.0%
		Common Stock (100 shares) <sup>(22)</sup>				0.0%
		Warrants (33,750 warrants) <sup>(22)</sup>				0.0%
				<b>3,152</b>	<b>2,132</b>	<b>0.3%</b>
C&J Cladding LLC	Texas / Metal Services and Minerals	Membership Interest (400 units) <sup>(23)</sup>		580	4,128	0.6%
				<b>580</b>	<b>4,128</b>	<b>0.6%</b>
Change Clean Energy Holdings, Inc. ( CCEHF <sup>5)</sup> )	Maine / Biomass Power	Common Stock (1,000 shares)		2,383		0.0%
				<b>2,383</b>		<b>0.0%</b>
Fischbein, LLC	North Carolina / Machinery	Senior Subordinated Debt (13.00% plus 5.50% PIK, due 5/01/2013)	3,811	3,631	3,811	0.5%
		Membership Interest <sup>(25)</sup>		1,899	4,812	0.7%
				<b>5,530</b>	<b>8,623</b>	<b>1.2%</b>
Freedom Marine Services LLC	Louisiana / Shipping Vessels	Subordinated Secured Note (16.00% PIK, due 12/31/2011) <sup>(3)</sup>	10,088	10,040	3,583	0.5%
						0.0%

		Net Profits Interest (22.50% payable on equity distributions) <sup>(3), (7)</sup>			<b>10,040</b>	<b>3,583</b>	<b>0.5%</b>
Gas Solutions Holdings, Inc. <sup>(8), (3)</sup>	Texas / Gas Gathering and Processing	Senior Secured Note (18.00%, due 12/11/2016)	25,000	25,000	25,000		3.5%
		Junior Secured Note (18.00%, due 12/12/2016)	7,500	7,500	7,500		1.1%
		Common Stock (100 shares)		5,003	60,596		8.5%
					<b>37,503</b>	<b>93,096</b>	<b>13.1%</b>

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Portfolio Company	Locale / Industry	Investments <sup>(1)</sup>	June 30, 2010			% of Net Assets
			Principal Value	Cost	Fair Value <sup>(2)</sup>	
<b>LEVEL 3 PORTFOLIO INVESTMENTS:</b>						
<b>Control Investments (25.00% or greater of voting control)</b>						
Integrated Contract Services, Inc. <sup>(9)</sup>	North Carolina / Contracting	Senior Demand Note (15.00%, past due) <sup>(10)</sup>	\$ 1,170	\$ 1,170	\$ 1,170	0.2%
		Senior Secured Note (7.00% plus 7.00% PIK plus 6.00% default interest, in non-accrual status effective 10/09/2007, past due)	1,100	800	1,100	0.2%
		Junior Secured Note (7.00% plus 7.00% PIK plus 6.00% default interest, in non-accrual status effective 10/09/2007, past due)	14,003	14,003	2,272	0.2%
		Preferred Stock Series A (10 shares) Common Stock (49 shares)		679		0.0%
			<b>16,652</b>		<b>4,542</b>	<b>0.6%</b>
Iron Horse Coiled Tubing, Inc. <sup>(24)</sup>	Alberta, Canada / Production Services	Senior Secured Tranche 1 (Zero Coupon, in non-accrual status effective 1/01/2010, due 12/31/2016)	615	396	615	0.1%
		Senior Secured Tranche 2 (Zero	2,337	2,338	2,338	0.3%

		Coupon, in non-accrual status effective 1/01/2010, due 12/31/2016)						
		Senior Secured Tranche 3 (1.00%, in non-accrual status effective 1/01/2010, due 12/31/2016)	18,000	18,000	9,101	1.3%		
		Common Stock (3,821 shares)		268		0.0%		
				<b>21,002</b>	<b>12,054</b>	<b>1.7%</b>		
Manx Energy, Inc. ( Manx <sup>12</sup> )	Kansas / Oil & Gas Production	Appalachian Energy Holdings, LLC ( AEH ) Senior Secured Note (8.00%, in non-accrual status effective 1/19/2010, due 1/19/2013)	2,073	2,000	472	0.1%		
		Coalbed, LLC Senior Secured Note (8.00%, in non-accrual status effective 1/19/2010, due 1/19/2013) <sup>(6)</sup>	6,219	5,991	1,414	0.2%		
		Manx Senior Secured Note (13.00%, in non-accrual status effective 1/19/2010, due 1/19/2013)	2,800	2,800	2,800	0.4%		
		Manx Preferred Stock (6,635 shares)		6,308		0.0%		
		Manx Common Stock (3,416,335 shares)		1,171		0.0%		
				<b>18,270</b>	<b>4,686</b>	<b>0.7%</b>		
NRG Manufacturing, Inc.	Texas / Manufacturing	Senior Secured Note (16.50%, due 8/31/2011) <sup>(3), (4)</sup>	13,080	13,080	13,080	1.8%		
		Common Stock (800 shares)		2,317	7,031	1.0%		
				<b>15,397</b>	<b>20,111</b>	<b>2.8%</b>		



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Nupla Corporation	California / Home & Office Furnishings, Housewares & Durable	Revolving Line of Credit \$2,000 Commitment (7.25% plus 2.00% default interest, due 9/04/2012) <sup>(4), (26)</sup>	1,093	958	1,093	0.2%
		Senior Secured Term Loan A (8.00% plus 2.00% default interest, due 9/04/2012) <sup>(4)</sup>	5,139	1,503	3,301	0.5%
		Senior Subordinated Debt (10.00% plus 5.00% PIK, in non-accrual status effective 4/01/2009, due 3/04/2013)	3,368			0.0%
		Preferred Stock Class A (2,850 shares)				0.0%
		Preferred Stock Class B (1,330 shares)				0.0%
		Common Stock (2,360,743 shares)				0.0%
			<b>2,461</b>	<b>4,394</b>	<b>0.7%</b>	
R-V Industries, Inc.	Pennsylvania / Manufacturing	Warrants (200,000 warrants, expiring 6/30/2017)	1,682	1,697		0.2%
		Common Stock (545,107 shares)	5,086	4,626		0.7%
			<b>6,768</b>	<b>6,323</b>		<b>0.9%</b>

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Portfolio Company	Locale / Industry	Investments <sup>(1)</sup>	June 30, 2010			% of Net Assets
			Principal Value	Cost	Fair Value <sup>(2)</sup>	
<b>LEVEL 3 PORTFOLIO INVESTMENTS:</b>						
<b>Control Investments (25.00% or greater of voting control)</b>						
Sidump r Trailer Company, Inc.	Nebraska / Automobile	Revolving Line of Credit \$2,000 Commitment (7.25%, in non-accrual status effective 11/01/2008, due 1/10/2011) <sup>(4), (26)</sup>	\$ 1,025	\$ 479	\$ 574	0.1%
		Senior Secured Term Loan A (7.25%, in non-accrual status effective 11/01/2008, due 1/10/2011) <sup>(4)</sup>	2,048	463		0.0%
		Senior Secured Term Loan B (8.75%, in-non-accrual status effective 11/01/2008, due 1/10/2011) <sup>(4)</sup>	2,321			0.0%
		Senior Secured Term Loan C (16.50% PIK, in non-accrual status effective 9/27/2008, due 7/10/2011)	3,085			0.0%
		Senior Secured Term Loan D (7.25%, in non-accrual status effective 11/01/2008, due	1,700			0.0%

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		7/10/2011) <sup>(4)</sup>				
		Preferred Stock (49,843 shares)				0.0%
		Common Stock (64,050 shares)				0.0%
				<b>942</b>	<b>574</b>	<b>0.1%</b>
Yatesville Coal Holdings, Inc. <sup>(11)</sup>	Kentucky / Mining, Steel, Iron and Non-Precious Metals and Coal Production	Senior Secured Note (Non-accrual status effective 1/01/2009, due 12/31/2010) <sup>(4)</sup>	10,000	1,035	808	0.1%
		Junior Secured Note (Non-accrual status effective 1/01/2009, due 12/31/2010) <sup>(4)</sup>	41,931	95		0.0%
		Common Stock (1,000 shares)				0.0%
				<b>1,130</b>	<b>808</b>	<b>0.1%</b>
		<b>Total Control Investments</b>		<b>185,720</b>	<b>195,958</b>	<b>27.6%</b>

**Affiliate Investments (5.00% to 24.99% voting control)**

Biotronic NeuroNetwork <sup>(17)</sup>	Michigan / Healthcare	Senior Secured Note (11.50% plus 1.00% PIK, due 2/21/2013) <sup>(3), (4)</sup>	26,227	26,227	26,744	3.8%
		Preferred Stock (9,925,455 shares) <sup>(13)</sup>		2,300	2,759	0.4%
				<b>28,527</b>	<b>29,503</b>	<b>4.2%</b>
Boxercraft Incorporated	Georgia / Textiles & Leather	Revolving Line of Credit \$1,000 Commitment (9.00%, due 9/16/2013) <sup>(26), (27)</sup>	1,000	1,000	1,000	0.1%
		Senior Secured Term Loan A (9.50%, due 9/16/2013) <sup>(3), (4)</sup>	3,843	3,330	3,577	0.5%
		Senior Secured Term Loan B (10.00%, due 9/16/2013) <sup>(3), (4)</sup>	4,822	3,845	4,386	0.6%

		Subordinated Secured Term Loan (12.00% plus 6.50% PIK, due 3/16/2014) <sup>(3)</sup>	7,235	5,775	6,717	0.9%
		Preferred Stock (1,000,000 shares)			205	0.0%
		Common Stock (10,000 shares)				0.0%
				<b>13,950</b>	<b>15,885</b>	<b>2.2%</b>
KTPS Holdings, LLC	Colorado / Textiles & Leather	Revolving Line of Credit \$1,500 Commitment (10.50%, due 1/31/2012) <sup>(26), (27)</sup>	1,000	1,000	1,000	0.1%
		Senior Secured Term Loan A (10.50%, due 1/31/2012) <sup>(3), (4)</sup>	3,130	2,847	2,916	0.4%
		Senior Secured Term Loan B (12.00%, due 1/31/2012) <sup>(3)</sup>	435	377	409	0.1%
		Senior Secured Term Loan C (12.00% plus 6.00% PIK, due 3/31/2012) <sup>(3)</sup>	4,932	4,345	4,796	0.7%
		Membership Interest Class A (730 units)				0.0%
		Membership Interest Common (199,795 units)				0.0%
				<b>8,569</b>	<b>9,121</b>	<b>1.3%</b>

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Portfolio Company	Locale / Industry	Investments <sup>(1)</sup>	Principal Value	June 30, 2010		% of Net Assets
				Cost	Fair Value <sup>(2)</sup>	
<b>LEVEL 3 PORTFOLIO INVESTMENTS:</b>						
<b>Affiliate Investments (5.00% to 24.99% voting control)</b>						
Smart, LLC <sup>(15)</sup>	New York / Diversified / Conglomerate Service	Membership Interest Class B (1,218 units)		\$	\$	0.0%
		Membership Interest Class D (1 unit)				0.0%
						<b>0.0%</b>
Sport Helmets Holdings, LLC <sup>(15)</sup>	New York / Personal & Nondurable Consumer Products	Revolving Line of Credit \$3,000 Commitment (4.54%, due 12/14/2013) <sup>(26), (27)</sup>				0.0%
		Senior Secured Term Loan A (4.54%, due 12/14/2013) <sup>(3), (4)</sup>	\$ 3,025	1,658	2,993	0.4%
		Senior Secured Term Loan B (5.04%, due 12/14/2013) <sup>(3), (4)</sup>	7,388	5,161	6,432	0.9%
		Senior Subordinated Debt Series A (12.00% plus 3.00% PIK, due 6/14/2014) <sup>(3)</sup>	7,325	5,857	6,734	0.9%
		Senior Subordinated Debt Series B (10.00% plus 5.00% PIK, due 6/14/2014) <sup>(3)</sup>	1,357	952	1,160	0.2%
		Common Stock (20,554 shares)		408	1,912	0.3%
				<b>14,036</b>	<b>19,231</b>	<b>2.7%</b>
		<b>Total Affiliate Investments</b>		<b>65,082</b>	<b>73,740</b>	<b>10.4%</b>

**Non-control/Non-affiliate Investments (less than 5.00% of voting control)**

ADAPCO, Inc.	Florida / Ecological	Common Stock (5,000 shares)	141	340	0.0%	
			<b>141</b>	<b>340</b>	<b>0.0%</b>	
Aircraft Fasteners International, LLC	California / Machinery	Revolving Line of Credit \$500 Commitment (9.50%, due 11/01/2012) <sup>(26), (27)</sup>			0.0%	
		Senior Secured Term Loan (9.50%, due 11/01/2012) <sup>(3), (4)</sup>	4,565	4,565	4,248	0.6%
		Junior Secured Term Loan (12.00% plus 6.00% PIK, due 5/01/2013) <sup>(3)</sup>	5,134	5,134	4,807	0.7%
		Convertible Preferred Stock (32,500 units)		396	98	0.0%
			<b>10,095</b>	<b>9,153</b>	<b>1.3%</b>	
American Gilsonite Company	Utah / Specialty Minerals	Senior Subordinated Note (12.00% plus 3.00% PIK, due 3/14/2013) <sup>(3)</sup>	14,783	14,783	14,931	2.1%
		Membership Interest in AGC/PEP, LLC (99.9999%) <sup>(16)</sup>		1,031	3,532	0.5%
				<b>15,814</b>	<b>18,463</b>	<b>2.6%</b>
Arrowhead General Insurance Agency, Inc. <sup>(17)</sup>	California / Insurance	Senior Secured Term Loan (8.50%, due 8/08/2012)	850	809	830	0.1%
		Junior Secured Term Loan (10.25% plus 2.50% PIK, due 2/08/2013)	6,179	5,002	5,122	0.7%
				<b>5,811</b>	<b>5,952</b>	<b>0.8%</b>
Caleel + Hayden, LLC <sup>(15)</sup>	Colorado / Personal & Nondurable Consumer Products	Membership Units (7,500 shares)		351	818	0.1%
		Options in Mineral Fusion Natural Brands, LLC (11,662 options)				0.0%

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Portfolio Company	Locale / Industry	Investments <sup>(1)</sup>	June 30, 2010			% of Net Assets
			Principal Value	Cost	Fair Value <sup>(2)</sup>	
<b>LEVEL 3 PORTFOLIO INVESTMENTS:</b>						
<b>Non-control/Non-affiliate Investments (less than 5.00% of voting control)</b>						
Castro Cheese Company, Inc.	Texas / Food Products	Subordinated Secured Note (11.00% plus 2.00% PIK, due 2/28/2013) <sup>(3)</sup>	\$ 7,692	\$ 7,597	\$ 7,769	1.1%
				<b>7,597</b>	<b>7,769</b>	<b>1.1%</b>
Copernicus Group	North Carolina / Healthcare	Revolving Line of Credit \$500 Commitment (10.00%, due 10/08/2013) <sup>(4), (26)</sup>	150	22	150	0.0%
		Senior Secured Term Loan A (10.00%, due 10/08/2013) <sup>(3), (4)</sup>	5,850	5,058	5,416	0.8%
		Senior Subordinated Debt (10.00% plus 10.00% PIK, due 4/08/2014)	13,390	11,421	12,677	1.8%
		Preferred Stock Series A (1,000,000 shares)		67	104	0.0%
		Preferred Stock Series C (212,121 shares)		212	246	0.0%
				<b>16,780</b>	<b>18,593</b>	<b>2.6%</b>
Deb Shops, Inc. <sup>(17)</sup>	Pennsylvania / Retail	Second Lien Debt (14.00% PIK, in non-accrual status effective 2/24/2009, due 10/23/2014)	17,562	14,606	2,051	0.3%
				<b>14,606</b>	<b>2,051</b>	<b>0.3%</b>
Diamondback Operating, LP	Oklahoma / Oil & Gas Production	Net Profits Interest (15.00% payable on Equity distributions) <sup>(7)</sup>			193	0.0%
					<b>193</b>	<b>0.0%</b>



