FEDERAL NATIONAL MORTGAGE ASSOCIATION FANNIE MAE
Form 10-K
May 02, 2007

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

Form 10-K

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

For the fiscal year ended December 31, 2005

Commission File No.: 0-50231

Federal National Mortgage Association
(Exact name of registrant as specified in its charter)
Fannie Mae

Federally chartered corporation *(State or other jurisdiction of incorporation or organization)*	**52-0883107** *(I.R.S. Employer Identification No.)*
3900 Wisconsin Avenue, NW Washington, DC *(Address of principal executive offices)*	**20016** *(Zip Code)*

Registrant s telephone number, including area code:
(202) 752-7000

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, without par value
(Title of class)

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 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 o No þ

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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

The aggregate market value of the common stock held by non-affiliates of the registrant computed by reference to the price at which the common stock was last sold on June 30, 2006 (the last business day of the registrant s most recently completed second fiscal quarter) was approximately $46,790 million.

As of February 28, 2007, there were 973,046,601 shares of common stock of the registrant outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

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PART I

Item 1. Business

EXPLANATORY NOTE ABOUT THIS REPORT

We filed our Annual Report on Form 10-K for the year ended December 31, 2004 (2004 Form 10-K) on December 6, 2006, which represented a significant step in our efforts to return to timely financial reporting. Our 2004 Form 10-K contained our consolidated financial statements and related notes for the year ended December 31, 2004, as well as a restatement of our previously issued consolidated financial statements and related notes for the years ended December 31, 2003 and 2002, and for the quarters ended June 30, 2004 and March 31, 2004. The filing of this Annual Report on Form 10-K for the year ended December 31, 2005 (2005 Form 10-K) has been delayed significantly as a result of the substantial time and effort devoted to ongoing controls remediation and systems reengineering and development necessary to complete the restatement of our financial results for 2003 and 2002. Because of the delay in our periodic reporting and the changes that have occurred in our business since December 31, 2005, where appropriate, the information contained in this report reflects current information about our business. All amounts in this Annual Report on Form 10-K affected by the restatement adjustments reported in our 2004 Form 10-K reflect such amounts as restated.

We have not filed our Annual Report on Form 10-K for the year ended December 31, 2006 (2006 Form 10-K) or quarterly reports on Form 10-Q for 2005 or 2006. In lieu of filing quarterly reports for 2005, we have included in this report substantially all of the information required to be included in quarterly reports. We previously announced that we expect to file our 2006 Form 10-K by the end of 2007. We are assessing how the timing of the filing of this 2005 Form 10-K will impact the timing of our filing the 2006 Form 10-K. We have made significant progress in our efforts to remediate operational weaknesses that have prevented us from reporting our financial results on a timely basis. We intend to continue to provide periodic updates regarding our progress toward timely financial reporting.

OVERVIEW

Fannie Mae s activities enhance the liquidity and stability of the mortgage market and contribute to making housing in the United States more affordable and more available to low-, moderate- and middle-income Americans. These activities include providing funds to mortgage lenders through our purchases of mortgage assets, and issuing and guaranteeing mortgage-related securities that facilitate the flow of additional funds into the mortgage market. We also make other investments that increase the supply of affordable housing.

We are a government-sponsored enterprise (GSE) chartered by the U.S. Congress under the name Federal National Mortgage Association and are aligned with national policies to support expanded access to housing and increased opportunities for homeownership. We are subject to government oversight and regulation. Our regulators include the Office of Federal Housing Enterprise Oversight (OFHEO), the Department of Housing and Urban Development (HUD), the Securities and Exchange Commission (SEC) and the Department of the Treasury.

While we are a Congressionally-chartered enterprise, the U.S. government does not guarantee, directly or indirectly, our securities or other obligations. We are a stockholder-owned corporation, and our business is self-sustaining and funded exclusively with private capital. Our common stock is listed on the New York Stock Exchange, or NYSE, and traded under the symbol FNM. Our debt securities are actively traded in the over-the-counter market.

RECENT SIGNIFICANT EVENTS

OFHEO Consent Order. In 2003, OFHEO commenced a special examination of our accounting policies and practices, internal controls, financial reporting, corporate governance, and other matters. On May 23, 2006, concurrently with OFHEO s release of its final report of the special examination, we agreed to OFHEO s issuance of a consent order that resolved open matters relating to their investigation of us. Under the consent order, we neither admitted nor denied any wrongdoing and agreed to make changes and take actions in specified areas, including our accounting practices, capital levels and activities, corporate governance, Board of Directors, internal controls, public disclosures, regulatory reporting, personnel and compensation practices. We also agreed not to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO for December 31, 2005 ($727.75 billion), except in limited circumstances at OFHEO s discretion. Our net mortgage portfolio assets refer to the unpaid principal balance of our mortgage assets, net of market valuation adjustments, impairments, allowances for loan losses, and unamortized premiums and discounts. In addition, we agreed to continue to maintain a 30% capital surplus over our statutory minimum capital requirement until the Director of OFHEO, in his discretion, determines the requirement should be modified or allowed to expire, taking into account factors such as resolution of our accounting and internal control issues. As part of the OFHEO consent order, we also agreed to pay a $400 million civil penalty, with $50 million payable to the U.S. Treasury and $350 million payable to the SEC for distribution to stockholders pursuant to the Fair Funds for Investors provision of the Sarbanes-Oxley Act of 2002, also known as SOX. We have paid this civil penalty in full.

Investigation by the U.S. Attorney s Office. In October 2004, the U.S. Attorney s Office for the District of Columbia notified us that it was investigating our past accounting practices. In August 2006, the U.S. Attorney s Office advised us that it had discontinued its investigation and would not be filing any charges against us.

Stockholder Lawsuits and Other Litigation. Several lawsuits related to our accounting practices prior to December 2004 are currently pending against us and certain of our current and former officers and directors. On December 12, 2006, we filed suit against KPMG LLP, our former outside auditor, to recover damages related to the accounting restatement for negligence and breach of contract. For more information on these lawsuits, see Item 3 Legal Proceedings.

Impairment Determination. On May 1, 2007, the Audit Committee of our Board of Directors reviewed the conclusion of our Chief Financial Officer and our Controller that we are required under GAAP to recognize the other-than-temporary impairment charges described in this 2005 Form 10-K for the year ended December 31, 2005. Following discussion with our independent registered public accounting firm, the Audit Committee affirmed that material impairments have occurred. Additional information relating to the other-than-temporary impairment charges, including the amounts of the other-than-temporary impairment charges, is included in Item 7 MD&A Consolidated Results of Operations Investment Losses, Net.

RESIDENTIAL MORTGAGE MARKET OVERVIEW

We operate in the U.S. residential mortgage market, specifically in the secondary mortgage market where mortgages are bought and sold. The following discusses the dynamics of the residential mortgage market and our role in the secondary mortgage market.

Residential Mortgage Market

Our business operates within the U.S. residential mortgage market and, therefore we consider the amount of U.S. residential mortgage debt outstanding to be the best measure of the size of our overall market. As of December 31, 2006, the latest date for which information was available, the amount of U.S. residential mortgage debt outstanding was estimated by the Federal Reserve to be approximately $10.9 trillion (including $10.2 trillion of single-family mortgages). Our mortgage credit book of business, which includes mortgage assets we hold in our investment portfolio, our Fannie Mae mortgage-backed securities held by third parties and credit enhancements that we provide on mortgage assets, was $2.5 trillion as of December 31, 2006, or approximately 23% of total U.S. residential mortgage debt outstanding. Fannie Mae mortgage-backed securities or Fannie Mae MBS generally refers to those mortgage-related securities that we issue and with respect to which we guarantee to the related trusts that we will supplement amounts received by those MBS trusts as required to permit timely payment of principal and interest on the Fannie Mae MBS. We also issue some forms of mortgage-related securities for which we do not provide this guaranty.

The residential mortgage market has experienced strong long-term growth. According to Federal Reserve estimates, total U.S. residential mortgage debt outstanding increased each year from 1945 to 2006. Growth in U.S. residential mortgage debt outstanding averaged 10.6% per year over that period, which is faster than the 6.9% average growth in the overall U.S. economy over the same period, as measured by nominal gross domestic product. Growth in U.S. residential mortgage debt outstanding was particularly strong during 2001 through 2005. As indicated in the table below, which provides a comparison of overall housing market statistics to our business activity, total U.S. residential mortgage debt outstanding grew at an estimated annual rate of 13.6% and 14.5% in 2005 and 2004, respectively. Growth in U.S. residential mortgage debt slowed to 8.7% in 2006.

Housing Market Data

					% Change from Prior Year		
	2006	**2005**	**2004**	**2003**	**2006**	**2005**	**2004**
		(Dollars in billions)					
Housing and mortgage market:(1)							
Home sale units (in thousands)	7,531	8,359	7,981	7,264	(10)%	5%	10%
House price appreciation(2)	9.1%	13.1%	10.7%	6.8%			
Single-family mortgage originations	$ 2,760	$ 3,034	$ 2,790	$ 3,852	(9)	9	(28)
Purchase share	52.2%	49.6%	47.8%	29.0%			
Refinance share	47.8%	50.4%	52.2%	71.0%			
ARM share(3)	28.6%	32.4%	33.4%	20.0%			
Fixed-rate mortgage share	71.4%	67.6%	66.6%	80.0%			
Residential mortgage debt outstanding	$ 10,921	$ 10,046	$ 8,847	$ 7,725	9	14	15
Fannie Mae:							
New business acquisitions(4)	$ 615	$ 612	$ 725	$ 1,423		(16)	(49)
Mortgage credit book of business(5)	$ 2,528	$ 2,356	$ 2,340	$ 2,223	7	1	5
Interest rate risk market share(6)	6.6%	7.2%	10.2%	11.6%			
Credit risk market share(7)	21.6%	21.8%	24.2%	27.1%			

(1) The sources of the housing and mortgage market data are the Federal Reserve Board, the Bureau of the Census, HUD, the National Association of Realtors, the Mortgage Bankers Association, and OFHEO. Mortgage originations, as well as the purchase and refinance shares, are estimates from Fannie Mae s Economic & Mortgage Market Analysis Group. Certain previously reported data may have been changed to reflect revised historical data from any or all of these organizations.