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EXL Acquisition Corporation	South Carolina / Electronics	Revolving Line of Credit \$1,000 Commitment (7.75%, due 06/24/2015) <sup>(26), (27)</sup>					0.0%
		Senior Secured Term Loan A (7.75%, due 6/24/2015) <sup>(3), (4)</sup>	12,250	12,250	12,250		1.7%
		Senior Secured Term Loan B (12.00% plus 2.00% PIK, due 12/24/2015) <sup>(3)</sup>	12,250	12,250	12,250		1.7%
		Common Stock Class A (2,475 shares)		437	363		0.1%
		Common Stock Class B (25 shares)		252	103		0.0%
					<b>25,189</b>	<b>24,966</b>	
Fairchild Industrial Products, Co. <sup>(2)</sup>	North Carolina / Electronics	Preferred Stock Class A (285.1 shares)		377	435		0.1%
		Common Stock Class B (28 shares)		211	228		0.0%
				<b>588</b>	<b>663</b>		<b>0.1%</b>
H&M Oil & Gas, LLC	Texas / Oil & Gas Production	Senior Secured Note (13.00% plus 3.00% PIK, due 9/30/2010)	59,107	59,107	48,867		6.9%
		Net Profits Interest (8.00% payable on Equity distributions) <sup>(7)</sup>			827		0.1%
				<b>59,107</b>	<b>49,694</b>		<b>7.0%</b>
Hoffmaster Group, Inc.	Wisconsin / Durable Consumer Products	Second Lien Term Loan (13.50%, due 6/2/2017) <sup>(3)</sup>	20,000	20,000	20,000		2.8%
				<b>20,000</b>	<b>20,000</b>		<b>2.8%</b>
Hudson Products Holdings, Inc. <sup>(17)</sup>	Texas / Manufacturing	Senior Secured Term Loan (8.00%, due 8/24/2015) <sup>(3), (4)</sup>	6,365	5,734	5,314		0.7%
				<b>5,734</b>	<b>5,314</b>		<b>0.7%</b>
IEC Systems LP ( IEC ) /Advanced Rig Services LLC ( ARS )	Texas / Oilfield Fabrication	IEC Senior Secured Note (12.00% plus 3.00% PIK, due 11/20/2012) <sup>(3), (4)</sup>	19,008	19,008	19,008		2.7%
		ARS Senior Secured Note (12.00% plus 3.00% PIK, due 11/20/2012) <sup>(3), (4)</sup>	11,421	11,421	11,421		1.6%
				<b>30,429</b>	<b>30,429</b>		<b>4.3%</b>

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			Principal Value	Cost	Fair Value <sup>(2)</sup>	
<b>LEVEL 3 PORTFOLIO INVESTMENTS:</b>						
<b>Non-control/Non-affiliate Investments (less than 5.00% of voting control)</b>						
Impact Products, LLC	Ohio / Home & Office Furnishings, Housewares & Durable	Junior Secured Term Loan (6.38%, due 9/09/2012) <sup>(4)</sup>	\$ 7,300	\$ 6,351	\$ 7,290	1.0%
		Senior Subordinated Debt (10.00% plus 5.00% PIK, due 9/09/2012)	5,548	5,300	5,548	0.8%
			<b>11,651</b>	<b>12,838</b>	<b>1.8%</b>	
Label Corp Holdings, Inc.	Nebraska / Printing & Publishing	Senior Secured Term Loan (8.50%, due 8/08/2014) <sup>(3), (4)</sup>	5,794	5,222	5,284	0.7%
			<b>5,222</b>	<b>5,284</b>	<b>0.7%</b>	
LHC Holdings Corp. <sup>(17)</sup>	Florida / Healthcare	Revolving Line of Credit \$1,000 Commitment (9.00%, due 11/30/2012) <sup>(26), (27)</sup>				0.0%
		Senior Secured Term Loan A (9.00%, due 11/30/2012) <sup>(3), (4)</sup>	2,015	2,015	1,839	0.3%
		Senior Subordinated Debt (12.00% plus 2.50% PIK, due 5/31/2013) <sup>(3)</sup>	4,565	4,199	4,220	0.6%
		Membership Interest (125 units)		216	217	0.0%
			<b>6,430</b>	<b>6,276</b>	<b>0.9%</b>	
Mac & Massey Holdings, LLC	Georgia / Food Products	Senior Subordinated Debt (10.00% plus 5.75% PIK, due 2/10/2013)	8,671	7,351	8,643	1.2%
				145	390	0.1%

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		Membership Interest (250 units)				
				<b>7,496</b>	<b>9,033</b>	<b>1.3%</b>
Maverick Healthcare, LLC	Arizona / Healthcare	Second Lien Debt (12.50% plus 3.50% PIK, due 4/30/2014) <sup>(3)</sup>	13,122	13,122	13,247	1.9%
		Preferred Units (1,250,000 units)		1,252	2,025	0.2%
		Common Units (1,250,000 units)				0.0%
				<b>14,374</b>	<b>15,272</b>	<b>2.1%</b>
Miller Petroleum, Inc.	Tennessee / Oil & Gas Production	Warrants, Common Stock (2,208,772 warrants, expiring 5/04/2010 to 3/31/2015) <sup>(14)</sup>		150	1,244	0.2%
				<b>150</b>	<b>1,244</b>	<b>0.2%</b>
Northwestern Management Services, LLC	Florida / Healthcare	Revolving Line of Credit \$1,000 Commitment (4.36%, due 12/13/2012) <sup>(26), (27)</sup>	350	350	350	0.0%
		Senior Secured Term Loan A (4.36%, due 12/13/2012) <sup>(3), (4)</sup>	4,309	3,516	3,578	0.5%
		Senior Secured Term Loan B (4.86%, due 12/13/2012) <sup>(3), (4)</sup>	1,219	904	956	0.1%
		Subordinated Secured Term Loan (12.00% plus 3.00%, due 6/13/2013) <sup>(3)</sup>	2,971	2,468	2,606	0.4%
		Common Stock (50 shares)		371	564	0.1%
				<b>7,609</b>	<b>8,054</b>	<b>1.1%</b>
Prince Mineral Company, Inc.	New York / Metal Services and Minerals	Junior Secured Term Loan (9.00%, due 12/21/2012) <sup>(4)</sup>	11,150	11,150	11,150	1.6%
		Senior Subordinated Debt (13.00% plus 2.00%, due 7/21/2013)	12,260	1,420	12,260	1.7%
				<b>12,570</b>	<b>23,410</b>	<b>3.3%</b>
Qualitest Pharmaceuticals, Inc. <sup>(17)</sup>	Alabama / Pharmaceuticals	Second Lien Debt (7.79%, due 4/30/2015) <sup>(3), (4)</sup>	12,000	11,955	12,000	1.7%

**11,955**    **12,000**    **1.7%**

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Portfolio Company	Locale / Industry	Investments <sup>(1)</sup>	Principal Value	June 30, 2010		% of Net Assets		
				Cost	Fair Value <sup>(2)</sup>			
<b>LEVEL 3 PORTFOLIO INVESTMENTS:</b>								
<b>Non-control/Non-affiliate Investments (less than 5.00% of voting control)</b>								
Regional Management Corporation	South Carolina / Financial Services	Second Lien Debt (12.00% plus 2.00% PIK, due 6/29/2012) <sup>(3)</sup>	25,814	25,814	25,592	3.6%		
				<b>25,814</b>	<b>25,592</b>	<b>3.6%</b>		
Roll Coater Acquisition Corp.	Indiana / Metal Services and Minerals	Subordinated Secured Debt (10.25%, due 9/30/2010)	6,268	6,102	6,082	0.9%		
				<b>6,102</b>	<b>6,082</b>	<b>0.9%</b>		
R-O-M Corporation	Missouri / Automobile	Revolving Line of Credit \$1,750 Commitment (4.50%, due 2/08/2013) <sup>(26), (27)</sup>				0.0%		
				Senior Secured Term Loan A (4.50%, due 2/08/2013) <sup>(3), (4)</sup>	4,640	4,025	4,571	0.6%
				Senior Secured Term Loan B (8.00%, due 5/08/2013) <sup>(3), (4)</sup>	7,251	7,251	7,078	1.0%
				Senior Subordinated Debt (12.00% plus 3.00% PIK due	7,118	6,799	6,392	0.9%

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8/08/2013)<sup>(3)</sup>

				<b>18,075</b>	<b>18,041</b>	<b>2.5%</b>
Seaton Corp.	Illinois / Business Services	Subordinated Secured (12.50% plus 2.00% PIK, due 3/14/2011)	12,296	12,060	12,132	1.7%
				<b>12,060</b>	<b>12,132</b>	<b>1.7%</b>
Shearer s Foods, Inc.	Ohio / Food Products	Junior Secured Debt (12.00% plus 3.00% PIK, due 3/31/2016) <sup>(3)</sup>	35,266	35,266	36,119	5.1%
		Membership Interest in Mistral Chip Holdings, LLC (2,000 units) <sup>(18)</sup>		2,560	6,136	0.9%
		Membership Interest in Mistral Chip Holdings, LLC 2 (595 units) <sup>(18)</sup>		762	1,825	0.3%
				<b>38,588</b>	<b>44,080</b>	<b>6.2%</b>
Skillsoft Public Limited Company	Ireland / Prepackaged Software	Subordinated Unsecured (11.125%, due 06/01/2018)	15,000	14,903	15,000	2.2%
				<b>14,903</b>	<b>15,000</b>	<b>2.2%</b>
Stryker Energy, LLC	Ohio / Oil & Gas Production	Subordinated Secured Revolving Credit Facility (12.00%, due 12/01/2012) <sup>(3), (4)</sup>	29,724	29,507	29,624	4.2%
		Overriding Royalty Interests <sup>(19)</sup>			2,768	0.4%
				<b>29,507</b>	<b>32,392</b>	<b>4.6%</b>
TriZetto Group <sup>(17)</sup>	California / Healthcare		15,434	15,306	15,895	2.2%

		Subordinated Unsecured Note (12.00% plus 1.50% PIK, due 10/01/2016) <sup>(3)</sup>		<b>15,306</b>	<b>15,895</b>	<b>2.2%</b>
Unitek <sup>(17)</sup>	Pennsylvania / Technical Services	Second Lien Debt (13.08%, due 12/31/2013) <sup>(3)</sup> , <sup>(4)</sup>	11,500	11,387	11,615	1.7%
				<b>11,387</b>	<b>11,615</b>	<b>1.7%</b>
Wind River Resources Corp. and Wind River II Corp.	Utah / Oil & Gas Production	Senior Secured Note (13.00% plus 3.00% default interest, in non-accrual status effective 12/01/2008, due 7/31/2010) <sup>(4)</sup>	15,000	15,000	8,779	1.2%
		Net Profits Interest (5.00% payable on Equity distributions) <sup>(7)</sup>				0.0%
				<b>15,000</b>	<b>8,779</b>	<b>1.2%</b>
		<b>Total Non-Control/Non-Affiliate Investments (Level 3 Investments)</b>		<b>476,441</b>	<b>477,417</b>	<b>67.1%</b>
		<b>Total Level 3 Portfolio Investments</b>		<b>727,243</b>	<b>747,115</b>	<b>105.1%</b>

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Portfolio Company	Locale / Industry	Investments <sup>(1)</sup>	Principal Value	June 30, 2010		% of Net Assets
				Cost	Fair Value <sup>(2)</sup>	
<b>LEVEL 1 PORTFOLIO INVESTMENTS:</b>						
<b>Non-control/Non-affiliate Investments (less than 5.00% of voting control)</b>						
Allied Defense Group, Inc.	Virginia / Aerospace & Defense	Common Stock (10,000 shares)		\$ 56	\$ 38	0.0%
				<b>56</b>	<b>38</b>	<b>0.0%</b>
Dover Saddlery, Inc.	Massachusetts / Retail	Common Stock (30,974 shares)		63	97	0.0%
				<b>63</b>	<b>97</b>	<b>0.0%</b>
LyondellBasell Industries N.V. <sup>(22)</sup>	Netherlands / Chemical Company	Class A Common Stock (26,961 shares)		874	435	0.2%
		Class B Common Stock (49,421 shares)		523	798	0.0%
				<b>1,397</b>	<b>1,233</b>	<b>0.2%</b>
		<b>Total Non-Control/Non-Affiliate Investments (Level 1 Investments)</b>		<b>1,516</b>	<b>1,368</b>	<b>0.2%</b>
		<b>Total Portfolio Investments</b>		<b>728,759</b>	<b>748,483</b>	<b>105.3%</b>
<b>SHORT TERM INVESTMENTS: Money Market Funds (Level 2 Investments)</b>						
Fidelity Institutional Money Market Funds (Class I)	Government Portfolio			62,183	62,183	8.8%
Fidelity Institutional Money Market Funds (Class I) <sup>(3)</sup>	Government Portfolio			6,687	6,687	0.9%
Victory Government Money Market Funds				1	1	0.0%
		<b>Total Money Market Funds</b>		<b>68,871</b>	<b>68,871</b>	<b>9.7%</b>

<b>Total Investments</b>	<b>797,630</b>	<b>817,354</b>	<b>115.0%</b>
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Portfolio Company	Locale / Industry	Investments <sup>(1)</sup>	June 30, 2009			% of Net Assets
			Principal Value	Cost	Fair Value <sup>(2)</sup>	
<b>LEVEL 3 INVESTMENTS:</b>						
<b>Control Investments (25.00% or greater of voting control)</b>						
Ajax Rolled Ring & Machine, Inc.	South Carolina / Manufacturing	Senior Secured Note Tranche A (10.50%, due 4/01/2013) <sup>(3), (4)</sup>	\$ 21,487	\$ 21,487	\$ 21,487	4.0%
		Subordinated Secured Note Tranche B (11.50% plus 6.00% PIK, due 4/01/2013) <sup>(3), (4)</sup>	11,675	11,675	10,151	1.9%
		Convertible Preferred Stock Series A (6,143 shares)		6,057		0.0%
		Unrestricted Common Stock (6 shares)				0.0%
			<b>39,219</b>	<b>31,638</b>		<b>5.9%</b>
C&J Cladding LLC	Texas / Metal Services and Minerals	Senior Secured Note (14.00%, due 3/30/2012) <sup>(3), (4)</sup>	3,150	2,722	3,308	0.6%
		Warrants (400 warrants, expiring 3/30/2014)		580	3,825	0.7%
			<b>3,302</b>	<b>7,133</b>		<b>1.3%</b>
Change Clean Energy Holdings, Inc. ( CCEHI <sup>(5)</sup> )	Maine / Biomass Power	Common Stock (1,000 shares)		2,530	2,530	0.5%
				<b>2,530</b>	<b>2,530</b>	<b>0.5%</b>
Gas Solutions Holdings, Inc. <sup>(8)</sup>	Texas / Gas Gathering and Processing	Senior Secured Note (18.00%, due 12/22/2018) <sup>(3)</sup>	25,000	25,000	25,000	4.7%
		Junior Secured Note (18.00%, due 12/23/2018) <sup>(3)</sup>	5,000	5,000	5,000	0.9%

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		Common Stock (100 shares) <sup>(3)</sup>	5,003	55,187	10.4%	
			<b>35,003</b>	<b>85,187</b>	<b>16.0%</b>	
Integrated Contract Services, Inc. <sup>(9)</sup>	North Carolina / Contracting	Senior Demand Note (15.00%, due 6/30/2009) <sup>(10)</sup>	1,170	1,170	1,170	0.2%
		Senior Secured Note (7.00% plus 7.00% PIK plus 6.00% default interest, in non-accrual status effective 10/09/2007, past due)	800	800	800	0.1%
		Junior Secured Note (7.00% plus 7.00% PIK plus 6.00% default interest, in non-accrual status effective 10/09/2007, past due)	14,003	14,003	3,030	0.6%
		Preferred Stock Series A (10 shares)				0.0%
		Common Stock (49 shares)		679		0.0%
			<b>16,652</b>	<b>5,000</b>	<b>0.9%</b>	
Iron Horse Coiled Tubing, Inc.	Alberta, Canada / Production Services	Bridge Loan (15.00% plus 3.00% PIK, due 12/31/2009)	9,826	9,826	9,602	1.8%
		Senior Secured Note (15.00%, due 12/31/2009)	9,250	9,250	3,004	0.6%
		Common Stock (1,781 shares)		268		0.0%
			<b>19,344</b>	<b>12,606</b>	<b>2.4%</b>	
NRG Manufacturing, Inc.	Texas / Manufacturing	Senior Secured Note (16.50%, due 8/31/2011) <sup>(3), (4)</sup>	13,080	13,080	13,080	2.5%
		Common Stock (800 shares)		2,317	19,294	3.6%
			<b>15,397</b>	<b>32,374</b>	<b>6.1%</b>	
R-V Industries, Inc.	Pennsylvania / Manufacturing	Warrants (200,000 warrants, expiring 6/30/2017)		1,682	4,500	0.8%
		Common Stock (545,107 shares)		5,086	12,267	2.3%
			<b>6,768</b>	<b>16,767</b>	<b>3.1%</b>	
Yatesville Coal Holdings, Inc. <sup>(11)</sup>	Kentucky / Mining, Steel, Iron and Non-Precious Metals and Coal	Senior Secured Note (15.72%, in non-accrual status effective 1/01/2009, due 12/31/2010) <sup>(4)</sup>	10,000	10,000	10,000	1.9%

Production

Junior Secured Note (15.72%, in non-accrual status effective 1/01/2009, due 12/31/2010) <sup>(4)</sup>	38,463	38,463	3,097	0.6%
Common Stock (1,000 shares)		427		0.0%
		<b>48,890</b>	<b>13,097</b>	<b>2.5%</b>
<b>Total Control Investments</b>	<b>187,105</b>	<b>206,332</b>	<b>38.7%</b>	

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Portfolio Company	Locale / Industry	Investments <sup>(1)</sup>	June 30, 2009			% of Net Assets	
			Principal Value	Cost	Fair Value <sup>(2)</sup>		
<b>LEVEL 3 INVESTMENTS:</b>							
<b>Affiliate Investments (5.00% to 24.99% voting control)</b>							
Appalachian Energy Holdings LLC <sup>(21)</sup>	West Virginia / Construction Services	Senior Secured Debt Tranche A (14.00% plus 3.00% PIK plus 3.00% default interest, in non-accrual status effective 11/01/2008, due 1/31/2011)	\$ 1,997	\$ 1,891	\$ 2,052	0.4%	
		Senior Secured Debt Tranche B (14.00% plus 3.00% PIK plus 3.00% default interest, in non-accrual status effective 11/01/2008, past due)	2,050	1,955	356	0.1%	
		Preferred Stock Series A (200 units)		82		0.0%	
		Preferred Stock Series B (241 units)		241		0.0%	
		Preferred Stock Series C (500 units)		500		0.0%	
		Warrants (6,065 warrants, expiring 2/13/2016)		176		0.0%	
		Warrants (6,025 warrants, expiring 6/17/2018)		172		0.0%	
		Warrants (25,000 warrants, expiring 11/30/2018)				0.0%	
				<b>5,017</b>	<b>2,408</b>	<b>0.5%</b>	
		Biotronic NeuroNetwork <sup>(17)</sup>	Michigan / Healthcare	Senior Secured Note (11.50% plus 1.00% PIK, due 2/21/2013) <sup>(3), (4)</sup>	26,227	26,227	27,007
Preferred Stock (9,925 shares) <sup>(13)</sup>				2,300	2,839	0.5%	
			<b>28,527</b>	<b>29,846</b>	<b>5.6%</b>		

<b>Total Affiliate Investments</b>	<b>33,544</b>	<b>32,254</b>	<b>6.1%</b>
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**Non-control/Non-affiliate Investments (less than 5.00% of voting control)**

American Gilsonite Company	Utah / Specialty Minerals	Senior Subordinated Note (12.00% plus 3.00% PIK, due 3/14/2013) <sup>(3)</sup>	14,783	14,783	15,073	2.8%
		Membership Interest Units in AGC/PEP, LLC (99.9999%) <sup>(16)</sup>		1,031	3,851	0.7%
				<b>15,814</b>	<b>18,924</b>	<b>3.5%</b>
Castro Cheese Company, Inc.	Texas / Food Products	Junior Secured Note (11.00% plus 2.00% PIK, due 2/28/2013) <sup>(3)</sup>	7,538	7,413	7,637	1.4%
				<b>7,413</b>	<b>7,637</b>	<b>1.4%</b>
Conquest Cherokee, LLC <sup>(6)</sup>	Tennessee / Oil & Gas Production	Senior Secured Note (13.00% plus 4.00% default interest, in non-accrual status effective 4/01/2009, past due) <sup>(4)</sup>	10,200	10,191	6,855	1.3%
		Overriding Royalty Interests <sup>(19)</sup>			565	0.1%
				<b>10,191</b>	<b>7,420</b>	<b>1.4%</b>
Deb Shops, Inc. <sup>(17)</sup>	Pennsylvania / Retail	Second Lien Debt (8.67%, due 10/23/2014)	15,000	14,623	6,272	1.2%
				<b>14,623</b>	<b>6,272</b>	<b>1.2%</b>
Diamondback Operating, LP	Oklahoma / Oil & Gas Production	Net Profits Interest (15.00% payable on Equity distributions) <sup>(7)</sup>			458	0.1%
					<b>458</b>	<b>0.1%</b>
Freedom Marine Services LLC	Louisiana / Shipping Vessels	Subordinated Secured Note (12.00% plus 4.00% PIK, due 12/31/2011) <sup>(3)</sup>	7,234	7,160	7,152	1.4%
		Net Profits Interest (22.50% payable on Equity distributions) <sup>(3), (7)</sup>			229	0.0%
				<b>7,160</b>	<b>7,381</b>	<b>1.4%</b>

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			Principal Value	Cost		Fair Value <sup>(2)</sup>
<b>LEVEL 3 INVESTMENTS:</b>						
<b>Non-control/Non-affiliate Investments (less than 5.00% of voting control)</b>						
H&M Oil & Gas, LLC	Texas / Oil & Gas Production	Senior Secured Note (13.00%, due 6/30/2010) <sup>(3)</sup>  Net Profits Interest (8.00% payable on Equity distributions) <sup>(3), (7)</sup>	\$ 49,688	\$ 49,688	\$ 49,697	9.3%
					1,682	0.3%
			<b>49,688</b>		<b>51,379</b>	<b>9.6%</b>
IEC Systems LP ( IEC ) /Advanced Rig Services LLC ( ARS )	Texas / Oilfield Fabrication	IEC Senior Secured Note (12.00% plus 3.00% PIK, due 11/20/2012) <sup>(3), (4)</sup>  ARS Senior Secured Note (12.00% plus 3.00% PIK, due 11/20/2012) <sup>(3), (4)</sup>	21,411	21,411	21,839	4.1%
			12,836	12,836	13,092	2.5%
			<b>34,247</b>		<b>34,931</b>	<b>6.6%</b>
Maverick Healthcare, LLC	Arizona / Healthcare	Second Lien Debt (12.00% plus 1.50% PIK, due 11/30/2014) <sup>(3)</sup>  Preferred Units (1,250,000 units) Common Units (1,250,000 units)	12,691	12,691	12,816	2.4%
				1,252	1,300	0.2%
						0.0%
			<b>13,943</b>		<b>14,116</b>	<b>2.6%</b>
Miller Petroleum, Inc.	Tennessee / Oil &	Warrants, Common Stock (1,935,523 warrants, expiring 5/04/2010 to 6/30/2014) <sup>(14)</sup>		150	241	0.1%

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	Gas Production			<b>150</b>	<b>241</b>	<b>0.1%</b>
Peerless Manufacturing	Texas / Subordinated Secured Note (11.50% plus 3.50% PIK, due 4/29/2013) <sup>(3)</sup>	20,000	20,000	20,400	3.8%	
			<b>20,000</b>	<b>20,400</b>	<b>3.8%</b>	
Qualitest Pharmaceuticals, Inc. <sup>(17)</sup>	Alabama / Second Lien Debt (8.10%, due 4/30/2015) <sup>(3), (4)</sup> Pharmaceuticals	12,000	11,949	11,452	2.2%	
			<b>11,949</b>	<b>11,452</b>	<b>2.2%</b>	
Regional Management Corporation.	South Carolina / Second Lien Debt (12.00% plus 2.00% PIK, due 6/20/2012) <sup>(3)</sup> Financial Services	25,424	25,424	23,073	4.3%	
			<b>25,424</b>	<b>23,073</b>	<b>4.3%</b>	
Resco Products, Inc.	Pennsylvania / Second Lien Debt (8.67%, due 6/22/2014) <sup>(3), (4)</sup> Manufacturing	9,750	9,594	9,750	1.8%	
			<b>9,594</b>	<b>9,750</b>	<b>1.8%</b>	
Shearer s Foods, Inc.	Ohio / Second Lien Debt (14.00%, due 10/31/2013) <sup>(3)</sup> Food Products	18,000	18,000	18,360	3.5%	
	Membership Interest Units in Mistral Chip Holdings, LLC (2,000 units) <sup>(18)</sup>		2,000	3,419	0.6%	
			<b>20,000</b>	<b>21,779</b>	<b>4.1%</b>	
Stryker Energy, LLC	Ohio / Subordinated Secured Revolving Credit Facility (12.00%, due 12/01/2011) <sup>(3), (4)</sup> Oil & Gas Production	29,500	29,154	29,554	5.5%	
	Overriding Royalty Interests <sup>(19)</sup>			2,918	0.6%	
			<b>29,154</b>	<b>32,472</b>	<b>6.1%</b>	
TriZetto Group <sup>(17)</sup>		15,205	15,065	16,331	3.1%	

California Subordinated Unsecured Note (12.00% plus 1.50%  
 / PIK, due 10/01/2016)<sup>(3)</sup>  
 Healthcare

**15,065 16,331 3.1%**

Unitek<sup>(17)</sup>

Pennsylvania Lien Debt (13.08%, due 12/31/2013)<sup>(3), (4)</sup>  
 /  
 Technical  
 Services

11,500 11,360 11,730 2.2%

**11,360 11,730 2.2%**

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				Cost	Fair Value <sup>(2)</sup>	
<b>LEVEL 3 INVESTMENTS:</b>						
<b>Non-control/Non-affiliate Investments (less than 5.00% of voting control)</b>						
Wind River Resources Corp. and Wind River II Corp.	Utah / Oil & Gas Production	Senior Secured Note (13.00% plus 3.00% default interest, in non-accrual status effective 12/01/2008, due 7/31/2010) <sup>(4)</sup>	\$ 15,000	\$ 15,000	\$ 12,644	2.4%
		Net Profits Interest (5.00% payable on Equity distributions) <sup>(7)</sup>			192	0.0%
				<b>15,000</b>	<b>12,836</b>	<b>2.4%</b>
		<b>Total Non-Control/Non-Affiliate Investments</b>		<b>310,775</b>	<b>308,582</b>	<b>57.9%</b>
		<b>Total Level 3 Portfolio Investments</b>		<b>531,424</b>	<b>547,168</b>	<b>102.7%</b>
<b>LEVEL 2 INVESTMENTS:</b>						
<b>Money Market Funds</b>						
Fidelity Institutional Money Market Funds (Class I)		Government Portfolio		94,753	94,753	17.8%
Fidelity Institutional Money Market Funds (Class I) <sup>(3)</sup>		Government Portfolio		3,982	3,982	0.7%
		<b>Total Money Market Funds (Level 2 Investments)</b>		<b>98,735</b>	<b>98,735</b>	<b>18.5%</b>
		<b>Total Investments</b>		<b>630,159</b>	<b>645,903</b>	<b>121.2%</b>

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULE OF INVESTMENTS (CONTINUED)**

**June 30, 2010 and June 30, 2009**

**(in thousands, except share data)**

**Endnote Explanations for the Consolidated Schedule of Investments as of June 30, 2010 and June 30, 2009**

- (1) The securities in which Prospect Capital Corporation ( we , us or our ) has invested were acquired in transactions that were exempt from registration under the Securities Act of 1933, as amended, or the Securities Act. These securities may be resold only in transactions that are exempt from registration under the Securities Act.
- (2) Fair value is determined by or under the direction of our Board of Directors. As of June 30, 2010, three of our portfolio investments, Allied Defense Group, Inc., Dover Saddlery, Inc. and Lyondell, were publically traded and classified as

Level 1 within the valuation hierarchy established by Accounting Standards Codification 820, *Fair Value Measurements and Disclosures* ( ASC 820 ). As of June 30, 2010 and June 30, 2009, the fair value of our remaining portfolio investments was determined using significant unobservable inputs. ASC 820 classifies such inputs used to measure fair value as Level 3 within the valuation hierarchy. Our investments in money market funds are classified as Level 2. See Note 3 and Note 4 within the accompanying consolidated financial statements for further discussion.

- (3) Security, or portion thereof, is held as collateral for the revolving credit facility (see Note 11). The market values of

these investments at June 30, 2010 and June 30, 2009 were \$512,244 and \$434,069, respectively; they represent 62.7% and 67.2% of total investments at fair value, respectively.

- (4) Security, or portion thereof, has a floating interest rate. Stated interest rate was in effect at June 30, 2010 and June 30, 2009.
- (5) There are several entities involved in the Biomass investment. We own 100 shares of common stock in Worcester Energy Holdings, Inc. ( WEHI ), representing 100% of the issued and outstanding common stock. WEHI, in turn, owns 51 membership certificates in Biochips LLC ( Biochips ), which represents a



51% ownership stake.

We own 282 shares of common stock in Worcester Energy Co., Inc. ( WECO ), which represents 51% of the issued and outstanding common stock.

We own directly 1,665 shares of common stock in Change Clean Energy Inc. ( CCEI ), f/k/a Worcester Energy Partners, Inc., which represents 51% of the issued and outstanding common stock and the remaining 49% is owned by WECO. CCEI owns 100 shares of common stock in Precision Logging and Landclearing, Inc. ( Precision ), which represents 100% of the issued and outstanding common stock.

During the quarter ended March 31, 2009, we created two new entities in anticipation of the foreclosure proceedings

against the co-borrowers (WECO, CCEI and Biochips) Change Clean Energy Holdings, Inc. ( CCEHI ) and DownEast Power Company, LLC ( DEPC ). We own 1,000 shares of CCEHI, representing 100% of the issued and outstanding stock, which in turn, owns a 100% of the membership interests in DEPC.