(2) OFHEO publishes a House Price Index (HPI) quarterly using data provided by Fannie Mae and Freddie Mac. The HPI is a weighted repeat transactions index, meaning that it measures average price changes in repeat sales or refinancings on the same properties. House price appreciation reported above reflects the annual average HPI of the reported year compared with the annual average HPI of the prior year.

(3) The ARM share is the ARM share of the number of conventional mortgage applications, reported in the Mortgage Banker s Association s Weekly Mortgage Applications Survey.

(4) Represents the sum in any given period of the unpaid principal balance of: (1) the mortgage loans and mortgage-related securities we purchase for our investment portfolio; and (2) the mortgage loans we securitize into Fannie Mae MBS that are acquired by third parties. Excludes mortgage loans we securitize from our portfolio.

(5) Represents the sum of the unpaid principal balance of: (1) the mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie Mae mortgage-related securities we hold in our investment portfolio; (3) Fannie Mae MBS held by third parties; and (4) credit enhancements that we provide on mortgage assets.

(6) Represents the estimated share of total U.S. residential mortgage debt outstanding on which we bear the interest rate risk. Calculated based on the unpaid principal balance of mortgage loans and mortgage-related securities we hold in our mortgage portfolio as a percentage of total U.S. residential mortgage debt outstanding.

(7) Represents the estimated share of total U.S. residential mortgage debt outstanding on which we bear the credit risk. Calculated based on the unpaid principal balance of mortgage loans we hold in our mortgage portfolio and Fannie Mae MBS outstanding as a percentage of total U.S. residential mortgage debt outstanding.

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Growth in U.S. residential mortgage debt outstanding in recent years has been driven primarily by record home sales, strong home price appreciation and historically low interest rates. Also contributing to growth in U.S. residential mortgage debt outstanding in recent years was the increased use of mortgage debt financing by homeowners and demographic trends that contributed to increased household formation and higher homeownership rates. Growth in U.S. residential mortgage debt outstanding moderated in 2006 in response to slower home price growth, a sharp drop-off in home sales and declining refinance activity. While total U.S. residential mortgage debt outstanding as of December 31, 2006 was about 9% higher than year-ago levels, the annualized growth rate in the fourth quarter of 2006 slowed to 6.4%. We expect that growth in total U.S. residential mortgage debt outstanding will continue at a slower pace in 2007, as the housing market cools further and average home prices possibly decline modestly.

We believe the housing market slowdown has occurred because of affordability challenges after many years of strong home price appreciation, augmented by a decline in investor demand for housing as home price gains have slowed (and prices have fallen in some areas). Additionally, subprime and Alt-A mortgage originations have represented an elevated level of market activity by historical standards in recent years, but we believe guidance by depository institution regulators will likely slow their growth significantly. We believe that the continuation of positive demographic trends, such as stable household formation rates and a growing economy, will help mitigate this slowdown in the growth in residential mortgage debt outstanding, but these trends are unlikely to offset the slowdown in the short- to medium-term.

Over the past 30 years, home values and income (as measured by per capita disposable personal income) have both risen at around a 6% annualized rate. During 2001 through 2006, however, this comparability between home values and income eroded, with income growth averaging 3.7% and home price appreciation averaging 9.1%. Home price appreciation was especially rapid in 2004 and 2005, with rates of home price appreciation of approximately 11% in 2004 and 13% in 2005 on a national basis (with some regional variation). There was a decline in this extraordinary rate of home price appreciation in 2006. Home prices increased nationally by approximately 9.1% in 2006, but according to the OFHEO House Price Index, only by a four-quarter growth rate of 5.9% in the fourth quarter, which was the slowest four-quarter pace of home price appreciation since 1999. We believe that average home prices could go down in 2007.

The amount of residential mortgage debt available for us to purchase or securitize and the mix of available loan products are affected by several factors, including the volume of single-family mortgages within the loan limits imposed under our charter, consumer preferences for different types of mortgages, and the purchase and securitization activity of other financial institutions. See Item 1A Risk Factors for a description of the risks associated with the recent slowdown in home price appreciation, as well as competitive factors affecting our business.

Our Role in the Secondary Mortgage Market

The mortgage market comprises a major portion of the domestic capital markets and provides a vital source of financing for the large housing segment of the economy, as well as one of the most important means for Americans to achieve their homeownership objectives. The U.S. Congress chartered Fannie Mae and certain other GSEs to help ensure stability and liquidity within the secondary mortgage market. Our activities are especially valuable when economic or financial market conditions constrain the flow of funds for mortgage lending. In addition, we believe our activities and those of other GSEs help lower the costs of borrowing in the mortgage market, which makes housing more affordable and increases homeownership, especially for low- to moderate-income families. We believe our activities also increase the supply of affordable rental housing.

Our principal customers are lenders that operate within the primary mortgage market by originating mortgage loans for homebuyers and for current homeowners refinancing their existing mortgage loans. Our customers include mortgage banking companies, investment banks, savings and loan associations, savings banks, commercial banks, credit unions, community banks, and state and local housing finance agencies. Lenders originating mortgages in the primary market often sell them in the secondary mortgage market in the form of loans or in the form of mortgage-related securities.

We operate in the secondary mortgage market where mortgages are bought and sold. We securitize mortgage loans originated by lenders in the primary market into Fannie Mae MBS, which can then be readily bought and sold in the secondary mortgage market. We also participate in the secondary mortgage market by purchasing mortgage loans (often referred to as whole loans) and mortgage-related securities, including Fannie Mae MBS, for our mortgage portfolio. By delivering loans to us in exchange for Fannie Mae MBS, lenders gain the advantage of holding a highly liquid instrument and the flexibility to determine under what conditions they will hold or sell the MBS. By selling loans to us, lenders replenish their funds and, consequently, are able to make additional loans. Pursuant to our charter, we do not lend money directly to consumers in the primary mortgage market.

BUSINESS SEGMENTS

We operate an integrated business that contributes to providing liquidity to the mortgage market and increasing the availability and affordability of housing in the United States. We are organized in three complementary business segments:

Our **Single-Family Credit Guaranty** (Single-Family) business works with our lender customers to securitize single-family mortgage loans into Fannie Mae MBS and to facilitate the purchase of single-family mortgage loans for our mortgage portfolio. Our Single-Family business has responsibility for managing our credit risk exposure relating to the single-family Fannie Mae MBS held by third parties (such as lenders, depositories and global investors), as well as the single-family mortgage loans and single-family Fannie Mae MBS held in our mortgage portfolio. Our Single-Family business also has responsibility for pricing the credit risk of the single-family mortgage loans we purchase for our mortgage portfolio. Revenues in the segment are derived primarily from the guaranty fees the segment receives as compensation for assuming the credit risk on the mortgage loans underlying single-family Fannie Mae MBS and on the single-family mortgage loans held in our portfolio.

Our **Housing and Community Development** (HCD) business helps to expand the supply of affordable and market-rate rental housing in the United States by working with our lender customers to securitize multifamily mortgage loans into Fannie Mae MBS and to facilitate the purchase of multifamily mortgage loans for our mortgage portfolio. Our HCD business also helps to expand the supply of affordable housing by making investments in rental and for-sale housing projects, including investments in rental housing that qualify for federal low-income housing tax credits. Our HCD business has responsibility for managing our credit risk exposure relating to the multifamily Fannie Mae MBS held by third parties, as well as the multifamily mortgage loans and multifamily Fannie Mae MBS held in our mortgage portfolio. Our HCD business also has responsibility for pricing the credit risk of the multifamily mortgage loans we purchase for our mortgage portfolio. Revenues in the segment are derived from a variety of sources, including the guaranty fees the segment receives as compensation for assuming the credit risk on the mortgage loans underlying multifamily Fannie Mae MBS and on the multifamily mortgage loans held in our portfolio, transaction fees associated with the multifamily business and bond credit enhancement fees. In addition, HCD s investments in housing projects eligible for the low-income housing tax credit and other tax credits generate both tax credits and net operating losses that reduce our federal income tax liability. Other investments in rental and for-sale housing generate revenue from operations and the eventual sale of the assets.

Our **Capital Markets** group manages our investment activity in mortgage loans and mortgage-related securities, and has responsibility for managing our assets and liabilities and our liquidity and capital positions. Through the issuance of debt securities in the capital markets, our Capital Markets group attracts capital from investors globally to finance housing in the United States. In addition, our Capital Markets group increases the liquidity of the mortgage market by maintaining a constant, reliable presence as an active investor in mortgage assets. Our

Capital Markets group has responsibility for managing our interest rate risk. Our Capital Markets group generates income primarily from the difference, or spread, between the yield on the mortgage assets we own and the cost of the debt we issue in the global capital markets to fund these assets.