On March 11, 2009, we foreclosed on the assets formerly held by CCEI and Biochips with a successful credit bid of \$6,000 to acquire the assets. The assets were subsequently assigned to DEPC. WECO, CCEI and Biochips are joint borrowers on the term note issued to Prospect Capital. Effective July 1, 2008, this loan was placed on

non-accrual  
status.

Biochips,  
WECO, CCEI,  
Precision and  
WEHI currently  
have no material  
operations and  
no significant  
assets. As of  
June 30, 2009,  
our Board of  
Directors  
assessed a fair  
value of \$0 for  
all of these  
equity positions  
and the loan  
position. We  
determined that  
the impairment  
of both CCEI  
and CCEHI as  
of June 30, 2009  
was other than  
temporary and  
recorded a  
realized loss for  
the amount that  
the amortized  
cost exceeds the  
fair value at  
June 30, 2009.  
Our Board of  
Directors set no  
value for the  
CCEHI  
investment as of  
June 30, 2010, a  
decrease of  
\$2,530 from the  
fair value as of  
June 30, 2009.

- (6) During the  
quarter ended  
December 31,  
2009, we  
created two new  
entities,

Coalbed Inc. and Coalbed LLC, to foreclose on the outstanding senior secured loan and assigned rights and interests of Conquest Cherokee, LLC ( Conquest ), as a result of the deterioration of Conquest s financial performance and inability to service debt payments. We own 1,000 shares of common stock in Coalbed Inc., representing 100% of the issued and outstanding common stock. Coalbed Inc., in turn owns 100% of the membership interest in Coalbed LLC.

On October 21, 2009, Coalbed LLC foreclosed on the loan formerly made to Conquest. On January 19, 2010, as part of the Manx rollup, the Coalbed LLC assets and loan was assigned to Manx, the holding

company. As of June 30, 2010, our Board of Directors assessed a fair value of \$1,414 for the loan position in Coalbed LLC.

- (7) In addition to the stated returns, the net profits interest held will be realized upon sale of the borrower or a sale of the interests.
- (8) Gas Solutions Holdings, Inc. is a wholly-owned investment of us.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
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**June 30, 2010 and June 30, 2009**

**(in thousands, except share data)**

**Endnote Explanations for the Consolidated Schedule of Investments as of June 30, 2010 and June 30, 2009  
(Continued)**

- (9) Entity was formed as a result of the debt restructuring of ESA Environmental Specialist, Inc. In early 2009, we foreclosed on the two loans on non-accrual status and purchased the underlying personal and real property. We own 1,000 shares of common stock in The Healing Staff ( THS ), f/k/a Lisamarie Fallon, Inc. representing 100% ownership. We own 1,500 shares of Vets Securing America, Inc. ( VSA ), representing 100% ownership. VSA is a holding company for the real property of Integrated Contract Services, Inc. ( ICS ) purchased during the foreclosure process.

(10)

Loan is with  
THS an affiliate  
of ICS.

- (11) On June 30, 2008, we consolidated our holdings in four coal companies into Yatesville Coal Holdings, Inc. ( Yatesville ), and consolidated the operations under one management team. As part of the transaction, the debt that we held of C&A Construction, Inc. ( C&A ), Genesis Coal Corp. ( Genesis ), North Fork Collieries LLC ( North Fork ) and Unity Virginia Holdings LLC ( Unity ) were exchanged for newly issued debt from Yatesville, and our ownership interests in C&A, E&L Construction, Inc. ( E&L ), Whymore Coal Company Inc. ( Whymore ) and North Fork were exchanged for 100% of the equity of Yatesville. This reorganization allows for a better utilization of the assets in

the consolidated group.

At June 30, 2010 and at June 30, 2009, Yatesville owned 100% of the membership interest of North Fork. In addition, Yatesville held a \$9,325 and \$8,062, respectively, note receivable from North Fork as of those two respective dates.

At June 30, 2010 and at June 30, 2009, we owned 96% and 87%, respectively, of the common stock of Genesis and held a note receivable of \$20,897 and \$20,802, respectively, as of those two respective dates.

Yatesville held a note receivable of \$4,261 from Unity at June 30, 2010 and at June 30, 2009.

There are several entities involved in Yatesville's investment in Whymore at June 30, 2009. As of June 30, 2009, Yatesville owned 10,000 shares of



common stock or 100% of the equity and held a \$14,973 senior secured debt receivable from C&A, which owns the equipment.

Yatesville owned 10,000 shares of common stock or 100% of the equity of E&L, which leases the equipment from C&A, employs the workers, is listed as the operator with the Commonwealth of Kentucky, mines the coal, receives revenues and pays all operating expenses.

Yatesville owned 4,900 shares of common stock or 49% of the equity of Whymore, which applies for and holds permits on behalf of E&L.

Yatesville also owned 4,285 Series A convertible preferred shares in each of C&A, E&L and Whymore.

Whymore and E&L are guarantors under the C&A credit agreement with Yatesville.

In August 2009, Yatesville sold its 49% ownership interest in the common shares of Whymore to the 51% holder of the Whymore common shares ( Whymore Purchaser ). All reclamation liability was transferred to the Whymore Purchaser. In September 2009, Yatesville completed an auction for all of its equipment.

Yatesville currently has no material operations. During the quarter ended December 31, 2009, our Board of Directors determined that the impairment of Yatesville was other than temporary and we recorded a realized loss for the amount that the amortized cost exceeds the fair value. Our Board of Directors set the value of the remaining Yatesville investment at \$808 as of June 30, 2010.

- (12) On January 19, 2010, we modified the terms of our senior secured debt in AEH and Coalbed in conjunction with the formation of Manx Energy, a new entity consisting in the assets of AEH, Coalbed and Kinley Exploration. The assets of the three companies were brought under new common management. We funded \$2,800 at closing to Manx to provide for working capital. A portion of our loans to AEH and Coalbed was exchanged for Manx preferred equity, while our AEH equity interest was converted into Manx common stock. There was no change to fair value at the time of restructuring, and we continue to fully reserve any income accrued for Manx.
- (13) On a fully diluted basis represents, 11.677% of voting common

shares.

- (14) Total common shares outstanding of 33,389,383 as of July 22, 2010 from Miller Petroleum, Inc. s ( Miller ) Annual Report on Form 10-K filed on July 28, 2010 as applicable to our June 30, 2010 reporting date. Total common shares outstanding of 15,811,856 as of March 11, 2009 from Miller s Quarterly Report on Form 10-Q filed on March 16, 2009.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
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**June 30, 2010 and June 30, 2009**

**(in thousands, except share data)**

**Endnote Explanations for the Consolidated Schedule of Investments as of June 30, 2010 and June 30, 2009  
(Continued)**

(15) A portion of the positions listed were issued by an affiliate of the portfolio company.

(16) We own 99.9999% of AGC/PEP, LLC. AGC/PEP, LLC owns 2,037.65 out of a total of 83,818.69 shares (including 4,932 vested and unvested management options) of American Gilsonite Holding Company which owns 100% of American Gilsonite Company.

(17) Syndicated investment which had been originated by another financial institution and broadly distributed.

(18) At June 30, 2010, Mistral

Chip Holdings, LLC owns 44,800 shares of Chip Holdings, Inc. and Mistral Chip Holdings 2, LLC owns 11,975 shares in Chip Holdings, Inc. Chip Holdings, Inc. is the parent company of Shearer's Foods, Inc. and has 67,936 shares outstanding before adjusting for management options.

At June 30, 2009, Mistral Chip Holdings, LLC owns 44,800 shares out of 50,650 total shares outstanding of Chip Holdings, Inc., before adjusting for management options.

(19) The overriding royalty interests held receive payments at the stated rates based upon operations of the borrower.

(20) On December 31, 2009, we sold our investment in Aylward Enterprises, LLC. AWCNC,

LLC is the remaining holding company with zero assets and our remaining outstanding debt has no value of June 30, 2010.

- (21) There are several entities involved in the Appalachian Energy Holdings LLC ( AEH ) investment. We own warrants, the exercise of which will permit us to purchase 37,090 Class A common units of AEH at a nominal cost and in near-immediate fashion. We own 200 units of Series A preferred equity, 241 units of Series B preferred equity, and 500 units of Series C preferred equity of AEH. The senior secured notes are with C&S Operating LLC and East Cumberland L.L.C., both operating companies owned by AEH.

(22)

We own warrants to purchase 33,750 shares of common stock in Metal Buildings Holding Corporation ( Metal Buildings ), the former holding company of Borga, Inc. Metal Buildings Holding Corporation owned 100% of Borga, Inc.

On March 8, 2010, we foreclosed on the stock in Borga, Inc. that was held by Metal Buildings, obtaining 100% ownership of Borga, Inc.

(23) We own 100% of C&J Cladding Holding Company, Inc., which owns 40% of the membership interests in C&J Cladding, LLC.

(24) On January 1, 2010, we restructured our senior secured and bridge loans investment in Iron Horse Coiled Tubing,



Inc. ( Iron Horse ) and we reorganized Iron Horse s management structure. The senior secured loan and bridge loan were replaced with three new tranches of senior secured debt. From June 30, 2009 to June 30, 2010, our total ownership of Iron Horse decreased from 80.0% to 70.4%, respectively.

As of June 30, 2010 and June 30, 2009, our Board of Directors assessed a fair value in Iron Horse of \$12,054 and \$12,606, respectively.

(25) We own 2,800,000 units in Class A Membership Interests and 372,094 units in Class A-1 Membership Interests.

(26) Undrawn committed revolvers incur a 0.50% commitment fee. As of

June 30, 2010,  
we have  
\$10,632 of  
undrawn  
revolver  
commitments to  
our portfolio  
companies.

- (27) Stated interest rates are based on June 30, 2010 one month LIBOR rates plus applicable spreads based on the respective credit agreements. Interest rates are subject to change based on actual elections by the borrower for a LIBOR rate contract or Base Rate contract when drawing on the revolver.

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**Note 1. Organization**

References herein to we, us or our refer to Prospect Capital Corporation ( Prospect ) and its subsidiary unless context specifically requires otherwise.

We were formerly known as Prospect Energy Corporation, a Maryland corporation. We were organized on April 13, 2004 and were funded in an initial public offering ( IPO ), completed on July 27, 2004. We are a closed-end investment company that has filed an election to be treated as a Business Development Company ( BDC ), under the Investment Company Act of 1940 (the 1940 Act ). As a BDC, we have qualified and have elected to be treated as a regulated investment company ( RIC ), under Subchapter M of the Internal Revenue Code. We invest primarily in senior and subordinated debt and equity of companies in need of capital for acquisitions, divestitures, growth, development, project financings, recapitalizations, and other purposes.

On May 15, 2007, we formed a wholly-owned subsidiary, Prospect Capital Funding, LLC, a Delaware limited liability company, for the purpose of holding certain of our loan investments in the portfolio which are used as collateral for our credit facility.

**Note 2. Patriot Acquisition**

On December 2, 2009, we acquired the outstanding shares of Patriot Capital Funding, Inc. ( Patriot ) common stock for \$201,083. Under the terms of the merger agreement, Patriot common shareholders received 0.363992 shares of our common stock for each share of Patriot common stock, resulting in 8,444,068 shares of common stock being issued by us. In connection with the transaction, we repaid all the outstanding borrowings of Patriot, in compliance with the merger agreement.

On December 2, 2009, Patriot made a final dividend payment equal to its undistributed net ordinary income and capital gains of \$0.38 per share. In accordance with a recent IRS revenue procedure, the dividend was paid 10% in cash and 90% in newly issued shares of Patriot's common stock. The exchange ratio was adjusted to give effect to the final income distribution.

The merger has been accounted for as an acquisition of Patriot by Prospect Capital Corporation ( Prospect ) in accordance with acquisition method of accounting as detailed in ASC 805, *Business Combinations* ( ASC 805 ). The fair value of the consideration paid was allocated to the assets acquired and liabilities assumed based on their fair values as the date of acquisition. As described in more detail in ASC 805, goodwill, if any, would have been recognized as of the acquisition date, if the consideration transferred exceeded the fair value of identifiable net assets acquired. As of the acquisition date, the fair value of the identifiable net assets acquired exceeded the fair value of the consideration transferred, and we recognized the excess as a gain. A preliminary gain of \$5,714 was recorded by Prospect in the quarter ended December 31, 2009 related to the acquisition of Patriot, which was revised in the fourth quarter of Fiscal 2010, to \$7,708, when we settled severance accruals related to certain members of Patriot's top management. Under ASC 805, the adjustment to our preliminary estimates is reflected in the three and six months ended December 31, 2009 (See Note 13). The acquisition of Patriot was negotiated in July 2009 with the purchase agreement being signed on August 3, 2009. Between July 2009 and December 2, 2009, our valuation of certain of the investments acquired from Patriot increased due to market improvement, which resulted in the recognition of the gain at closing.

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*Preliminary Purchase Price Allocation*

The purchase price has been allocated to the assets acquired and the liabilities assumed based on their estimated fair values as summarized in the following table:

Cash (to repay Patriot debt)	\$ 107,313
Cash (to fund purchase of restricted stock from former Patriot employees)	970
Common stock issued <sup>(1)</sup>	92,800
 Total purchase price	 201,083
Assets acquired:	
Investments <sup>(2)</sup>	207,126
Cash and cash equivalents	1,697
Other assets	3,859
 Assets acquired	 212,682
Other liabilities assumed	(3,891)
 Net assets acquired	 208,791
 Preliminary gain on Patriot acquisition <sup>(3)</sup>	 \$ 7,708

(1) The value of the shares of common stock exchanged with the Patriot common shareholders was based upon the closing price of our common stock on December 2, 2009, the price immediately prior to the closing of the transaction.

(2) The fair value of Patriot's investments were determined by the Board of

Directors in conjunction with an independent valuation agent. This valuation resulted in a purchase price which was \$98,150 below the amortized cost of such investments. For those assets which are performing, Prospect will record the accretion to par value in interest income over the remaining term of the investment.

- (3) The preliminary gain has been determined based upon the estimated value of certain liabilities which are not yet settled. Any changes to such accruals will be recorded in future periods as an adjustment to such gain. We do not believe such adjustments will be material.

*Preliminary Condensed Statement of Net Assets Acquired*

The following condensed statement of net assets acquired reflects the preliminary values assigned to Patriot's net assets as of the acquisition date, December 2, 2009.

Investment securities	\$ 207,126
Cash and cash equivalents	1,697
Other assets	3,859

Total assets	212,682
Other liabilities	(3,891)
Preliminary fair value of net assets acquired	\$ 208,791

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The following unaudited pro forma condensed combined financial information does not purport to be indicative of actual financial position or results of our operations had the Patriot acquisition actually been consummated at the beginning of each period presented. Certain one-time charges have been eliminated. The pro forma adjustments reflecting the allocation of the purchase price of Patriot and the gain of \$7,708 recognized on the Patriot Acquisition have been eliminated from all periods presented. Management expects to realize net operating synergies from this transaction. The pro forma condensed combined financial information does not reflect the potential impact of these synergies and does not reflect any impact of additional accretion which would have been recognized on the transaction, except for that which was recorded after the transaction was consummated on December 2, 2009.

	<b>Year ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
Total Investment Income	\$ 119,258	\$ 137,473
Net Investment Income	65,538	74,553
Net Increase (Decrease) in Net Assets Resulting from Operations	12,117	(7,302)
Net Increase (Decrease) in Net Assets Resulting from Operations per share	0.19	(0.14)

**Note 3. Significant Accounting Policies**

The following are significant accounting policies consistently applied by us:

*Basis of Presentation*

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) and pursuant to the requirements for reporting on Form 10-K and Regulation S-X. The financial results of our portfolio investments are not consolidated in the financial statements.

*Use of Estimates*

The preparation of GAAP financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reported period. Changes in the economic environment, financial markets, creditworthiness of our portfolio companies and any other parameters used in determining these estimates could cause actual results to differ, and these differences could be material.

*Basis of Consolidation*

Under the 1940 Act rules, the regulations pursuant to Article 6 of Regulation S-X and the American Institute of Certified Public Accountants Audit and Accounting Guide for Investment Companies, we are precluded from consolidating any entity other than another investment company or an operating company which provides substantially all of its services and benefits to us. Our financial statements include our accounts and the accounts of Prospect Capital Funding, LLC, our only wholly-owned, closely-managed subsidiary that is also an investment company. All intercompany balances and transactions have been eliminated in consolidation.

*Investment Classification*

We are a non-diversified company within the meaning of the 1940 Act. We classify our investments by level of control. As defined in the 1940 Act, control investments are those where there is the ability or power to exercise a controlling influence over the management or policies of a company. Control is generally deemed to exist when a company or individual possesses or has the right to acquire within 60 days or less, a beneficial ownership of 25% or more of the voting securities of an investee company. Affiliated investments and affiliated companies are defined by a lesser degree of influence and are deemed to exist through the possession outright or via the right to acquire within 60 days or less, beneficial ownership of 5% or more of the outstanding voting securities of another person.





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Investments are recognized when we assume an obligation to acquire a financial instrument and assume the risks for gains or losses related to that instrument. Investments are derecognized when we assume an obligation to sell a financial instrument and forego the risks for gains or losses related to that instrument. Specifically, we record all security transactions on a trade date basis. Investments in other, non-security financial instruments are recorded on the basis of subscription date or redemption date, as applicable. Amounts for investments recognized or derecognized but not yet settled are reported as receivables for investments sold and payables for investments purchased, respectively, in the Consolidated Statements of Assets and Liabilities.

*Investment Risks*

The Company's investments are subject to a variety of risks. Those risks include the following:

*Market Risk*

Market risk represents the potential loss that can be caused by a change in the fair value of the financial instrument.

*Credit Risk*

Credit risk represents the risk that the Company would incur if the counterparties failed to perform pursuant to the terms of their agreements with the Company.

*Liquidity Risk*

Liquidity risk represents the possibility that the Company may not be able to rapidly adjust the size of its positions in times of high volatility and financial stress at a reasonable price.

*Interest Rate Risk*

Interest rate risk represents a change in interest rates, which could result in an adverse change in the fair value of an interest-bearing financial instrument.

*Prepayment Risk*

Most of the Company's debt investments allow for prepayment of principal without penalty. Downward changes in interest rates may cause prepayments to occur at a faster than expected rate, thereby effectively shortening the maturity of the security and making the security less likely to be an income producing instrument.

*Investment Valuation*

Our Board of Directors has established procedures for the valuation of our investment portfolio. These procedures are detailed below.

Investments for which market quotations are readily available are valued at such market quotations.

For most of our investments, market quotations are not available. With respect to investments for which market quotations are not readily available or when such market quotations are deemed not to represent fair value, our Board of Directors has approved a multi-step valuation process each quarter, as described below:

- 1) Each portfolio company or investment is reviewed by our investment professionals with the independent valuation firm;

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- 2) the independent valuation firm engaged by our Board of Directors conducts independent appraisals and makes their own independent assessment;
- 3) the audit committee of our Board of Directors reviews and discusses the preliminary valuation of our Investment Adviser and that of the independent valuation firm; and
- 4) the Board of Directors discusses valuations and determines the fair value of each investment in our portfolio in good faith based on the input of our Investment Adviser, the respective independent valuation firm and the audit committee.

Investments are valued utilizing a market approach, an income approach, a liquidation approach, or a combination of approaches, as appropriate. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present value amount (discounted) calculated based on an appropriate discount rate. The measurement is based on the net present value indicated by current market expectations about those future amounts. In following these approaches, the types of factors that we may take into account in fair value pricing our investments include, as relevant: available current market data, including relevant and applicable market trading and transaction comparables, applicable market yields and multiples, security covenants, call protection provisions, information rights, the nature and realizable value of any collateral, the portfolio company's ability to make payments, its earnings and discounted cash flows, the markets in which the portfolio company does business, comparisons of financial ratios of peer companies that are public, M&A comparables, the principal market and enterprise values, among other factors.

In September 2006, the Financial Accounting Standards Board ( FASB ) issued ASC 820, *Fair Value Measurements and Disclosures* ( ASC 820 ). ASC 820 defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. We adopted ASC 820 on a prospective basis beginning in the quarter ended September 30, 2008.

ASC 820 classifies the inputs used to measure these fair values into the following hierarchy:

**Level 1:** Quoted prices in active markets for identical assets or liabilities, accessible by us at the measurement date.

**Level 2:** Quoted prices for similar assets or liabilities in active markets, or quoted prices for identical or similar assets or liabilities in markets that are not active, or other observable inputs other than quoted prices.

**Level 3:** Unobservable inputs for the asset or liability.

In all cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined 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 considers factors specific to each investment. The changes to GAAP from the application of ASC 820 relate to the definition of fair value, framework for measuring fair value, and the expanded disclosures about fair value measurements. ASC 820 applies to fair value measurements already required or permitted by other standards. In accordance with ASC 820, the fair value of our investments is defined as the price that we would receive upon selling an investment in an orderly transaction to an independent buyer in the principal or most advantageous market in which that investment is transacted.

In April 2009, the FASB issued ASC Subtopic 820-10-65, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ( ASC 820-10 ). This update provides further clarification for ASC 820 in markets that are not active and provides additional guidance for determining when the volume of trading level of activity for an asset or liability has significantly decreased and for identifying circumstances that indicate a transaction is not orderly. ASC 820-10-65 is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of ASC 820-10-65 for the year ended June 30, 2010, did not have any effect on our net asset value, financial position or results of operations as

there was no change to the fair value measurement principles set forth in ASC 820.

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*Valuation of Other Financial Assets and Financial Liabilities*

In February 2007, FASB issued ASC Subtopic 820-10-05-1, *The Fair Value Option for Financial Assets and Financial Liabilities* ( ASC 820-10-05-1 ). ASC 820-10-05-1 permits an entity to elect fair value as the initial and subsequent measurement attribute for many of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. We adopted this statement on July 1, 2008 and have elected not to value other assets and liabilities at fair value as would be permitted by ASC 820-10-05-1.

*Revenue Recognition*

Realized gains or losses on the sale of investments are calculated using the specific identification method.

Interest income, adjusted for amortization of premium and accretion of discount, is recorded on an accrual basis. Origination, closing and/or commitment fees associated with investments in portfolio companies are accreted into interest income over the respective terms of the applicable loans. Accretion of such purchase discounts or premiums is calculated by the effective interest method as of the purchase date and adjusted only for material amendments or prepayments. Upon the prepayment of a loan or debt security, any prepayment penalties and unamortized loan origination, closing and commitment fees are recorded as interest income. The purchase discount for portfolio investments acquired from Patriot was determined based on the difference between par value and fair market value as of December 2, 2009, and will continue to accrete until maturity or repayment of the respective loans.

Dividend income is recorded on the ex-dividend date.

Structuring fees and similar fees are recognized as income as earned, usually when paid. Structuring fees, excess deal deposits, net profits interests and overriding royalty interests are included in other income.

Loans are placed on non-accrual status when principal or interest payments are past due 90 days or more or when there is reasonable doubt that principal or interest will be collected. Accrued interest is generally reversed when a loan is placed on non-accrual status. Interest payments received on non-accrual loans may be recognized as income or applied to principal depending upon management's judgment. Non-accrual loans are restored to accrual status when past due principal and interest is paid and in management's judgment, are likely to remain current.

*Federal and State Income Taxes*

We have elected to be treated as a regulated investment company and intend to continue to comply with the requirements of the Internal Revenue Code of 1986 (the Code ), applicable to regulated investment companies. We are required to distribute at least 90% of our investment company taxable income and intend to distribute (or retain through a deemed distribution) all of our investment company taxable income and net capital gain to stockholders; therefore, we have made no provision for income taxes. The character of income and gains that we will distribute is determined in accordance with income tax regulations that may differ from GAAP. Book and tax basis differences relating to stockholder dividends and distributions and other permanent book and tax differences are reclassified to paid-in capital.

If we do not distribute (or are not deemed to have distributed) at least 98% of our annual taxable income in the calendar year it is earned, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such taxable income for the year. To the extent that we determine that our estimated current year annual taxable income will be in excess of estimated current year dividend distributions from such taxable income, we accrue excise taxes, if any, on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

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We adopted FASB ASC 740, *Income Taxes* ( ASC 740 ). 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 our tax returns to determine whether the tax positions are more-likely-than-not of being sustained by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. Adoption of ASC 740 was applied to all open tax years as of July 1, 2007. The adoption of ASC 740 did not have an effect on our net asset value, financial condition or results of operations as there was no liability for unrecognized tax benefits and no change to our beginning net asset value. As of June 30, 2010 and for the year then ended, we did not have a liability for any unrecognized tax benefits. 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 on-going analysis of tax laws, regulations and interpretations thereof.

*Dividends and Distributions*

Dividends and distributions to common stockholders are recorded on the ex-dividend date. The amount, if any, to be paid as a dividend or distribution is approved by our Board of Directors each quarter and is generally based upon our management's estimate of our earnings for the quarter. Net realized capital gains, if any, are distributed at least annually.

*Financing Costs*

We record origination expenses related to our credit facility as deferred financing costs. These expenses are deferred and amortized as part of interest expense using the effective interest method over the stated life of the facility.

We record registration expenses related to shelf filings as prepaid assets. These expenses consist principally of Securities and Exchange Commission ( SEC ) registration fees, legal fees and accounting fees incurred. These prepaid assets will be charged to capital upon the receipt of an equity offering proceeds or charged to expense if no offering completed.

*Guarantees and Indemnification Agreements*

We follow FASB ASC 460, *Guarantees* ( ASC 460 ). ASC 460 elaborates on the disclosure requirements of a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires a guarantor to recognize, at the inception of a guarantee, for those guarantees that are covered by ASC 460, the fair value of the obligation undertaken in issuing certain guarantees. ASC 460 did not have a material effect on the financial statements. Refer to Note 11 for further discussion of guarantees and indemnification agreements.

*Per Share Information*

Net increase or decrease in net assets resulting from operations per common share are calculated using the weighted average number of common shares outstanding for the period presented. Diluted net increase or decrease in net assets resulting from operations per share are not presented as there are no potentially dilutive securities outstanding.

*Reclassifications*

Certain reclassifications have been made in the presentation of prior consolidated financial statements to conform to the presentation as of and for the twelve months ended June 30, 2010.

*Recent Accounting Pronouncements*

In May 2009, the FASB issued ASC 855, *Subsequent Events* ( ASC 855 ). ASC 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The standard, which includes a new required disclosure of the date through which an entity has evaluated subsequent events, is effective for interim or annual periods ending after June 15, 2009. We evaluated all events or transactions that occurred after June 30, 2010 up through the date we issued the accompanying financial statements. During this period, we did not have any material recognizable subsequent events other than those disclosed in our financial statements.



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In June 2009, the FASB issued ASC 105, *Generally Accepted Accounting Principles* ( ASC 105 ), which establishes the FASB Codification which supersedes all existing accounting standard documents and will become the single source of authoritative non-governmental U.S. GAAP. All other accounting literature not included in the Codification will be considered non-authoritative. The Codification did not change GAAP but reorganizes the literature. ASC 105 is effective for interim and annual periods ending after September 15, 2009. We have conformed our financial statements and related Notes to the new Codification.

In June 2009, the FASB issued ASC 860, *Accounting for Transfers of Financial Assets – an amendment to FAS 140* ( ASC 860 ). ASC 860 improves the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets: the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. ASC 860 is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Our management does not believe that the adoption of the amended guidance in ASC 860 will have a significant effect on our financial statements.

In June 2009, the FASB issued ASC 810, *Consolidation* ( ASC 810 ). ASC 810 is intended to (1) address the effects on certain provisions of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, as a result of the elimination of the qualifying special-purpose entity concept in ASC 860, and (2) constituent concerns about the application of certain key provisions of Interpretation 46(R), including those in which the accounting and disclosures under the Interpretation do not always provided timely and useful information about an enterprise's involvement in a variable interest entity. ASC 810 is effective as of the beginning of our first annual reporting period that begins after November 15, 2009. Our management does not believe that the adoption of the amended guidance in ASC 860 will have a significant effect on our financial statements.

In August 2009, the FASB issued Accounting Standards Update ( ASU ) 2009-05, *Measuring Liabilities at Fair Value, to amend FASB Accounting Standards Codification ASC 820, Fair Value Measurements and Disclosures* ( ASC 820 ), to clarify how entities should estimate the fair value of liabilities. ASC 820, as amended, includes clarifying guidance for circumstances in which a quoted price in an active market is not available, the effect of the existence of liability transfer restrictions, and the effect of quoted prices for the identical liability, including when the identical liability is traded as an asset. We adopted ASU 2009-05 effective October 1, 2009. The amended guidance in ASC 820 does not have a significant effect on our financial statements for the year ended June 30, 2010.

In September 2009, the FASB issued ASU 2009-12, *Measuring Fair Value of Certain Investments* ( ASU 2009-12 ). This update provides further amendments to ASC 820 to offer investors a practical expedient for measuring the fair value of investments in certain entities that calculate net asset value per share. Specifically, measurement using net asset value per share is reasonable for investments within the scope of ASU 2009-12. We adopted ASU 2009-12 effective October 1, 2009. The amended guidance in ASC 820 does not have a significant effect on our financial statements for the year ended June 30, 2010.

In January 2010, the FASB issued Accounting Standards Update 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* ( ASC 2010-06 ). ASU 2010-06 amends ASC 820-10 and clarifies and provides additional disclosure requirements related to recurring and non-recurring fair value measurements and employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective December 15, 2009, except for the disclosure about purchase, sales, issuances and settlements in the roll forward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. Our management does not believe that the adoption of the amended guidance in ASC 820-10 will have a significant effect on our financial statements.

In February 2010, the FASB issued Accounting Standards Update 2010-09, *Subsequent Events (Topic 855) Amendments to Certain Recognition and Disclosure Requirements* ( ASU 2010-09 ), which amends ASC Subtopic 855-10. ASU 2010-09 requires an entity that is an SEC filer to evaluate subsequent events through the date that the

financial statements are issued and removes the requirement that an SEC filer disclose the date through which subsequent events have been evaluated. ASC 2010-09 was effective upon issuance. The adoption of this standard had no effect on our results of operation or our financial position.



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In February 2010, the FASB issued Accounting Standards Update 2010-10, *Consolidation (Topic 810) Amendments for Certain Investments Funds* ( ASU 2010-10 ), which defers the application of the consolidation guidance in ASC 810 for certain investments funds. The disclosure requirements continue to apply to all entities. ASU 2010-10 is effective as of the beginning of the first annual period that begins after November 15, 2009 and for interim periods within that first annual period. Our management does not believe that the adoption of the amended guidance in ASU 2010-10 will have a significant effect on our financial statements.

In August 2010, the FASB issued Accounting Standards Update 2010-21, *Accounting for Technical Amendments to Various SEC Rules and Schedules* ( ASU 2010-21 ). This Accounting Standards Update various SEC paragraphs pursuant to the issuance of Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules and Codification of Financial Reporting Policies. We are assessing the potential effect this guidance will have on our consolidated financial statements.