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Although we operate our business through three separate business segments, there are important interrelationships among the functions of these three segments. For example:

Mortgage Acquisition. As noted above, our Single-Family and HCD businesses work with our lender customers to securitize mortgage loans into Fannie Mae MBS and to facilitate the purchase of mortgage loans for our mortgage portfolio. Accordingly, although the Single-Family and HCD businesses principally manage the relationships with our lender customers, our Capital Markets group works closely with Single-Family and HCD in making mortgage acquisition decisions. Our Capital Markets group works directly with our lender customers on structured Fannie Mae MBS transactions.

Portfolio Credit Risk Management. Our Single-Family and HCD businesses support our Capital Markets group by assuming and managing the credit risk of borrowers defaulting on payments of principal and interest on the mortgage loans held in our mortgage portfolio or underlying Fannie Mae MBS held in our mortgage portfolio. Our Single-Family and HCD businesses also price the credit risk of the mortgage loans purchased by our Capital Markets group for our mortgage portfolio.

Securitization Activities. All three of our businesses engage in securitization activities. Our Single-Family business issues our single-family single-class Fannie Mae MBS. These securities are principally created through lender swap transactions and constitute the substantial majority of our Fannie Mae MBS issues. Our HCD business issues multifamily single-class Fannie Mae MBS that are principally created through lender swap transactions. Our Capital Markets group issues Fannie Mae MBS from mortgage loans that we hold in our mortgage portfolio and also issues structured Fannie Mae MBS.

Liquidity Support. The Capital Markets group supports the liquidity of single-family and multifamily Fannie Mae MBS by holding Fannie Mae MBS in our mortgage portfolio. This support of our Fannie Mae MBS helps to maintain the competitiveness of our Single-Family and HCD businesses, and increases the value of our Fannie Mae MBS.

Mission Support. All three of our businesses contribute to meeting the statutory housing goals established by HUD. We meet our housing goals both by purchasing mortgage loans for our mortgage portfolio and by securitizing mortgage loans into Fannie Mae MBS. Both our Single-Family and HCD businesses securitize mortgages that contribute to our housing goals. In addition, our Capital Markets group purchases mortgages for our mortgage portfolio that contribute to our housing goals.

The table below displays the revenues, net income and total assets for each of our business segments for each of the three years in the period ended December 31, 2005.

Business Segment Summary Financial Information

	For the Year Ended December 31,		
	2005	2004	2003
	(Dollars in millions)		
Revenues:[1]			
Single-Family Credit Guaranty	$ 5,805	$ 5,153	$ 4,994
Housing and Community Development	743	538	398
Capital Markets	43,601	46,135	47,293
Total	$ 50,149	$ 51,826	$ 52,685

Net income:			
Single-Family Credit Guaranty	$ 2,889	$ 2,514	$ 2,481
Housing and Community Development	462	337	286
Capital Markets	2,996	2,116	5,314
Total	$ 6,347	$ 4,967	$ 8,081

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	As of December 31, 2005	As of December 31, 2004
Total assets:		
Single-Family Credit Guaranty	$ 12,871	$ 11,543
Housing and Community Development	11,829	10,166
Capital Markets	809,468	999,225
Total	$ 834,168	$ 1,020,934

(1) Includes interest income, guaranty fee income, and fee and other income.

We use various management methodologies to allocate certain balance sheet and income statement line items to the responsible operating segment. For a description of our allocation methodologies, see Notes to Consolidated Financial Statements Note 14, Segment Reporting. For further information on the results and assets of our business segments, see Item 7 MD&A Business Segment Results.

Single-Family Credit Guaranty

Our Single-Family Credit Guaranty business works with our lender customers to securitize single-family mortgage loans into Fannie Mae MBS and to facilitate the purchase of single-family mortgage loans for our mortgage portfolio. Our Single-Family business manages our relationships with over 1,000 lenders from which we obtain mortgage loans. These lenders are part of the primary mortgage market, where mortgage loans are originated and funds are loaned to borrowers. Our lender customers include mortgage banking companies, investment banks, savings and loan associations, savings banks, commercial banks, credit unions, community banks, and state and local housing finance agencies.

In our Single-Family business, mortgage lenders generally deliver mortgage loans to us in exchange for our Fannie Mae MBS. In a typical MBS transaction, we guaranty to each MBS trust that we will supplement amounts received by the MBS trust as required to permit timely payment of principal and interest on the related Fannie Mae MBS. In return, we receive a guaranty fee. Our guaranty supports the liquidity of Fannie Mae MBS and makes it easier for lenders to sell these securities. When lenders receive Fannie Mae MBS in exchange for mortgage loans, they may hold the Fannie Mae MBS for investment or sell the MBS in the capital markets. This option allows lenders to manage their assets so that they continue to have funds available to make new mortgage loans. In holding Fannie Mae MBS created from a pool of whole loans, a lender has securities that are generally more liquid than whole loans, which provides the lender with greater financial flexibility. The ability of lenders to sell Fannie Mae MBS quickly allows them to continue making mortgage loans even under economic and capital markets conditions that might otherwise constrain mortgage financing activities.

Our Single-Family business manages the risk that borrowers will default in the payment of principal and interest due on the single-family mortgage loans held in our investment portfolio or underlying Fannie Mae MBS (whether held in our investment portfolio or held by third parties). We provide a breakdown of our single-family mortgage credit book of business as of December 31, 2005, 2004 and 2003 in Item 7 MD&A Risk Management Credit Risk Management.

To ensure that acceptable loans are received from lenders as well as to assist lenders in efficiently and accurately processing loans that they deliver to us, we have established guidelines for the types of loans and credit risks that we accept. These guidelines also ensure compliance with the types of loans that our charter authorizes us to purchase. For a description of our charter requirements, see Our Charter and Regulation of Our Activities. We have developed technology-based solutions that assist our lender customers in delivering loans to us efficiently and at lower costs. Our automated underwriting system for single-family mortgage loans, known as Desktop Underwriter®, assists lenders in applying our underwriting guidelines to the single-family loans they originate. Desktop Underwriter® is designed to help lenders process mortgage applications in a more efficient and accurate manner and to apply our underwriting criteria to prospective borrowers consistently and objectively. After assessing the creditworthiness of the borrowers and originating the loans,

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lenders deliver the whole loans to us and represent and warrant to us that the loans meet our guidelines and any agreed-upon variances from the guidelines.

Guaranty Services

Our Single-Family business provides guaranty services by assuming the credit risk of the single-family mortgage loans underlying our guaranteed Fannie Mae MBS held by third parties. Our Single-Family business also assumes the credit risk of the single-family mortgage loans held in our investment portfolio, as well as the single-family mortgage loans underlying Fannie Mae MBS held in our portfolio.

Our most common type of guaranty transaction is referred to as a lender swap transaction. Lenders pool their loans and deliver them to us in exchange for Fannie Mae MBS backed by these loans. After receiving the loans in a lender swap transaction, we place them in a trust that is established for the sole purpose of holding the loans separate and apart from our assets. We serve as trustee for the trust. Upon creation of the trust, we deliver to the lender (or its designee) Fannie Mae MBS that are backed by the pool of mortgage loans in the trust and that represent a beneficial ownership interest in each of the loans. We guarantee to each MBS trust that we will supplement amounts received by the MBS trust as required to permit timely payment of principal and interest on the related Fannie Mae MBS. The mortgage servicers for the underlying mortgage loans collect the principal and interest payments from the borrowers. We permit them to retain a portion of the interest payment as compensation for servicing the mortgage loans before distributing the principal and remaining interest payments to us. We retain a portion of the interest payment as the fee for providing our guaranty. Then, on behalf of the trust, we make monthly distributions to the Fannie Mae MBS certificate holders from the principal and interest payments and other collections on the underlying mortgage loans.

The following diagram illustrates the basic process by which we create a typical Fannie Mae MBS in the case where a lender chooses to sell the Fannie Mae MBS to a third-party investor.

To better serve the needs of our lender customers as well as to respond to changing market conditions and investor preferences, we offer different types of Fannie Mae MBS backed by single-family loans, as described below:

Single-Family Single-Class Fannie Mae MBS represent beneficial interests in single-family mortgage loans held in an MBS trust that were delivered to us typically by a single lender in exchange for the single-class Fannie Mae MBS. The certificate holders in a single-class Fannie Mae MBS issue receive principal and interest payments in proportion to their percentage ownership of the MBS issue.

Fannie Majors® are a form of single-class Fannie Mae MBS in which generally two or more lenders deliver mortgage loans to us, and we then group all of the loans together in one MBS pool. In this case, the certificate holders receive beneficial interests in all of the loans in the pool. As a result, the certificate holders may benefit from having a diverse group of lenders contributing loans to the MBS rather than having an interest in loans obtained from only one lender, as well as increased liquidity due to a larger-sized pool.

Single-Family Whole Loan Multi-Class Fannie Mae MBS are multi-class Fannie Mae MBS that are formed from single-family whole loans. Our Single-Family business works with our Capital Markets group in structuring these single-family whole loan multi-class Fannie Mae MBS. Single-family whole loan multi-class Fannie Mae MBS divide the cash flows on the underlying loans and create several classes of securities, each of which represents a beneficial ownership interest in a separate portion of the cash flows.

Guaranty Fees

We enter into agreements with our lender customers that establish the guaranty fee arrangements for those customers Fannie Mae MBS transactions. Guaranty fees are generally paid to us on a monthly basis from a portion of the interest payments made on the underlying mortgage loans in the MBS trust.