In August 2010, the FASB issued Accounting Standards Update 2010-22, *Accounting for Various Topics - Technical Corrections to SEC Paragraphs* ( ASU 2010-22 ). ASU 2010-22 amends various SEC paragraphs based on external comments received and the issuance of Staff Accounting Bulletin ( SAB ) 112, which amends or rescinds portions of certain SAB topics. We are assessing the potential effect this guidance will have on our consolidated financial statements.

**Note 4. Portfolio Investments**

At June 30, 2010, we had invested in 58 long-term portfolio investments, which had an amortized cost of \$728,759 and a fair value of \$748,483 and at June 30, 2009, we had invested in 30 long-term portfolio investments, which had an amortized cost of \$531,424 and a fair value of \$547,168.

As of June 30, 2010, we own controlling interests in Ajax Rolled Ring & Machine ( Ajax ), AWCNC, LLC, Borga, Inc. ( Borga ), C&J Cladding, LLC, Change Clean Energy Holdings, Inc. ( CCEHI ), Fischbein, LLC, Freedom Marine Services LLC, Gas Solutions Holdings, Inc. ( GSHI ), Integrated Contract Services, Inc. ( ICS ), Iron Horse Coiled Tubing, Inc. ( Iron Horse ), Manx Energy, Inc. ( Manx ), NRG Manufacturing, Inc., Nupla Corporation ( Nupla ), R-V Industries, Inc., Sidump r Trailer Company, Inc. ( Sidump r ) and Yatesville Coal Holdings, Inc. ( Yatesville ). We also own an affiliated interest in Biotronic NeuroNetwork, Boxercraft Incorporated, KTPS Holdings, LLC, Smart, LLC, and Sport Helmets Holdings, LLC.

The fair values of our portfolio investments as of June 30, 2010 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Fair Value Hierarchy			Total
	Level 1	Level 2	Level 3	
Investments at fair value				
Control investments	\$	\$	\$ 195,958	\$ 195,958
Affiliate investments			73,740	73,740
Non-control/non-affiliate investments	1,368		477,417	478,785
	1,368		747,115	748,483
Investments in money market funds		68,871		68,871
Total assets reported at fair value	\$ 1,368	\$ 68,871	\$ 747,115	\$ 817,354

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The fair values of our portfolio investments as of June 30, 2009 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Fair Value Hierarchy			Total
	Level 1	Level 2	Level 3	
Investments at fair value				
Control investments	\$	\$	\$ 206,332	\$ 206,332
Affiliate investments			32,254	32,254
Non-control/non-affiliate investments			308,582	308,582
			547,168	547,168
Investments in money market funds		98,735		98,735
Total assets reported at fair value	\$	\$ 98,735	\$ 547,168	\$ 645,903

The aggregate values of Level 3 portfolio investments changed during the twelve months ended June 30, 2010 as follows:

	Fair Value Measurements Using Unobservable Inputs (Level 3)			Total
	Control Investments	Affiliate Investments	Non-Control/Non-Affiliate Investments	
Fair value as of June 30, 2009	\$ 206,332	\$ 32,254	\$ 308,582	\$ 547,168
Total realized losses	(51,228)			(51,228)
Change in unrealized (depreciation) appreciation	(8,403)	9,948	4,085	5,630 <sup>(1)</sup>
Net realized and unrealized (loss) gain	(59,631)	9,948	4,085	(45,598)
Assets acquired in the Patriot acquisition	10,534	36,400	160,073	207,007
Purchases of portfolio investments	16,240	2,800	126,788	145,828
Payment-in-kind interest	2,871	775	3,905	7,551
Accretion of original issue discount	3,535	1,475	15,303	20,313
Dispositions of portfolio investments	(9,396)	(4,884)	(120,874)	(135,154)
Transfers within Level 3	25,473	(5,028)	(20,445)	
Transfers in (out) of Level 3				
Fair value as of June 30, 2010	\$ 195,958	\$ 73,740	\$ 477,417	\$ 747,115

<sup>(1)</sup> Relates to assets held at June 30, 2010

During the year ended June 30, 2010, the valuation methodology for Ajax changed from a discounted cash flow analysis to an enterprise and equity valuation. The independent valuation agent proposed this adjustment due to our

controlling equity interest in Ajax. As a result, and combined with declining financial results, the fair market value of Ajax decreased from \$31,638 to \$30,904 as of June 30, 2009 and June 30, 2010, respectively. There were no other material changes to our valuation methodology.

At June 30, 2010, nine loan investments were on non-accrual status: Borga, Deb Shops, Inc., ICS, Iron Horse, Nupla, Manx, Sidump r, Wind River Resources Corp. and Wind River II Corp. ( Wind River ), and Yatesville. At June 30, 2009, five loan investments were on non-accrual status: Appalachian Energy Holdings, LLC ( AEH ), Coalbed LLC./Coalbed Inc. ( Coalbed ), ICS, Wind River and Yatesville. The loan principal of these loans amounted to \$163,653 and \$92,513 as of June 30, 2010 and June 30, 2009, respectively. The fair values of these investments represent approximately 5.6% and 7.3% of our net assets as of June 30, 2010 and June 30, 2009, respectively. For the years ended June 30, 2010, June 30, 2009 and June 30, 2008, the income foregone as a result of not accruing interest on non-accrual debt investments amounted to \$19,764, \$18,746 and \$3,449, respectively.

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During the quarter ended December 31, 2009, we discontinued operations at Yatesville. At December 31, 2009, consistent with the decision to discontinue operations, we determined that the impairment of Yatesville was other-than-temporary and recorded a realized loss of \$51,228 for the amount that the amortized cost exceeded the fair market value. As of June 30, 2010 and June 30, 2009, Yatesville is valued at \$808 and \$13,097, respectively. At June 30, 2009, we determined that one of our investments, CCEHI was other than temporarily impaired and recorded a realized loss representing the amount by which the amortized cost exceeded the fair value.

GSHI has indemnified us against any legal action arising from its investment in Gas Solutions, LP. We have incurred approximately \$2,093 from the inception of the investment in GSHI through June 30, 2010 for fees associated with a legal action, and GSHI has reimbursed us for the entire amount. Of the \$2,093 reimbursement, \$179 and \$118 was reflected as dividend income: control investments in the Consolidated Statements of Operations for the years ended June 30, 2009 and June 30, 2008, respectively. There were no such legal fees incurred or reimbursed for the year ended June 30, 2010. Additionally, certain other expenses incurred by us which are attributable to GSHI have been reimbursed by GSHI and are reflected as dividend income: control investments in the Consolidated Statements of Operations. For the years ended June 30, 2010, June 30, 2009 and June 30, 2008, such reimbursements totaled as \$3,103, \$4,422 and \$4,589, respectively.

The original cost basis of debt placements and equity securities acquired, including follow-on investments for existing portfolio companies, totaled \$157,662, \$98,305 and \$311,947 during the year ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. Debt repayments and sales of equity securities with a cost basis of approximately \$136,221, \$66,084 and \$143,434 were received during the year ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively.

During the year ended June 30, 2010, we restructured our loans to Aircraft Fasteners International, LLC, EXL Acquisition Corporation, LHC Holdings Corp., Prince Mineral Company, Inc. and R-O-M Corporation. The revised terms were more favorable than the original terms and increased the present value of the future cash flows. In accordance with ASC 320-20-35 the cost basis of the new loans were recorded at par value, which included \$8,099 of accelerated original purchase discount recognized as interest income.

**Note 5. Other Investment Income**

Other investment income consists of structuring fees, overriding royalty interests, prepayment penalty on net profits interests, settlement of net profits interests, deal deposits, administrative agent fee, and other miscellaneous and sundry cash receipts. Income from such sources was \$11,751, \$14,762 and \$8,336 for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively.

<b>Income Source</b>	<b>For The Year Ended</b>		
	<b>June 30, 2010</b>	<b>June 30, 2009</b>	<b>June 30, 2008</b>
Gain on Patriot acquisition (Note 2)	\$ 7,708	\$	\$
Structuring and amendment fees	3,338	1,274	4,751
Overriding royalty interests	194	550	1,819
Prepayment penalty on net profits interests			1,659
Settlement of net profits interests		12,651	
Deal deposit		62	49
Administrative agent fee	100	55	48
Miscellaneous	411	170	10
Other Investment Income	\$ 11,751	\$ 14,762	\$ 8,336



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**Note 6. Equity Offerings, Offering Expenses, and Distributions**

During the year ended June 30, 2010, we issued 16,683,197 shares of our common stock through public offerings, a registered direct offering, and through the exercise of over-allotment options on the part of the underwriters. Offering expenses were charged against paid-in capital in excess of par. All underwriting fees and offering expenses were borne by us. The proceeds raised, the related underwriting fees, the offering expenses, and the prices at which common stocks were issued since inception are detailed in the following table:

Issuances of Common Stock	Number of Shares Issued	Gross Proceeds Raised	Underwriting Fees	Offering Expenses	Offering Price
March 23, 2010 June 30, 2010 <sup>(1)</sup>	5,251,400	\$ 60,378	\$ 1,210	\$ 624	\$ 11.50
September 24, 2009 <sup>(2)</sup>	2,807,111	\$ 25,264	\$	\$ 840	\$ 9.000
August 20, 2009 <sup>(2)</sup>	3,449,686	\$ 29,322	\$	\$ 117	\$ 8.500
July 7, 2009	5,175,000	\$ 46,575	\$ 2,329	\$ 200	\$ 9.000
May 26, 2009 over-allotment	1,012,500	\$ 8,353	\$ 418	\$	\$ 8.250
May 26, 2009	6,750,000	55,687	2,784	300	8.250
April 27, 2009 over-allotment	480,000	\$ 3,720	\$ 177	\$	\$ 7.750
April 27, 2009	3,200,000	24,800	1,177	210	7.750
March 19, 2009	1,500,000	\$ 12,300	\$	\$ 513	\$ 8.200
June 2, 2008	3,250,000	\$ 48,425	\$ 2,406	\$ 254	\$ 14.900
March 31, 2008	1,150,000	\$ 17,768	\$ 759	\$ 350	\$ 15.450
March 28, 2008	1,300,000	19,786	\$	350	15.220
November 13, 2007 over-allotment	200,000	\$ 3,268	\$ 163	\$	\$ 16.340
October 17, 2007	3,500,000	57,190	2,860	551	16.340
January 11, 2007 over-allotment	810,000	\$ 14,026	\$ 688	\$	\$ 17.315 <sup>(3)</sup>
December 13, 2006	6,000,000	106,200	5,100	279	17.700
August 28, 2006 over-allotment	745,650	\$ 11,408	\$ 566	\$	\$ 15.300
August 10, 2006	4,971,000	76,056	3,778	595	15.300
August 27, 2004 over-allotment	55,000	\$ 825	\$ 58	\$ 2	\$ 15.000
July 27, 2004	7,000,000	105,000	7,350	1,385	15.000

- (1) On March 17, 2010, we established an at-the-market program through which we may sell, from time to time and at our sole discretion, 8,000,000 shares of our common stock. Through this program we issued 5,251,400 shares of our common stock at an average price of \$11.50 per share, raising \$60,378 of gross proceeds, from March 23, 2010 through June 30, 2010.
- (2) Concurrent with the sale of these shares, we entered into a registration rights agreement in which we granted the purchasers certain registration rights with respect to the shares. We have filed with the SEC a post-effective amendment to the registration statement on Form N-2 which has been

declared  
effective by the  
SEC.

- (3) We declared a dividend of \$0.385 per share between offering and over allotment dates.



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Our shareholders' equity accounts at June 30, 2010 and June 30, 2009 reflect cumulative shares issued as of those respective dates. Our common stock has been issued through public offerings, a registered direct offering, the exercise of over-allotment options on the part of the underwriters and our dividend reinvestment plan. When our common stock is issued, the related offering expenses have been charged against paid-in capital in excess of par. All underwriting fees and offering expenses were borne by us.

On October 9, 2008, our Board of Directors approved a share repurchase plan under which we may repurchase up to \$20,000 of our common stock at prices below our net asset value as reported in our financial statements published for the year ended June 30, 2008. We have not made any purchases of our common stock during the period from October 9, 2008 to June 30, 2010 pursuant to this plan.

On June 18, 2010, we announced a change in dividend policy from quarterly to monthly dividends and declared monthly dividends in the following amounts and with the following dates:

- \$0.10 per share for June 2010 to holders of record on June 30, 2010 with a payment date of July 30, 2010;
- \$0.10025 per share for July 2010 to holders of record on July 30, 2010 with a payment date of August 31, 2010; and
- \$0.10050 per share for August 2010 to holders of record on August 31, 2010 with a payment date of September 30, 2010.

**Note 7. Net Increase in Net Assets per Common Share**

The following information sets forth the computation of net increase in net assets resulting from operations per common share for the years ended June 30, 2010, 2009 and 2008, respectively.

	<b>For The Year Ended</b>		
	<b>June 30, 2010</b>	<b>June 30, 2009</b>	<b>June 30, 2008</b>
Net increase in net assets resulting from operations	\$ 18,886	\$ 35,104	\$ 27,591
Weighted average common shares outstanding	59,429,222	31,559,905	23,626,642
 Net increase in net assets resulting from operations per common share	 \$ 0.32	 \$ 1.11	 \$ 1.17

**Note 8. Related Party Agreements and Transactions***Investment Advisory Agreement*

We have entered into an investment advisory and management agreement with Prospect Capital Management (the Investment Advisory Agreement) under which the Investment Adviser, subject to the overall supervision of our Board of Directors, manages the day-to-day operations of, and provides investment advisory services to, us. Under the terms of the Investment Advisory Agreement, our Investment Adviser: (i) determines the composition of our portfolio, the nature and timing of the changes to our portfolio and the manner of implementing such changes, (ii) identifies, evaluates and negotiates the structure of the investments we make (including performing due diligence on our prospective portfolio companies); and (iii) closes and monitors investments we make.

Prospect Capital Management's services under the Investment Advisory Agreement are not exclusive, and it is free to furnish similar services to other entities so long as its services to us are not impaired. For providing these services the Investment Adviser receives a fee from us, consisting of two components: a base management fee and an incentive fee. The base management fee is calculated at an annual rate of 2.00% on our gross assets (including amounts borrowed). For services currently rendered under the Investment Advisory Agreement, the base management fee is payable quarterly in arrears. The base management fee is calculated based on the average value of our gross assets at the end of the two most recently completed calendar quarters and appropriately adjusted for any share issuances or

repurchases during the current calendar quarter.

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The total base management fees earned by and paid to Prospect Capital Management for the years ended June 30, 2010, June 30, 2009 and June 30, 2008 were \$13,929, \$11,915 and \$8,921, respectively.

The incentive fee has two parts. The first part, the income incentive fee, is calculated and payable quarterly in arrears based on our pre-incentive fee net investment income for the immediately preceding calendar quarter. For this purpose, pre-incentive fee net investment income means interest income, dividend income and any other income (including any other fees (other than fees for providing managerial assistance), such as commitment, origination, structuring, diligence and consulting fees and other fees that we receive from portfolio companies) accrued during the calendar quarter, minus our operating expenses for the quarter (including the base management fee, expenses payable under the Administration Agreement described below, and any interest expense and dividends paid on any issued and outstanding preferred stock, but excluding the incentive fee). Pre-incentive fee net investment income includes, in the case of investments with a deferred interest feature (such as original issue discount, debt instruments with payment in kind interest and zero coupon securities), accrued income that we have not yet received in cash. Pre-incentive fee net investment income does not include any realized capital gains, realized capital losses or unrealized capital appreciation or depreciation. Pre-incentive fee net investment income, expressed as a rate of return on the value of our net assets at the end of the immediately preceding calendar quarter, is compared to a hurdle rate of 1.75% per quarter (7.00% annualized).