The aggregate amount of single-family guaranty fees we receive in any period depends on the amount of Fannie Mae MBS outstanding during that period and the applicable guaranty fee rates. The amount of Fannie Mae MBS outstanding at any time is primarily determined by the rate at which we issue new Fannie Mae MBS and by the repayment rate for the loans underlying our outstanding Fannie Mae MBS. Less significant factors affecting the amount of Fannie Mae MBS outstanding are the rates of borrower defaults on the loans and the extent to which lenders repurchase loans from the pools because the loans do not conform to the representations made by the lenders.

Since we began issuing our Fannie Mae MBS over 25 years ago, the total amount of our outstanding single-family Fannie Mae MBS (which includes both Fannie Mae MBS held in our portfolio and Fannie Mae MBS held by third parties) has grown steadily. As of December 31, 2006, 2005 and 2004, total outstanding single-family Fannie Mae MBS was $2.0 trillion, $1.8 trillion and $1.7 trillion, respectively. Growth in our total outstanding Fannie Mae MBS has been supported by the value that lenders and other investors place on Fannie Mae MBS.

Our Customers

Our Single-Family business is primarily responsible for managing the relationships with our lender customers that supply mortgage loans both for securitization into Fannie Mae MBS and for purchase by our mortgage portfolio. During 2005, over 1,000 lenders delivered mortgage loans to us, either for purchase by our mortgage portfolio or for securitization into Fannie Mae MBS. We acquire a significant portion of our single-family mortgage loans from several large mortgage lenders. During 2005, our top five lender customers, in the aggregate, accounted for approximately 49% of our single-family business volume. This was a small decline from 2004 when our top five lender customers accounted for approximately 53% of our single-family business volume. Our top customer, Countrywide Financial Corporation (through its subsidiaries), accounted for approximately 25% of our single-family business volume in 2005. Due to consolidation within the mortgage industry, we, as well as our competitors, have been competing for business from a decreasing number of large mortgage lenders. See Item 1A Risk Factors for a discussion of the risks to our business resulting from this customer concentration.

TBA Market

The TBA, or to be announced, securities market is a forward, or delayed delivery, market for 30-year and 15-year fixed-rate single-family mortgage-related securities issued by us and other agency issuers. Most of our single-class single-family Fannie Mae MBS are sold by lenders in the TBA market. Lenders use the TBA market both to purchase and sell Fannie Mae MBS.

A TBA trade represents a forward contract for the purchase or sale of single-family mortgage-related securities to be delivered on a specified future date. In a typical TBA trade, the specific pool of mortgages that will be delivered to fulfill the forward contract are unknown at the time of the trade. Parties to a TBA trade agree upon the issuer, coupon, price, product type, amount of securities and settlement date for delivery. Settlement for TBA trades is standardized to occur on one specific day each month. The mortgage-related securities that ultimately will be delivered, and the loans backing those mortgage-related securities, frequently have not been created or originated at the time of the TBA trade, even though a price for the securities is agreed to at that time. Some trades are stipulated trades, in which the buyer and seller agree on specific characteristics of the mortgage loans underlying the mortgage-related securities to be delivered (such as loan age, loan size or geographic area of the loan). Some other transactions are specified trades, in which the buyer and seller identify the actual mortgage pool to be traded (specifying the pool or CUSIP number). These specified trades typically involve existing, seasoned TBA-eligible securities issued in the market. TBA sales enable originating mortgage lenders to hedge their interest rate risk and efficiently lock in interest rates for mortgage loan applicants throughout the loan origination process. The TBA market lowers transaction costs, increases liquidity and facilitates efficient settlement of sales and purchases of mortgage-related securities.

Credit Risk Management

Our Single-Family business bears the credit risk of borrowers defaulting on their payments of principal and interest on the single-family mortgage loans that back our guaranteed Fannie Mae MBS, including Fannie Mae MBS held in our mortgage portfolio. In return, the Single-Family business receives a guaranty fee for bearing this credit risk. In addition, Single-Family bears the credit risk associated with the single-family mortgage loans held in our mortgage portfolio. In return for bearing this credit risk, Single-Family is allocated fees from the Capital Markets group comparable to the guaranty fees that Single-Family receives on guaranteed Fannie Mae MBS. As a result, in our segment reporting, the expenses of the Capital Markets group include the transfer cost of the guaranty fees and related fees allocated to Single-Family, and the revenues of Single-Family include the guaranty fees and related fees received from the Capital Markets group.

The credit risk associated with a single-family mortgage loan is largely determined by the creditworthiness of the borrower, the nature and terms of the loan, the type of property securing the loan, the ratio of the unpaid principal amount of the loan to the value of the property that serves as collateral for the loan (the loan-to-value ratio or LTV ratio) and general economic conditions, including employment levels and the rate of increases or decreases in home prices. We actively manage, on an aggregate basis, the extent and nature of the credit risk we bear, with the objective of ensuring that we are adequately compensated for the credit risk we take, consistent with our mission goals. One important part of our management strategy is the use of credit enhancements, including primary mortgage insurance. For a description of our methods for managing mortgage credit risk and a description of the credit characteristics of our single-family mortgage credit book of business, refer to Item 7 MD&A Risk Management Credit Risk Management. Refer to Item 1A Risk Factors for a description of the risks associated with our management of credit risk.

Our Single-Family business is also responsible for managing the credit risk to our business posed by defaults by most of our institutional counterparties, such as our mortgage insurance providers and mortgage lenders and servicers. See Item 7 MD&A Risk Management Credit Risk Management for a description of our methods for managing institutional counterparty credit risk and Item 1A Risk Factors for a description of the risks associated with our management of credit risk.

Housing and Community Development

Our Housing and Community Development business engages in a range of activities primarily related to increasing the supply of affordable rental and for-sale housing, as well as increasing liquidity in the debt and equity markets related to such housing. In 2006, approximately 95% of the units financed by the multifamily mortgage loans we purchased or securitized contributed to the achievement of the housing goals established by HUD. See Our Charter and Regulation of Our Activities Regulation and Oversight of Our Activities HUD Regulation Housing Goals for a description of our housing goals.

Our HCD business also engages in other activities through our Community Investment and Community Lending Groups, including investing in affordable rental properties that qualify for federal low-income housing tax credits, making equity investments in other rental and for-sale housing, investing in acquisition, development and construction (AD&C) financing for single-family and multifamily housing developments, providing loans and credit support to public entities such as housing finance agencies and public housing authorities to support their affordable housing efforts, and working with not-for-profit entities and local banks to support community development projects in underserved areas.

Multifamily Group

HCD s Multifamily Group securitizes multifamily mortgage loans into Fannie Mae MBS and facilitates the purchase of multifamily mortgage loans for our mortgage portfolio. The amount of multifamily mortgage loan volume that we purchase for our portfolio as compared to the amount that we securitize into Fannie Mae MBS fluctuates from period to period. In recent years, the percentage of our multifamily business that has consisted of purchases for our investment portfolio has increased relative to our securitization activities. Our multifamily mortgage loans relate to properties with five or more residential units. The properties may be apartment communities, cooperative properties or manufactured housing communities.

Most of the multifamily loans we purchase or securitize are made by lenders that participate in our Delegated Underwriting and Servicing, or DUS™, program. Under the DUS program, we delegate the underwriting of loans to qualified lenders. As long as the lender represents and warrants that eligible loans meet our underwriting guidelines, we will not require the lender to obtain loan-by-loan approval before acquisition by us. DUS lenders generally act as servicers on the loans they sell to us, and servicing transfers must be approved by us. We also work with DUS lenders to provide credit enhancement for taxable and tax-exempt bonds issued by entities such as housing finance authorities. DUS lenders generally share the credit risk of loans they sell to us by absorbing a portion of the loss incurred as a result of a loan default. DUS lenders receive a higher servicing fee to compensate them for this risk. We believe that the risk-sharing feature of the DUS program aligns our interests and the interests of the lenders in making a sound credit decision at the time the loan is originated by the lender and acquired by us, and in servicing the loan throughout its life.

Our HCD business manages the risk that borrowers will default in the payment of principal and interest due on the multifamily mortgage loans held in our investment portfolio or underlying Fannie Mae MBS (whether held in our investment portfolio or held by third parties). We provide a breakdown of our multifamily mortgage credit book of business as of December 31, 2005, 2004 and 2003 in Item 7 MD&A Risk Management Credit Risk Management.

Unlike single-family loans, most multifamily loans require that the borrower pay a prepayment premium if the loan is paid before the maturity date. Additionally, some multifamily loans are subject to lock-out periods during which the loan may not be prepaid. The prepayment premium can take a variety of forms, including yield maintenance, defeasance or declining percentage. These prepayment provisions may reduce the likelihood that a borrower will prepay a loan during a period of declining interest rates, thereby providing incremental levels of certainty and reinvestment cash flow protection to investors in multifamily loans and mortgage-related securities.

Our Multifamily Group generally creates multifamily Fannie Mae MBS in the same manner as our Single-Family business creates single-family Fannie Mae MBS. Mortgage lenders deliver multifamily mortgage loans to us in exchange for our Fannie Mae MBS, which thereafter may be held by the lenders or sold in the capital markets. We guarantee to each MBS trust that we will supplement amounts received by the MBS trust as required to permit timely payment of principal and interest on the related multifamily Fannie Mae MBS. In return for our guaranty, we are paid a guaranty fee out of a portion of the interest on the loans underlying the multifamily Fannie Mae MBS. For a description of a typical lender swap transaction by which we create Fannie Mae MBS, see Single-Family Credit Guaranty Guaranty Services above.

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As with our Single-Family business, our Multifamily Group offers different types of Fannie Mae MBS as a service to our lenders and as a response to specific investor preferences. The most commonly issued multifamily Fannie Mae MBS are described below:

Multifamily Single-Class Fannie Mae MBS represent beneficial interests in multifamily mortgage loans held in an MBS trust and that were delivered to us by a lender in exchange for the single-class Fannie Mae MBS. The certificate holders in a single-class Fannie Mae MBS issue receive principal and interest payments in proportion to their percentage ownership of the MBS issue.

Discount Fannie Mae MBS are short-term securities that generally have maturities between three and nine months and are backed by one or more participation certificates representing interests in multifamily loans. Investors earn a return on their investment in these securities by purchasing them at a discount to their principal amounts and receiving the full principal amount when the securities reach maturity. Discount MBS have no prepayment risk since prepayments are not allowed prior to maturity.

Multifamily Whole Loan Multi-Class Fannie Mae MBS are multi-class Fannie Mae MBS that are formed from multifamily whole loans, Federal Housing Administration (FHA) participation certificates and/or Government National Mortgage Association (Ginnie Mae) participation certificates. Our HCD business works with our Capital Markets group in structuring these multifamily whole loan multi-class Fannie Mae MBS. Multifamily whole loan multi-class Fannie Mae MBS divide the cash flows on the underlying loans or participation certificates and create several classes of securities, each of which represents a beneficial ownership interest in a separate portion of the cash flows.

The fee and guaranty arrangements between HCD and Capital Markets are similar to the arrangements between Single-Family and Capital Markets. Our HCD business bears the credit risk of borrowers defaulting on their payments of principal and interest on the multifamily mortgage loans that back our guaranteed Fannie Mae MBS, including Fannie Mae MBS held in our mortgage portfolio. In addition, HCD bears the credit risk associated with the multifamily mortgage loans held in our mortgage portfolio. The HCD business receives a guaranty fee in return for bearing the credit risk on guaranteed multifamily Fannie Mae MBS, including Fannie Mae MBS held in our mortgage portfolio. In return for bearing credit risk on the multifamily mortgage loans held in our mortgage portfolio, our HCD business is allocated fees from the Capital Markets group comparable to the guaranty fees that it receives on guaranteed Fannie Mae MBS. As a result, in our segment reporting, the expenses of the Capital Markets group include the transfer cost of the guaranty fees and related fees allocated to our HCD segment, and the revenues of the HCD segment include the guaranty fees and related fees received from the Capital Markets group.

HCD s Multifamily Group manages credit risk in a manner similar to that of our Single-Family business by managing the quality of the mortgages we acquire for our portfolio or securitize into Fannie Mae MBS, diversifying our exposure to credit losses, continually assessing the level of credit risk that we bear, and actively managing problem loans and assets to mitigate credit losses. Additionally, multifamily loans sold to us are often subject to lender risk-sharing or other lender recourse arrangements. As of December 31, 2005, credit enhancements existed on approximately 95% of the multifamily mortgage loans that we owned or that backed our Fannie Mae MBS. As described above, in our DUS program, lenders typically bear a portion of the credit losses incurred on an individual DUS loan. From time to time, we acquire multifamily loans in transactions where the lenders do not bear any credit risk on the loans and we therefore bear all of the credit risk. In such cases, our compensation takes into account the fact that we are bearing all of the credit risk on the loan. For a description of our management of multifamily credit risk, see Item 7 MD&A Risk Management Credit Risk Management. Refer to Item 1A Risk Factors for a description of the risks associated with our management of credit risk.

Community Investment Group

HCD s Community Investment Group makes investments that increase the supply of affordable housing. Most of these investments are in rental housing that qualifies for federal low-income housing tax credits, and the remainder are in conventional rental and primarily entry-level, for-sale housing. These investments are

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consistent with our focus on serving communities in need and making affordable housing more available and easier to rent or own.

The Community Investment Group s investments have been made predominantly in low-income housing tax credit (LIHTC) limited partnerships or limited liability companies (referred to collectively in this report as LIHTC partnerships) that directly or indirectly own an interest in rental housing that the partnerships or companies have developed or rehabilitated. By renting a specified portion of the housing units to qualified low-income tenants over a 15-year period, the partnerships become eligible for the federal low-income housing tax credit. The low-income housing tax credit was enacted as part of the Tax Reform Act of 1986 to encourage investment by private developers and investors in low-income rental housing. To qualify for this tax credit, among other requirements, the project owner must irrevocably elect that either (1) a minimum of 20% of the residential units will be rent-restricted and occupied by tenants whose income does not exceed 50% of the area median gross income, or (2) a minimum of 40% of the residential units will be rent-restricted and occupied by tenants whose income does not exceed 60% of the area median gross income. The LIHTC partnerships are generally organized by fund manager sponsors who seek out investments with third-party developers who in turn develop or rehabilitate the properties and subsequently manage them. We invest in these partnerships as a limited partner with the fund manager acting as the general partner.

In making investments in these LIHTC partnerships, our Community Investment Group identifies qualified sponsors and structures the terms of our investment. Our risk exposure is limited to the amount of our investment and the possible recapture of the tax benefits we have received from the partnership. To manage the risks associated with a partnership, we track compliance with the LIHTC requirements, as well as the property condition and financial performance of the underlying investment throughout the life of the investment. In addition, we evaluate the strength of the partnership s sponsor through periodic financial and operating assessments. Furthermore, in some of our partnership investments, our exposure to loss is further mitigated by our having a guaranteed economic return from an investment grade counterparty.

Our recorded investment in these LIHTC partnerships totaled approximately $7.7 billion and $6.8 billion as of December 31, 2005 and 2004, respectively. We earn a return on our investments in LIHTC partnerships through reductions in our federal income tax liability as a result of the use of the tax credits for which the LIHTC partnerships qualify, as well as the deductibility of the partnerships net operating losses. For additional information regarding our investments in LIHTC partnerships, refer to Item 7 MD&A Off-Balance Sheet Arrangements and Variable Interest Entities LIHTC Partnership Interests.

In addition to investing in LIHTC partnerships, HCD s Community Investment Group provides equity investments for rental and for-sale housing. These investments are typically made through fund managers or directly with developers and operators that are well-recognized firms within the industry. Because we invest as a limited partner or as a non-managing member in a limited liability company, our exposure is generally limited to the amount of our investment. Most of our investments in for-sale housing involve the construction of entry-level homes that are generally eligible for conforming mortgages. Our recorded investment in these transactions totaled approximately $1.6 billion and $1.3 billion as of December 31, 2005 and 2004, respectively.

Community Lending Group

HCD s Community Lending Group supports the expansion of available housing by participating in specialized debt financing for a variety of customers and by acquiring mortgage loans. These activities include:

- helping to meet the financing needs of single-family and multifamily home builders by purchasing participation interests in AD&C loans from lending institutions;

acquiring small multifamily loans from a variety of lending institutions that do not participate in our DUS^{tm} program;

providing loans to Community Development Financial Institution intermediaries to re-lend for community revitalization projects that expand the supply of affordable housing stock; and providing financing for single-family and multifamily housing to housing finance agencies, public housing authorities and municipalities.

In July 2006, OFHEO advised us to suspend new AD&C business until we have finalized and implemented specified policies and procedures required to strengthen risk management practices related to this business. We are implementing these new policies and procedures and are also implementing new controls and reporting mechanisms relating to our AD&C business. We are currently in discussions with OFHEO regarding these improvements.

Capital Markets

Our Capital Markets group manages our investment activity in mortgage loans, mortgage-related securities and other liquid investments. We purchase mortgage loans and mortgage-related securities from mortgage lenders, securities dealers, investors and other market participants. We also sell mortgage loans and mortgage-related securities.

We fund these investments primarily through proceeds from our issuance of debt securities in the domestic and international capital markets. By using the proceeds of this debt funding to invest in mortgage loans and mortgage-related securities, we directly and indirectly increase the amount of funding available to mortgage lenders. By managing the structure of our debt obligations and through our use of derivatives, we strive to substantially limit adverse changes in the net fair value of our investment portfolio that result from interest rate changes.

Our Capital Markets group earns most of its income from the difference, or spread, between the interest we earn on our mortgage portfolio and the interest we pay on the debt we issue to fund this portfolio, which is referred to as our net interest yield. As described below, our Capital Markets group uses various debt and derivative instruments to help manage the interest rate risk inherent in our mortgage portfolio. Changes in the fair value of the derivative instruments we hold impact the net income reported by the Capital Markets group business segment. Our Capital Markets group also earns transaction fees for issuing structured Fannie Mae MBS, as described below under Securitization Activities.

Mortgage Investments

Our net mortgage investments totaled $736.5 billion and $924.8 billion as of December 31, 2005 and 2004, respectively. We estimate that the amount of our net mortgage investments was approximately $722 billion as of December 31, 2006. As described above under Recent Significant Events, as part of our May 2006 consent order with OFHEO, we agreed not to increase our net mortgage portfolio assets above $727.75 billion, except in limited circumstances at OFHEO s discretion. We will be subject to this limitation on mortgage investment growth until the Director of OFHEO has determined that modification or expiration of the limitation is appropriate in light of specified factors such as resolution of accounting and internal control issues. For additional information on our capital requirements and regulations affecting the amount of our mortgage investments, see Our Charter and Regulation of Our Activities and Item 7 MD&A Liquidity and Capital Management Capital Management.