The net investment income used to calculate this part of the incentive fee is also included in the amount of the gross assets used to calculate the 2.00% base management fee. We pay the Investment Adviser an income incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate;

100.00% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 125.00% of the quarterly hurdle rate in any calendar quarter (8.75% annualized assuming a 7.00% annualized hurdle rate); and

20.00% of the amount of our pre-incentive fee net investment income, if any, that exceeds 125.00% of the quarterly hurdle rate in any calendar quarter (8.75% annualized assuming a 7.00% annualized hurdle rate).

These calculations are appropriately prorated for any period of less than three months and adjusted for any share issuances or repurchases during the current quarter.

The second part of the incentive fee, the capital gains incentive fee, is determined and payable in arrears as of the end of each calendar year (or upon termination of the Investment Advisory Agreement, as of the termination date), and equals 20.00% of our realized capital gains for the calendar year, if any, computed net of all realized capital losses and unrealized capital depreciation at the end of such year. In determining the capital gains incentive fee payable to the Investment Adviser, we calculate the aggregate realized capital gains, aggregate realized capital losses and aggregate unrealized capital depreciation, as applicable, with respect to each investment that has been in its portfolio. For the purpose of this calculation, an investment is defined as the total of all rights and claims which maybe asserted against a portfolio company arising from our participation in the debt, equity, and other financial instruments issued by that company. Aggregate realized capital gains, if any, equal the sum of the differences between the aggregate net sales price of each investment and the aggregate cost basis of such investment when sold or otherwise disposed. Aggregate realized capital losses equal the sum of the amounts by which the aggregate net sales price of each investment is less than the aggregate cost basis of such investment when sold or otherwise disposed. Aggregate unrealized capital depreciation equals the sum of the differences, if negative, between the aggregate valuation of each investment and the aggregate cost basis of such investment as of the applicable calendar year-end. At the end of the applicable calendar year, the amount of capital gains that serves as the basis for our calculation of the capital gains incentive fee involves netting aggregate realized capital gains against aggregate realized capital losses on a since-inception basis and then reducing this amount by the aggregate unrealized capital depreciation. If this number is positive, then the capital gains incentive fee payable is equal to 20.00% of such amount, less the aggregate amount of any capital gains incentive fees

paid since inception.

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Income incentive fees totaling \$16,613, \$14,790 and \$11,278 were earned for the years ended June 30, 2010, June 30, 2009 and June 30, 2008, respectively. No capital gains incentive fees were earned for years ended June 30, 2010, June 30, 2009 and June 30, 2008.

*Administration Agreement*

We have also entered into an Administration Agreement with Prospect Administration, LLC ( Prospect Administration ) under which Prospect Administration, among other things, provides (or arranges for the provision of) administrative services and facilities for us. For providing these services, we reimburse Prospect Administration for our allocable portion of overhead incurred by Prospect Administration in performing its obligations under the Administration Agreement, including rent and our allocable portion of the costs of our chief compliance officer and chief financial officer and their respective staffs. For the years ended June 30, 2010, 2009 and 2008, the reimbursement was approximately \$3,361, \$2,856 and \$2.139, respectively. Under this agreement, Prospect Administration furnishes us with office facilities, equipment and clerical, bookkeeping and record keeping services at such facilities. Prospect Administration also performs, or oversees the performance of, our required administrative services, which include, among other things, being responsible for the financial records that we are required to maintain and preparing reports to our stockholders and reports filed with the SEC. In addition, Prospect Administration assists us in determining and publishing our net asset value, overseeing the preparation and filing of our tax returns and the printing and dissemination of reports to our stockholders, and generally oversees the payment of our expenses and the performance of administrative and professional services rendered to us by others. Under the Administration Agreement, Prospect Administration also provides on our behalf managerial assistance to those portfolio companies to which we are required to provide such assistance. The Administration Agreement may be terminated by either party without penalty upon 60 days written notice to the other party. Prospect Administration is a wholly owned subsidiary of our Investment Adviser.

The Administration Agreement provides that, absent willful misfeasance, bad faith or negligence in the performance of its duties or by reason of the reckless disregard of its duties and obligations, Prospect Administration and its officers, managers, partners, agents, employees, controlling persons, members and any other person or entity affiliated with it are entitled to indemnification from us for any damages, liabilities, costs and expenses (including reasonable attorneys fees and amounts reasonably paid in settlement) arising from the rendering of Prospect Administration s services under the Administration Agreement or otherwise as administrator for us.

Prior to July 1, 2009, Prospect Administration, pursuant to the approval of our Board of Directors, engaged Vastardis Fund Services LLC ( Vastardis ) to serve as our sub-administrator to perform certain services required of Prospect Administration. Under the sub-administration agreement, Vastardis provided us with office facilities, equipment, clerical, bookkeeping and record keeping services at such facilities. Vastardis also conducted relations with custodians, depositories, transfer agents, dividend disbursing agents, other stockholder servicing agents, accountants, attorneys, underwriters, brokers and dealers, corporate fiduciaries, insurers, banks and such other persons in any such other capacity deemed to be necessary or desirable. Vastardis provided reports to the Administrator and the Directors of its performance of obligations and furnished advice and recommendations with respect to such other aspects of our business and affairs as it shall determine to be desirable. Under the sub-administration agreement, Vastardis also provided the service of William E. Vastardis as our Chief Financial Officer ( CFO ). We compensated Vastardis for providing us these services by the payment of an asset-based fee with a \$400 annual minimum, payable monthly. Our service agreement was amended on September 28, 2008 so that Mr. Vastardis no longer served as our CFO effective as of November 11, 2008. At that time, Brian H. Oswald, a managing director at Prospect Administration, assumed the role of CFO.

We terminated our agreement with Vastardis to provide sub-administration services effective June 30, 2009. We entered into a new consulting services agreement for the period from July 1, 2009 until the filing of our Form 10-K for the year ended June 30, 2009. We paid Vastardis a total of \$30 for services rendered in conjunction with preparation of Form 10-K under the new agreement. This amount was accrued during the quarter ended June 30, 2009. All

services previously provided by Vastardis were assumed by Prospect Administration beginning on July 1, 2009 for the fiscal year ending June 30, 2010 and thereafter.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
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(in thousands, except share and per share data)**

*Managerial Assistance*

As a business development company, we offer, and must provide upon request, managerial assistance to certain of our portfolio companies. This assistance could involve, among other things, monitoring the operations of our portfolio companies, participating in board and management meetings, consulting with and advising officers of portfolio companies and providing other organizational and financial guidance. We billed \$892, \$846, and \$1,027 of managerial assistance fees for the years ended June 30, 2010, June 30, 2009, and June 30, 2008, respectively, of which \$247 and \$60 remains on the consolidated statement of assets and liabilities as of June 30, 2010, and June 30, 2009, respectively. These fees are paid to the Administrator so we simultaneously accrue a payable to the Administrator for the same amounts, which remain on the consolidated statements of assets and liabilities.

**Note 9. Financial Highlights**

	<b>Year Ended June 30, 2010</b>	<b>Year Ended June 30, 2009</b>	<b>Year Ended June 30, 2008</b>	<b>Year Ended June 30, 2007</b>	<b>Year Ended June 30, 2006</b>
<b>Per Share Data<sup>(1)</sup>:</b>					
Net asset value at beginning of period	\$ 12.40	\$ 14.55	\$ 15.04	\$ 15.31	\$ 14.59
Costs related to the initial public offering					0.01
Costs related to the secondary public offering			(0.07)	(0.06)	
Net investment income	1.12	1.87	1.91	1.47	1.21
Realized (loss) gain	(0.87)	(1.24)	(0.69)	0.12	0.04
Net unrealized appreciation (depreciation)	0.07	0.48	(0.05)	(0.52)	0.58
Net (decrease) increase in net assets as a result of public offering	(0.85)	(2.11)		0.26	
Net increase in net assets as a result of shares issued for Patriot acquisition	0.12				
Dividends declared and paid	(1.70)	(1.15)	(1.59)	(1.54)	(1.12)
Net asset value at end of period	\$ 10.29	\$ 12.40	\$ 14.55	\$ 15.04	\$ 15.31
Per share market value at end of period	\$ 9.65	\$ 9.20	\$ 13.18	\$ 17.47	\$ 16.99
Total return based on market value <sup>(2)</sup>	21.96%	(22.04%)	(15.90%)	12.65%	44.90%
Total return based on net asset value <sup>(2)</sup>	(3.51%)	(4.81%)	7.84%	7.62%	12.76%
Shares outstanding at end of period	69,086,862	42,943,084	29,520,379	19,949,065	7,069,873

Average weighted shares outstanding for period	59,429,222	31,559,905	23,626,642	15,724,095	7,056,846
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**Ratio / Supplemental Data:**

Net assets at end of period (in thousands)	\$ 710,685	\$ 532,596	\$ 429,623	\$ 300,048	\$ 108,270
Annualized ratio of operating expenses to average net assets	7.51%	9.03%	9.62%	7.36%	8.19%
Annualized ratio of net investment income to average net assets	10.58%	13.14%	12.66%	9.71%	7.90%

(1) Financial highlights are based on weighted average shares.

(2) Total return based on market value is based on the change in market price per share between the opening and ending market prices per share in each period and assumes that dividends are reinvested in accordance with our dividend reinvestment plan. Total return based on net asset value is based upon the change in net asset value per share between the opening and ending net asset values per share in each period and assumes that dividends are reinvested in accordance with our dividend



reinvestment  
plan.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
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**Note 10. Litigation**

From time to time, we may become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to intellectual property, employment, tax, regulation, contract or other matters. The resolution of these matters as they arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources. On December 6, 2004, Dallas Gas Partners, L.P. ( DGP ) served us with a complaint filed November 30, 2004 in the U.S. District for the Southern District of Texas, Galveston Division. DGP alleges that DGP was defrauded and that we breached our fiduciary duty to DGP and tortiously interfered with DGP s contract to purchase Gas Solutions, Ltd. (a subsidiary of our portfolio company, GSHI) in connection with our alleged agreement in September 2004 to loan DGP funds with which DGP intended to buy Gas Solutions, Ltd. for approximately \$26,000. The complaint sought relief not limited to \$100,000. On November 30, 2005, U.S. Magistrate Judge John R. Froeschner of the U.S. District Court for the Southern District of Texas, Galveston Division, issued a recommendation that the court grant our Motion for Summary Judgment dismissing all claims by DGP. On February 21, 2006, U.S. District Judge Samuel Kent of the U.S. District Court for the Southern District of Texas, Galveston Division issued an order granting our Motion for Summary Judgment dismissing all claims by DGP, against us. On May 16, 2007, the Court also granted us summary judgment on DGP s liability to us on our counterclaim for DGP s breach of a release and covenant not to sue. On January 4, 2008, the Court, Judge Melinda Harmon presiding, granted our motion to dismiss all DGP s claims asserted against certain of our officers and affiliates. On August 20, 2008, Judge Harmon entered a Final Judgment dismissing all of DGP s claims. DGP appealed to the U.S. Court of Appeals for the Fifth Circuit, which affirmed the Final Judgment on June 24, 2009. DGP then moved for rehearing on July 8, 2009, which the Fifth Circuit denied on August 6, 2009. Our damage claims against DGP remain pending.

In May 2006, based in part on unfavorable due diligence and the absence of investment committee approval, we declined to extend a loan for \$10,000 to a potential borrower ( plaintiff ). Plaintiff was subsequently sued by its own attorney in a local Texas court for plaintiff s failure to pay fees owed to its attorney. In December 2006, plaintiff filed a cross-action against us and certain affiliates (the defendants ) in the same local Texas court, alleging, among other things, tortious interference with contract and fraud. We petitioned the United States District Court for the Southern District of New York (the District Court ) to compel arbitration and to enjoin the Texas action. In February 2007, our motions were granted. Plaintiff appealed that decision. On July 24, 2008, the Second Circuit Court of Appeals affirmed the judgment of the District Court. The arbitration commenced in July 2007 and concluded in late November 2007. Post-hearing briefings were completed in February 2008. On April 14, 2008, the arbitrator rendered an award in our favor, rejecting all of plaintiff s claims. On April 18, 2008, we filed a petition before the District Court to confirm the award. On October 8, 2008, the District Court granted the Company s petition to confirm the award, confirmed the awards and subsequently entered judgment thereon in favor of the Company in the amount of \$2,288. After filing a defective notice of appeal to the United States Court of Appeals for the Second Circuit on November 5, 2008, plaintiff s counsel resubmitted a new notice of appeal on January 9, 2009. The plaintiff subsequently requested that the Company agree to stipulate to the withdrawal of plaintiff s appeal to the Second Circuit. Such a stipulation was filed with the Second Circuit on or about April 14, 2009. Based on this stipulation, the Second Circuit issued a mandate terminating the appeal, which was transmitted to the District Court on April 23, 2009. Post-judgment discovery against plaintiff is continuing and we have filed a motion for sanctions against plaintiff s counsel. Argument for the motion for sanctions was held on November 19, 2009 and a decision from the court is pending. On March 9, 2010, Judge Leonard Sands granted our motion for sanctions against plaintiff s counsel. On July 14, 2010, Arnold & Itkin filed a notice of appeal appealing the judgment and the Court s March 9, 2010 Memorandum and Order.

**Note 11. Revolving Credit Agreements**

On June 6, 2007, we closed on a \$200,000 three-year revolving credit facility (as amended on December 31, 2007) with Rabobank Nederland ( Rabobank ) as administrative agent and sole lead arranger (the Rabobank Facility ). Until November 14, 2008, interest on the Rabobank Facility was charged at LIBOR plus 175 basis points; thereafter, under

the terms of a commitment letter with Rabobank to arrange and structure a new rated credit facility, we agreed to an immediate increase in the current borrowing rate on the Rabobank Facility to LIBOR plus 250 basis points. Additionally, Rabobank charged a fee on the unused portion of the facility. This fee is assessed at the rate of 37.5 basis points per annum of the amount of that unused portion.

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On June 25, 2009, we completed a first closing on an expanded \$250,000 revolving credit facility (the Syndicated Facility). The new Syndicated Facility, which had \$175,000 total commitments as of June 30, 2009, includes an accordion feature which allows the Syndicated Facility to accept up to an aggregate total of \$250,000 of commitments for which we continue to solicit additional commitments from other lenders for the additional \$75,000. The revolving period extends through June 24, 2010, with an additional one year amortization period thereafter whereby all principal, interest and fee payments received in conjunction with collateral pledged to the Syndicated Facility, less a monthly servicing fee payable to us, are required to be used to repay outstanding borrowings under the Syndicated Facility. Any remaining outstanding borrowings would be due and payable on the commitment termination date, which is currently June 24, 2011.

On June 11, 2010, we closed an extension and expansion of our revolving credit facility with a syndicate of lenders. The lenders have commitments of \$210 million under the new credit facility as of June 11, 2010. The new credit facility includes an accordion feature which allows the facility to be increased to up to \$300 million of commitments in the aggregate to the extent additional or existing lenders commit to increase the commitments. We will seek to add additional lenders in order to reach the maximum size; although no assurance can be given we will be able to do so. As we make additional investments which are eligible to be pledged under the credit facility, we will generate additional availability to the extent such investments are eligible to be placed into the borrowing base. The revolving period of the credit facility extends through June 2012, with an additional one year amortization period (with distributions allowed) after the completion of the revolving period. During such one year amortization period, all principal payments on the pledged assets will be applied to reduce the balance. At the end of the one year amortization period, the remaining balance will become due if required by the lenders.