Our mortgage investments include both mortgage-related securities and mortgage loans. We purchase primarily conventional single-family fixed-rate or adjustable-rate, first lien mortgage loans, or mortgage-related securities backed by such loans. In addition, we purchase loans insured by the FHA, loans guaranteed by the Department of Veterans Affairs (VA) or by the Rural Housing Service of the Department of Agriculture (RHS), manufactured housing loans, multifamily mortgage loans, subordinate lien mortgage loans (e.g., loans secured by second liens) and other mortgage-related securities. Most of these loans are prepayable at the option of the borrower. Some of our investments in mortgage-related securities are effected in the TBA market, which is described above under Single-Family Credit Guaranty TBA Market. Our investments in mortgage-related securities include structured mortgage-related securities such as real estate mortgage investment conduits (REMICs). The interest rates on the structured mortgage-related securities held in our portfolio may not be the same as the interest rates on the underlying loans. For example, we may hold a floating rate REMIC security with an interest rate that adjusts periodically based on changes in a specified market reference rate, such as the London Inter-Bank Offered Rate (LIBOR); however, the REMIC may be backed by fixed-rate mortgage loans. The REMIC securities we own primarily fall into two categories: agency REMICs, which are generally Fannie Mae-issued REMICs, and non-agency REMICs issued by private-label issuers. For information on the composition of our mortgage investment portfolio by product type, refer to Table 13 in Item 7 MD&A Business Segment Results Capital Markets Group Mortgage Investments.

While our Single-Family and HCD businesses are responsible for managing the credit risk associated with our investments in mortgage loans and Fannie Mae MBS, our Capital Markets group is responsible for managing the credit risk of the non-Fannie Mae mortgage-related securities in our portfolio.

Investment Activities and Objectives

Our Capital Markets group seeks to maximize long-term total returns while fulfilling our chartered liquidity function. Our total return management involves acquiring mortgage assets that allow us to achieve an acceptable spread over our cost of funding. Prior to 2005, we realized this return primarily by holding assets to maturity.

Beginning in 2005, we also began to look for opportunities to sell assets and accelerate the realization of the spread income. These opportunities occur when the option-adjusted spread of a security tightens, compared to spreads when we acquired the security, causing the security s fair value to increase relative to its expected future cost of funding. By selling these assets, we are able to realize the economic spread we otherwise would earn over the life of the asset. After these sales, we may reinvest the capital we receive from these sales in assets with more attractive risk-adjusted spreads. For the Capital Markets group, we expect that, in normal market conditions, our selling activity will represent a modest portion of the total change in the total portfolio for the year. In 2005 and 2006, total sales were 12% and 8% of the opening mortgage portfolio balances, and 9% and 5% when excluding sales of securities created through the securitization of loans we held for a short time.

The level of our purchases and sales of mortgage assets in any given period has been generally determined by the rates of return that we expect to be able to earn on the equity capital underlying our investments. When we expect to earn returns greater than our cost of equity capital, we generally will be an active purchaser of mortgage loans and mortgage-related securities. When few opportunities exist to earn returns above our cost of equity capital, we generally will be a less active purchaser, and may be a net seller, of mortgage loans and mortgage-related securities. This investment strategy is consistent with our chartered liquidity function, as the periods during which our purchase of mortgage assets is economically attractive to us generally have been periods in which market demand for mortgage assets is low.

The difference, or spread, between the yield on mortgage assets available for purchase or sale and our borrowing costs, after consideration of the net risks associated with the investment, is an important factor in determining whether we are a net buyer or seller of mortgage assets. When the spread between the yield on mortgage assets and our borrowing costs is wide, which is typically when demand for mortgage assets from other investors is low, we will look for opportunities to add liquidity to the market primarily by purchasing mortgage assets and issuing debt to investors to fund those purchases. When this spread is narrow, which is typically when market demand for mortgage assets is high, we will look for opportunities to meet demand by selling mortgage assets from our portfolio. Even in periods of high market demand for mortgage assets, however, we expect to be an active purchaser of less liquid forms of mortgage loans and mortgage-related securities. The amount of our purchases of these mortgage loans and mortgage-related securities may be less than the amortization, prepayments and sales of mortgage loans we hold and, as a result, our investment balances may decline during periods of high market demand.

We determine our total return by measuring the change in the estimated fair value of our net assets (net of tax effect), a non-GAAP measure that we refer to as the fair value of our net assets. The fair value of our net assets will change from period to period as a result of changes in the mix of our assets and liabilities and changes in interest rates, expected volatility and other market factors. The fair value of our net assets is also subject to change due to inherent market fluctuations in the yields on our mortgage assets relative to the yields on our debt securities. The fair value of our guaranty assets and guaranty obligations will also fluctuate in the short term due to changes in interest rates. These fluctuations are likely to produce volatility in the fair value of our net assets in the short-term that may not be representative of our long-term performance. Refer to Item 7 MD&A Supplemental Non-GAAP Information Fair Value Balance Sheet for information on the fair value of our net assets.

There are factors that may constrain our ability to maximize our return through asset sales including our portfolio growth limitation, operational limitations, and our intent to hold certain temporarily impaired securities until recovery and achieve certain tax consequences, as well as risk parameters applied to the mortgage portfolio.

Customer Transactions and Services

Our Capital Markets group provides services to our lender customers and their affiliates, which include:

- offering to purchase a wide variety of mortgage assets, including non-standard mortgage loan products, which we either retain in our portfolio for investment or sell to other investors as a service to assist our customers in accessing the market;

- segregating customer portfolios to obtain optimal pricing for their mortgage loans (for example, segregating Community Reinvestment Act or CRA eligible loans, which typically command a premium);

- providing funds at the loan delivery date for purchase of loans delivered for securitization; and

- assisting customers with the hedging of their mortgage business, including entering into options and forward contracts on mortgage-related securities, which we offset in the capital markets.

These activities provide a significant source of assets for our mortgage portfolio, help to create a broader market for our customers and enhance liquidity in the secondary mortgage market. Although certain securities acquired in this activity are accounted for as trading securities, we contemporaneously enter into economically offsetting positions if we do not intend to retain the securities in our portfolio.

In connection with our customer transactions and services activities, we may enter into forward commitments to purchase mortgage loans or mortgage-related securities that we decide not to retain in our portfolio. In these instances, we generally will enter into an offsetting sell commitment with another investor or require the lender to deliver a sell commitment to us together with the loans to be pooled into mortgage-related securities.

Mortgage Innovation

Our Capital Markets group also aids our lender customers in their efforts to introduce new mortgage products into the marketplace. Lenders often face limited secondary market appetite for new or innovative mortgage products. Our Capital Markets group supports these lenders by purchasing new products for our investment portfolio before the products develop full track records for credit performance and pricing. Among the innovations that our Capital Markets group has supported recently are 40-year mortgages, interest-only mortgages and reverse mortgages.

Housing Goals

Our Capital Markets group contributes to our regulatory housing goals by purchasing goals-qualifying mortgage loans and mortgage-related securities for our mortgage portfolio. In particular, our Capital Markets group is able to purchase highly-rated mortgage-related securities backed by mortgage loans that meet our regulatory housing goals requirements. Our Capital Markets group s purchase of goals-qualifying mortgage loans is a critical factor in our ability to meet our housing goals.

Funding of Our Investments

Our Capital Markets group funds its investments primarily through the issuance of debt securities in the domestic and international capital markets. The objective of our debt financing activities is to manage our liquidity requirements while obtaining funds as efficiently as possible. We structure our financings not only to satisfy our funding and risk management requirements, but also to access the market in an orderly manner with debt securities designed to appeal to a wide range of investors. International investors, seeking many of the features offered in our debt programs for their U.S. dollar-denominated investments, have been a significant and growing source of funding in recent years. The most significant of the debt financing programs that we conduct are the following:

Benchmark Securities®. Through our Benchmark Securities program, we sell large, regularly scheduled issues of unsecured debt. Our Benchmark Securities issues tend to appeal to investors who value liquidity and price transparency. The Benchmark Securities program includes:

Benchmark Bills® have maturities of up to one year. On a weekly basis, we auction three-month and six-month Benchmark Bills with a minimum issue size of $1.0 billion. On a monthly basis, we auction one-year Benchmark Bills with a minimum issue size of $1.0 billion.

Benchmark Notes® have maturities ranging between two and ten years. Each month, we typically sell one or more new, fixed-rate issues of Benchmark Notes through dealer syndicates. Each issue has a minimum size of $3.0 billion.

Discount Notes. We issue short-term debt securities called Discount Notes with maturities ranging from overnight to 360 days from the date of issuance. Investors purchase these notes at a discount to the principal amount and receive the principal amount when the notes mature.

Medium-Term Notes. We issue medium-term notes (MTNs) with a wide range of maturities, interest rates and call features. The specific terms of our MTN issuances are determined through individually negotiated transactions with broker-dealers. Our MTNs are often callable prior to maturity. We issue both fixed-rate and floating-rate securities, as well as various types of structured notes that combine features of traditional debt with features of other capital market instruments.

Subordinated Debt. Pursuant to voluntary commitments that we made in October 2000, from time to time we have issued qualifying subordinated debt. The terms of our qualifying subordinated debt require us to defer interest payments on this debt in specified limited circumstances. The difference, or spread, between the trading prices of our subordinated debt and our senior debt serves as a market indicator to investors of the relative credit risk of our debt. A narrow spread between the trading prices of our subordinated debt and senior debt implies that the market perceives the credit risk of our debt to be relatively low. A wider spread between these prices implies that the market perceives our debt to have a higher relative credit risk. As of the date of this filing, we had $9.0 billion in qualifying subordinated debt outstanding. We have not issued any subordinated debt since 2003 and are not likely to resume issuances until we return to timely reporting of our financial results. Our October 2000 voluntary commitments relating to subordinated debt have been replaced by an agreement we entered into with OFHEO on September 1, 2005, pursuant to which we agreed to maintain a specified amount of qualifying subordinated debt. Although we have not issued subordinated debt since 2003, we are in compliance with our obligations relating to the maintenance of qualifying subordinated debt under our September 1, 2005 agreement with OFHEO. For more information on our subordinated debt, see Item 7 MD&A Liquidity and Capital Management Capital Management Capital Activity Subordinated Debt.

We engage in periodic repurchases of our debt securities to support the liquidity and strength of our debt programs, among other reasons. For more information regarding our approach to funding our investments and other activities, see Item 7 MD&A Liquidity and Capital Management Liquidity Debt Funding.

Although we are a corporation chartered by the U.S. Congress, we are solely responsible for our debt obligations, and neither the U.S. government nor any instrumentality of the U.S. government guarantees any of our debt. Our debt trades in the agency sector of the capital markets, along with the debt of other GSEs. Debt in the agency sector benefits from bank regulations that allow commercial banks to invest in our debt and other agency debt to a greater extent than other debt. These factors, along with the high credit rating of our senior unsecured debt securities and the manner in which we conduct our financing programs, contribute to the favorable trading characteristics of our debt. As a result, we generally are able to borrow at lower interest rates than other corporate debt issuers. For information on the credit ratings of our long-term and

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short-term senior unsecured debt, qualifying subordinated debt and preferred stock, refer to Item 7 MD&A Liquidity and Capital Management Liquidity Credit Ratings and Risk Ratings.

Securitization Activities

Our Capital Markets group engages in two principal types of securitization activities:

- creating and issuing Fannie Mae MBS from our mortgage portfolio assets, either for sale into the secondary market or to retain in our portfolio; and

- issuing structured Fannie Mae MBS for customers in exchange for a transaction fee.

Our Capital Markets group creates Fannie Mae MBS using mortgage loans and mortgage-related securities that we hold in our investment portfolio (referred to as portfolio securitizations). We currently securitize a majority of single-family mortgage loans within the first month of purchase. Our Capital Markets group may sell these Fannie Mae MBS into the secondary market or may retain the Fannie Mae MBS in our investment portfolio. The types of Fannie Mae MBS that our Capital Markets group creates through portfolio securitizations include the same types as those created by our Single-Family and HCD businesses, as described in Single-Family Credit Guaranty Guaranty Services and Housing and Community Development Multifamily Group above. In addition, the Capital Markets group issues structured Fannie Mae MBS, which are described below. The structured Fannie Mae MBS are generally created through swap transactions, typically with our lender customers or securities dealer customers. In these transactions, the customer swaps a mortgage-related security they own for one of the types of structured Fannie Mae MBS described below. This process is referred to as resecuritization.

Our Capital Markets group earns transaction fees for issuing structured Fannie Mae MBS for third parties. The most common forms of such securities are the following:

- *Fannie Mae Megas*®, which are resecuritized single-class Fannie Mae MBS that are created in transactions in which a lender or a securities dealer contributes two or more previously issued single-class Fannie Mae MBS or previously issued Megas, or a combination of Fannie Mae MBS and Megas, in return for a new issue of Mega certificates.

- *Multi-class Fannie Mae MBS*, including *REMICs*, which may separate the cash flows from underlying single-class and/or multi-class Fannie Mae MBS, other mortgage-related securities or mortgage loans into separately tradable classes of securities. By separating the cash flows, the resulting classes may consist of: (1) interest-only payments; (2) principal-only payments; (3) different portions of the principal and interest payments; or (4) combinations of each of these. Terms to maturity of some multi-class Fannie Mae MBS, particularly REMIC classes, may match or be shorter than the maturity of the underlying mortgage loans and/or mortgage-related securities. As a result, each of the classes in a multi-class Fannie Mae MBS may have a different coupon rate, average life, repayment sensitivity or final maturity. In some of our multi-class Fannie Mae MBS transactions, we may issue senior classes where we have guaranteed to the trust that we will supplement amounts received by the trust on the underlying mortgage assets as required to permit timely payment of principal and interest on the related senior class. In these multi-class Fannie Mae MBS transactions, we also may issue one or more subordinated classes for which we do not provide a guaranty. Our Capital Markets group may work with our Single-Family or HCD businesses in structuring multi-class Fannie Mae MBS.

Interest Rate Risk Management

Our Capital Markets group is subject to the risks of changes in long-term earnings and net asset values that may occur due to changes in interest rates, interest rate volatility and other factors within the financial markets. These risks arise because the expected cash flows of our mortgage assets are not perfectly matched with the cash flows of our debt instruments.

Our principal source of interest rate risk arises from our investment in mortgage assets that give the borrower the option to prepay the mortgage at any time without penalty. For example, if interest rates decrease,

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borrowers are more likely to refinance their mortgages. Refinancings could result in prepaid loans being replaced with new investments in lower interest rate loans and, consequently, a decrease in future interest income earned on our mortgage assets. At the same time, we may not be able to redeem or repay a sufficient portion of our existing debt to lower our interest expense by the same amount, which may reduce our net interest yield.

We strive to maintain low exposure to the risks associated with changes in interest rates. To manage our exposure to interest rate risk, we engage in the following activities:

Issuance of Callable and Non-Callable Debt. We issue a broad range of both callable and non-callable debt securities to manage the duration and prepayment risk of expected cash flows of the mortgage assets we own.

Use of Derivative Instruments. While our debt is the primary means by which we manage our interest rate risk exposure, we supplement our issuance of debt with interest rate-related derivatives to further manage duration and prepayment risk. We use derivatives in combination with our issuance of debt to reduce the volatility of the estimated fair value of our mortgage investments. The benefits of derivatives include:

- the speed and efficiency with which we can alter our risk position; and

- the ability to modify some aspects of our expected cash flows in a specialized manner that might not be readily achievable with debt instruments.

The use of derivatives also involves costs to our business. Changes in the estimated fair value of these derivatives impact our net income. Accordingly, our net income will be reduced to the extent that we incur losses relating to our derivative instruments. In addition, our use of derivatives exposes us to credit risk relating to our derivative counterparties. We have derivative transaction policies and controls in place to minimize our derivative counterparty risk. See Item 7 MD&A Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management Derivatives Counterparties for a description of our derivative counterparty risk and our policies and controls in place to minimize such risk. Refer to Item 1A Risk Factors for a description of the risks associated with transactions with our derivatives counterparties.

Continuous Monitoring of Our Risk Position. We continuously monitor our risk position and actively rebalance our portfolio of interest-rate sensitive financial instruments to maintain a close match between the duration of our assets and liabilities. We use a wide range of risk measures and analytical tools to assess our exposure to the risks inherent in the asset and liability structure of our business and use these assessments in the day-to-day management of the mix of our assets and liabilities. If market conditions do not permit us to fund and manage our investments within our risk parameters, we will not be an active purchaser of mortgage assets.

For more information regarding our methods for managing interest rate risk and other market risks that impact our business, refer to Item 7 MD&A Risk Management Interest Rate Risk Management and Other Market Risks.

COMPETITION

Our competitors include the Federal Home Loan Mortgage Corporation, referred to as Freddie Mac, the Federal Home Loan Banks, financial institutions, securities dealers, insurance companies, pension funds and other investors. Our market share of loans purchased for our investment portfolio or securitized into Fannie Mae MBS is affected by the amount of residential mortgage loans offered for sale in the secondary market by loan originators and other market participants, and the amount purchased or securitized by our competitors. Our market share is also affected by the mix of available mortgage loan products and the credit risk and prices associated with those loans.

We are an active investor in mortgage-related assets and we compete with a broad range of investors for the purchase and sale of these assets. Our primary competitors for the purchase and sale of mortgage assets are participants in the secondary mortgage market that we believe also share our general investment objective of seeking to maximize the returns they receive through the purchase and sale of mortgage assets. In addition, in recent years, several large mortgage lenders have increased their retained holdings of the mortgage loans they originate. Competition for mortgage-related assets among investors in the secondary market was intense in 2004, 2005 and 2006. The spreads between the yield on our debt securities and expected yields on mortgage assets, after consideration of the net risks associated with the investments, were very narrow in 2004, 2005 and 2006, reflecting strong investor demand from banks, funds and other investors. This high demand for mortgage assets increased the price of mortgage assets relative to the credit risks associated with these assets.

We have been the largest agency issuer of mortgage-related securities in every year since 1990. Competition for the issuance of mortgage-related securities is intense and participants compete on the basis of the value of their products and services relative to the prices they charge. Value can be delivered through the liquidity and trading levels for an issuer s securities, the range of products and services offered, and the reliability and consistency with which it conducts its business. In recent years, there has been a significant increase in the issuance of mortgage-related securities by non-agency issuers. Non-agency issuers, also referred to as private-label issuers, are those issuers of mortgage-related securities other than agency issuers Fannie Mae, Freddie Mac or Ginnie Mae. Private-label issuers have significantly increased their share of the mortgage-related securities market and accounted for more than half of new single-family mortgage-related securities issuances in 2006. As the market share for private-label securities has increased, our market share has decreased. During 2006, our estimated market share of new single-family mortgage-related securities issuance was 23.7%, compared to 23.5% in 2005, 29.2% in 2004 and 45.0% in 2003. Our estimates of market share are based on publicly available data and exclude previously securitized mortgages. We expect our Single-Family business to continue to face significant competition from private-label issuers.