The Syndicated Facility contains restrictions pertaining to the geographic and industry concentrations of funded loans, maximum size of funded loans, interest rate payment frequency of funded loans, maturity dates of funded loans and minimum equity requirements. The Syndicated Facility also contains certain requirements relating to portfolio performance, including required minimum portfolio yield and limitations on delinquencies and charge-offs, violation of which could result in the early termination of the Syndicated Facility. The Syndicated Facility also requires the maintenance of a minimum liquidity requirement. At June 30, 2010, we were in compliance with the applicable covenants.

Interest on borrowings under the credit facility is one-month LIBOR plus 325 basis points, subject to a minimum Libor floor of 100 basis points. Additionally, the lenders charge a fee on the unused portion of the credit facility equal to either 75 basis points if at least half of the credit facility is used or 100 basis points otherwise. As of June 30, 2010 and 2009, we had \$180,678 and \$125,746 available to us for borrowing under our credit facility, of which \$100,300 and \$124,800 was outstanding, respectively. As we make additional investments which are eligible to be pledged under the credit facility, we will generate additional availability to the extent such investments are eligible to be placed into the borrowing base. At June 30, 2010, the investments used as collateral for the Syndicated Facility had an aggregate market value of \$512,244, which represents 72.1% of net assets.

In connection with the origination and amendment of the Syndicated Facility, we incurred approximately \$7,580 of fees, including \$3,224 of fees carried over from the previous facility, which are being amortized over the term of the facility, and wrote off \$759 of the unamortized debt issue costs associated with the original credit facility, in accordance with ASC 470-50, *Debt Modifications and Extinguishments*.

**Note 12. Merger Proposal to Allied Capital Corporation**

In January 2010, we delivered a proposal letter to Allied Capital Corporation (Allied) noting our opposition to Allied's proposed merger with Ares Capital Corporation (Ares) and containing an offer to acquire each outstanding Allied share in exchange for 0.385 of a share of our common stock. Allied expressed that our offer did not constitute a Superior Proposal as defined in their Merger Agreement with Ares and declined our January 2010 offer. In February 2010, we increased our offer to 0.4416 of a share of our common stock. This final offer was also declined by Allied. On March 5, 2010, following Allied's announcement of a special dividend to shareholders, we terminated our

solicitation in opposition of the proposed merger with Ares. We incurred \$852 of administrative and legal expense for advice relating to this potential acquisition for the year ended June 30, 2010.

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**Note 13. Selected Quarterly Financial Data (Unaudited)**

Quarter Ended	Investment Income		Net Investment Income		Net Realized and Unrealized Gains (Losses)		Net Increase (Decrease) in Net Assets from Operations	
	Total	Per Share <sup>(1)</sup>	Total	Per Share <sup>(1)</sup>	Total	Per Share <sup>(1)</sup>	Total	Per Share <sup>(1)</sup>
September 30, 2007	15,391	0.77	7,865	0.39	685	0.04	8,550	0.43
December 31, 2007	18,563	0.80	10,660	0.46	(14,346)	(0.62)	(3,686)	(0.16)
March 31, 2008	22,000	0.92	12,919	0.54	(14,178)	(0.59)	(1,259)	(0.05)
June 30, 2008	23,448	0.85	13,669	0.50	10,317	0.38	23,986	0.88
September 30, 2008 <sup>(2)</sup>	35,799	1.21	23,502	0.80	(9,504)	(0.33)	13,998	0.47
December 31, 2008	22,213	0.75	11,960	0.40	(5,436)	(0.18)	6,524	0.22
March 31, 2009	20,669	0.69	11,720	0.39	3,611	0.12	15,331	0.51
June 30, 2009	21,800	0.59	11,981	0.32	(12,730)	(0.34)	(749)	(0.02)
September 30, 2009	21,517	0.43	12,318	0.25	(18,696)	(0.38)	(6,378)	(0.13)
December 31, 2009 <sup>(3)</sup>	30,877	0.54	18,519	0.32	(33,778)	(0.59)	(15,259)	(0.26)
March 31, 2010	32,005	0.50	18,974	0.30	6,966	0.11	25,940	0.41
June 30, 2010	29,236	0.44	16,640	0.25	(2,057)	(0.03)	14,583	0.22

(1) Per share amounts are calculated using weighted average shares during period.

(2) Additional income for this quarter was driven by other investment income from the settlement of net profits interests on IEC Systems LP and Advanced Rig

Services LLC  
for \$12,576. See  
Note 5.

- (3) As adjusted for  
increase in  
earnings from  
Patriot. See  
Note 2.

**Note 14. Subsequent Events**

On July 14, 2010, we closed a \$37,400 first lien senior secured credit facility to support the acquisition by H.I.G. Capital of a leading consumer credit enhancement services company.

On July 23, 2010, we made a secured debt investment of \$21,000 in SonicWALL, Inc., a global leader in network security and data protection for small, mid-sized, and large enterprise organizations.

On July 30, 2010, we issued 83,875 shares of our common stock in connection with the dividend reinvestment plan.

On July 30, 2010, we invested \$52,420 of combined debt and equity in AIRMALL USA Inc., a leading developer and manager of airport retail operations.

On July 30, 2010, we recapitalized our debt investment in Northwestern Management Services, LLC, a leading dental practice management company in the Southeast Florida market, providing \$10,774 of additional funding to fund the acquisition of six dental practices.

During the period from July 1, 2010 to July 21, 2010, we issued 2,748,600 shares of our common stock at an average price of \$9.75 per share, and raised \$26,799 of gross proceeds, under our at-the-market program. Net proceeds were \$26,262 after 2% commission to the broker-dealer on shares sold.

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During the period from July 22, 2010 to August 24, 2010, we issued 3,814,528 shares of our common stock at an average price of \$9.71 per share, and raised \$37,052 of gross proceeds, under our at-the-market program. Net proceeds were \$36,335 after 2% commission to the broker-dealer on shares sold.

On August 26, 2010, we declared monthly dividends in the following amounts and with the following dates:

\$0.100625 per share for September 2010 to holders of record on September 30, 2010 with a payment date of October 29, 2010;

\$0.100750 per share for October 2010 to holders of record on October 29, 2010 with a payment date of November 30, 2010.

On August 26, 2010, Regional Management Corporation repaid the \$25,814 loan receivable to us.



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**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

As of June 30, 2010, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the 1934 Act). Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective and provided reasonable assurance that information required to be disclosed in our periodic SEC filings is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. However, in evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of such possible controls and procedures.

*Report of Management on Internal Control Over Financial Reporting*

Management is responsible for establishing and maintaining adequate internal control over financial reporting, and for performing an assessment of the effectiveness of internal control over financial reporting as of June 30, 2010. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that (i) pertain to assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Management performed an assessment of the effectiveness of the Company's internal control over financial reporting as of June 30, 2010 based upon criteria in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ). Based on our assessment, management determined that the Company's internal control over financial reporting was effective as of June 30, 2010 based on the criteria on Internal Control - Integrated Framework issued by COSO. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2010 that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

Our management's assessment of the effectiveness of our internal control over financial reporting as of June 30, 2010 has been audited by BDO USA, LLP, an independent registered public accounting firm, as stated in their report which appears herein.

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*Report of Independent Registered Public Accounting Firm*

Board of Directors and Shareholders

Prospect Capital Corporation

New York, New York

We have audited Prospect Capital Corporation's internal control over financial reporting as of June 30, 2010, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Prospect Capital Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A, Report of Management on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Prospect Capital Corporation maintained, in all material respects, effective internal control over financial reporting as of June 30, 2010, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of assets and liabilities of Prospect Capital Corporation as of June 30, 2010 and 2009, and the related consolidated statements of income, changes in net assets, and cash flows for each of the three years in the period ended June 30, 2010 and our report dated, August 30, 2010 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

New York, New York

August 30, 2010

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**Item 9B. Other Information**

None.

**PART III**

We will file a definitive Proxy Statement for our 2010 Annual Meeting of Stockholders, or the 2010 Proxy Statement, with the SEC, pursuant to Regulation 14A, not later than 120 days after the end of our fiscal year. Accordingly, certain information required by Part III has been omitted under General Instruction G(3) to Form 10-K. Only those sections of the 2010 Proxy Statement that specifically address the items set forth herein are incorporated by reference.

**Item 10. Directors, Executive Officers and Corporate Governance.**

*Section 16(a) Beneficial Ownership Reporting Compliance*

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's directors and executive officers, and persons who own more than 10% of the Company's common stock to file reports of ownership and changes in ownership with the Securities and Exchange Commission (SEC). To the Company's knowledge, during the fiscal year ended June 30, 2010, the Company's officers, directors and greater than 10% stockholders had complied with all Section 16(a) filing requirements.

The information required by Item 10 is hereby incorporated by reference from our 2010 Proxy Statement.

*Code of Ethics*

We and Prospect Capital Management have each adopted a code of ethics pursuant to Rule 17j-1 under the 1940 Act that establishes procedures for personal investments and restricts certain personal securities transactions. Personnel subject to each code may invest in securities for their personal investment accounts, including securities that may be purchased or held by us, so long as such investments are made in accordance with the code's requirements. For information on how to obtain a copy of each code of ethics, see Available Information in Part I, Item 1 of this report.

**Item 11. Executive Compensation.**

The information required by Item 11 is hereby incorporated by reference from our 2010 Proxy Statement.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information required by Item 12 is hereby incorporated by reference from our 2010 Proxy Statement.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information required by Item 13 is hereby incorporated by reference from our 2010 Proxy Statement.

**Item 14. Principal Accounting Fees and Services.**

The information required by Item 14 is hereby incorporated by reference from our 2010 Proxy Statement.

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**PART IV**

**Item 15. Exhibits, Financial Statement Schedules**

The following exhibits are filed as part of this report or hereby incorporated by reference to exhibits previously filed with the SEC (according to the number assigned to them in Item 601 of Regulation S-K):

- 2.1 Agreement and Plan of Merger by and between Patriot Capital Funding, Inc. and Prospect Capital Corporation, dated as of August 3, 2009 (12).
- 3.1 Articles of Amendment and Restatement (1).
- 3.2 Amended and Restated Bylaws (9).
- 4.1 Form of Share Certificate (1).
- 10.1 Investment Advisory Agreement between Registrant and Prospect Capital Management LLC (1).
- 10.2 Custodian Agreement (2).
- 10.3 Administration Agreement between Registrant and Prospect Administration LLC (1).
- 10.4 Transfer Agency and Service Agreement (2).
- 10.5 Dividend Reinvestment Plan (1).
- 10.6 License Agreement between Registrant and Prospect Capital Management LLC (1).
- 10.7 Loan and Servicing Agreement dated June 6, 2007 among Prospect Capital Funding LLC, Prospect Capital Corporation, the lenders from time to time party thereto and Coöperative Centrale Raisseisen-Boerenleenbank B.A., Rabobank Nederland, New York Branch (6).
- 10.8 First Amendment to Loan and Servicing Agreement dated December 31, 2007 among Prospect Capital Funding LLC, Prospect Capital Corporation, and Coöperative Centrale Raisseisen-Boerenleenbank B.A., Rabobank Nederland, New York Branch (7).
- 10.9 Amended and Restated Loan and Servicing Agreement dated June 25, 2009 among Prospect Capital Funding LLC, Prospect Capital Corporation and Coöperative Centrale Raiffeisen-Boerenleenbank B.A., Rabobank Nederland, New York Branch (11).
- 10.10 Amended and Restated Loan and Servicing Agreement dated June 11, 2010 among Prospect Capital Funding LLC, Prospect Capital Corporation, the lenders from time to time party thereto, the managing agents from time to time party thereto, Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A., Rabobank Nederland, New York Branch and Key Equipment Finance Inc. as Syndication Agents, U.S. Bank National Association as Calculation Agent, Paying Agent and Documentation Agent, and Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A., Rabobank Nederland, New York Branch as Facility Agent (14).
- 10.11

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Stock Purchase Agreement, dated as of August 17, 2009, among Prospect Capital Corporation and the purchasers named therein (13).

- 10.12 Registration Rights Agreement, dated as of August 17, 2009, among Prospect Capital Corporation and the purchasers named therein (13).
- 11 Computation of Per Share Earnings (included in the notes to the financial statements contained in this report).
- 12 Computation of Ratios (included in the notes to the financial statements contained in this report).
- 14 Code of Conduct (10)
- 16 Letter regarding change in certifying accountant (4).

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21	Subsidiaries of the Registrant: (included in the notes to the consolidated financial statements contained in this annual report). (8)
22.1	Proxy Statement (5).
31.1*	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2*	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1*	Certification of Chief Executive Officer pursuant to Section 906 of The Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).
32.2*	Certification of Chief Financial Officer pursuant to Section 906 of The Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

\* Filed herewith.

(1) Incorporated by reference to Pre-Effective Amendment No. 2 to the Registrant's Registration Statement on Form N-2 (File No. 333-114522), filed on July 6, 2004.

(2) Incorporated by reference to Pre-Effective Amendment No. 3 to the Registrant's Registration Statement on Form N-2 (File No. 333-114522), filed on July 23, 2004.

(3) Incorporated by reference from the Registrant's Form 10-K filed on

September 28,  
2006.

- (4) Incorporated by reference to the form 8-K/A (File No. 814-00659), filed on January 21, 2005.
- (5) Incorporated by reference from the Registrant's Proxy Statement filed on October 20, 2008.
- (6) Incorporated by reference from the Registrant's Registration Statement on Form N-2 (File No. 333-143819) filed on September 5, 2007.
- (7) Incorporated by reference from the Registrant's Quarterly Report on Form 10-Q filed on February 11, 2008.
- (8) Incorporated by reference from the Registrant's Form 10-K filed on September 28, 2007.
- (9) Incorporated by reference from the Registrant's Form 8-K filed on September 10, 2008.

(10)

Incorporated by reference from the Registrant's Quarterly Report on Form 10-Q filed on November 10, 2008.

(11) Incorporated by reference to Exhibit 99.1 of the Registrant's Form 8-K filed on June 26, 2009.

(12) Incorporated by reference to Exhibit 2.1 of the Registrant's Form 8-K filed on August 5, 2009

(13) Incorporated by reference to Exhibit 10.1 and 10.2 of the Registrant's Form 8-K filed on August 21, 2009.

(14) Incorporated by reference to Exhibit 99.1 of the Registrant's Form 8-K filed on June 15, 2010.



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**SIGNATURE**

Pursuant to the requirements of Section 13 or 15(d) 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 August 30, 2010.

**PROSPECT CAPITAL CORPORATION**

**By:**

/s/ John F. Barry III

John F. Barry III  
Chief Executive Officer and Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

SIGNATURE	TITLE	DATE
/s/ John F. Barry III	Chairman of the Board, Chief Executive Officer, Director	August 30, 2010
John F. Barry, III		
/s/ Brian H. Oswald	Chief Financial Officer	August 30, 2010
Brian H. Oswald		
/s/ M. Grier Eliasek	President, Chief Operations Officer, Director	August 30, 2010
M. Grier Eliasek		
/s/ Andrew C. Cooper	Director	August 30, 2010
Andrew C. Cooper		
/s/ William J. Grempe	Director	August 30, 2010
William J. Grempe		
/s/ Eugene S. Stark	Director	August 30, 2010
Eugene S. Stark		