We also expect private-label issuers to provide increased competition to our HCD business. The commercial mortgage-backed securities (CMBS) issued by private-label issuers are typically backed not only by loans secured by multifamily residential property, but also by loans secured by a mix of retail, office, hotel and other commercial properties. We are restricted by our charter to issuing Fannie Mae MBS backed by residential loans, which often have lower yields than other types of commercial real estate loans. Private-label issuers include multifamily residential loans in pools backing CMBS because those properties, while generally generating lower cash flow than other types of commercial properties, generally have lower default rates, which improves the overall performance of CMBS pools. To obtain multifamily residential property loans for CMBS pools, private-label issuers are sometimes willing to purchase loans of a lesser credit quality than the loans we purchase and to price their purchases of these loans more aggressively than we typically price our purchases. Because we usually guarantee our Fannie Mae MBS, we generally maintain high credit standards to limit our exposure to defaults. Private-label issuers often structure their CMBS transactions so that certain classes of the securities issued in each transaction bear most of the default risk on the loans underlying the transaction. These securities are placed with investors that are prepared to assume that risk in exchange for higher yields.

OUR CHARTER AND REGULATION OF OUR ACTIVITIES

We are a stockholder-owned corporation organized and existing under the Federal National Mortgage Association Charter Act, which we refer to as the Charter Act or our charter. We were established in 1938 pursuant to the National Housing Act and originally operated as a U.S. government entity. Title III of the National Housing Act amended our charter in 1954, and we became a mixed-ownership corporation, with our preferred stock owned by the federal government and our non-voting common stock held by private investors. In 1968, our charter was further amended and our predecessor entity was divided into the present Fannie Mae and Ginnie Mae. Ginnie Mae remained a government entity, but all of the preferred stock of Fannie Mae that had been held by the U.S. government was retired, and Fannie Mae became privately owned.

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Charter Act

The Charter Act, as it was further amended from 1970 through 1998, sets forth the activities that we are permitted to conduct, authorizes us to issue debt and equity securities, and describes our general corporate powers. The Charter Act states that our purpose is to:

- provide stability in the secondary market for residential mortgages;

- respond appropriately to the private capital market;

- provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and

- promote access to mortgage credit throughout the nation (including central cities, rural areas and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

In addition to our overall strategy being aligned with these purposes, all of our business activities must be permissible under the Charter Act. Our charter specifically authorizes us to purchase, service, sell, lend on the security of, or otherwise deal in conventional mortgage loans. Our purchase of these mortgage loans is subject to limitations on the maximum original principal balance for single-family loans and requirements for credit enhancement for some loans. Under our Charter Act authority, we can purchase mortgage loans secured by first or subordinate liens, issue debt and issue mortgage-backed securities. In addition, we can guarantee mortgage-backed securities. We can also act as a depository, custodian or fiscal agent for our own account or as fiduciary, and for the account of others. Furthermore, the Charter Act expressly enables us to lease, purchase, or acquire any property, real, personal, or mixed, or any interest therein, to hold, rent, maintain, modernize, renovate, improve, use, and operate such property, and to sell, for cash or credit, lease, or otherwise dispose of the same as we may deem necessary or appropriate and also to do all things as are necessary or incidental to the proper management of [our] affairs and the proper conduct of [our] business.

Loan Standards

The single-family conventional mortgage loans we purchase or securitize must meet the following standards required by the Charter Act.

- *Principal Balance Limitations.* Our charter permits us to purchase and securitize single-family conventional mortgage loans subject to maximum original principal balance limits. Conventional mortgage loans are loans that are not federally insured or guaranteed. The principal balance limits are often referred to as conforming loan limits and are established each year by OFHEO based on the national average price of a one-family residence. For 2005, the conforming loan limit for a one-family residence was $359,650, and for 2006 and 2007 it is $417,000. Higher original principal balance limits apply to mortgage loans secured by two- to four-family residences and also to loans in Alaska, Hawaii, Guam and the Virgin Islands. No statutory limits apply to the maximum original principal balance of multifamily mortgage loans (loans secured by properties that have five or more residential dwelling units) that we purchase or securitize. In addition, the Charter Act imposes no maximum original principal balance limits on loans we purchase or securitize that are insured by the FHA or guaranteed by the VA.

Quality Standards. The Charter Act requires that, so far as practicable and in our judgment, the mortgage loans we purchase or securitize must be of a quality, type and class that generally meet the purchase standards of private institutional mortgage investors. To comply with this requirement and for the efficient operation of our business, we have eligibility policies and make available guidelines for the mortgage loans we purchase or securitize as well as for the sellers and servicers of these loans.

Loan-to-Value and Credit Enhancement Requirements. The Charter Act requires credit enhancement on any conventional single-family mortgage loan that we purchase or securitize if it has a loan-to-value ratio over 80% at the time of purchase or securitization. Credit enhancement may take the form of insurance or a guaranty issued by a qualified insurer, a repurchase arrangement with the seller of the loans or seller-retained loan participation interests. In addition, our policies and guidelines have loan-to-value ratio requirements that depend upon a variety of factors, such as the borrower credit history, the loan purpose, the repayment terms and the number of dwelling units in the property securing the loan. Depending on these factors and the amount and type of credit enhancement we obtain, our underwriting guidelines provide that the loan-to-value ratio for loans that we purchase or securitize can be up to 100% for conventional single-family loans; however, from time to time, we may make an exception to these guidelines and acquire loans with a loan-to-value ratio greater than 100%.

Other Charter Act Limitations and Requirements

In addition to specifying our purpose, authorizing our activities and establishing various limitations and requirements relating to the loans we purchase and securitize, the Charter Act has the following provisions related to issuances of our securities, exemptions for our securities from the registration requirements of the federal securities laws, the taxation of our income, the structure of our Board of Directors and other limitations and requirements.

Issuances of Our Securities. The Charter Act authorizes us, upon approval of the Secretary of the Treasury, to issue debt obligations and mortgage-related securities. At the discretion of the Secretary of the Treasury, the U.S. Department of the Treasury may purchase obligations of Fannie Mae up to a maximum of $2.25 billion outstanding at any one time. We have not used this facility since our transition from government ownership in 1968. Neither the United States nor any of its agencies guarantees our debt or is obligated to finance our operations or assist us in any other manner. On June 13, 2006, the U.S. Department of the Treasury announced that it would undertake a review of its process for approving our issuances of debt. We cannot predict whether the outcome of this review will materially impact our current business activities.

Exemptions for Our Securities. Securities we issue are exempted securities under laws administered by the SEC. As a result, registration statements with respect to offerings of our securities are not filed with the SEC. In March 2003, however, we voluntarily registered our common stock with the SEC pursuant to Section 12(g) of the Securities Exchange Act of 1934 (the Exchange Act). We are thereby required to file periodic and current reports with the SEC, including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. Since undertaking to restate our 2002 and 2003 consolidated financial statements and improve our accounting practices and internal control over financial reporting, we have not been a timely filer of our periodic reports on Form 10-K or Form 10-Q. We are continuing to improve our accounting and internal control over financial reporting and are striving to become a timely filer as soon as practicable. We are also required to file proxy statements with the SEC. In addition, our directors and certain officers are required to file reports with the SEC relating to their ownership of Fannie Mae equity securities.

Exemption from Certain Taxes and Qualifications. Pursuant to the Charter Act, we are exempt from taxation by states, counties, municipalities or local taxing authorities, except for taxation by those authorities on our real property. We are not exempt from the payment of federal corporate income taxes. In addition, we may conduct our business without regard to any qualification or similar statute in any state of the United States, including the District of Columbia, the Commonwealth of Puerto Rico, and the territories and possessions of the United States.

Structure of Our Board of Directors. The Charter Act provides that our Board of Directors will consist of 18 persons, five of whom are to be appointed by the President of the United States and the remainder of whom are to be elected annually by our stockholders at our annual meeting of stockholders. All members of our Board of Directors either are elected by our stockholders or appointed by the President for one-year terms, or until their successors are elected and qualified. The five appointed director positions have been vacant since May 2004. Of the remaining 13 director positions, two are vacant. Our Board has determined that all of our current directors, except our Chief Executive Officer, are independent directors under New York Stock Exchange standards. Because we have not held an annual meeting of stockholders since 2004, some of our directors are serving terms that have exceeded one year. In accordance with OFHEO regulation, we have elected to follow the applicable corporate governance practices and procedures of the Delaware General Corporation Law, as it may be amended from time to time.

Other Limitations and Requirements. Under the Charter Act, we may not originate mortgage loans or advance funds to a mortgage seller on an interim basis, using mortgage loans as collateral, pending the sale of the mortgages in the secondary market. In addition, we may only purchase or securitize mortgages originated in the United States, including the District of Columbia, the Commonwealth of Puerto Rico, and the territories and possessions of the United States.

Regulation and Oversight of Our Activities

As a federally chartered corporation, we are subject to Congressional legislation and oversight and are regulated by HUD and OFHEO. In addition, we are subject to regulation by the U.S. Department of the Treasury and by the SEC. The Government Accountability Office is authorized to audit our programs, activities, receipts, expenditures and financial transactions.

HUD Regulation

Program Approval

HUD has general regulatory authority to promulgate rules and regulations to carry out the purposes of the Charter Act, excluding authority over matters granted exclusively to OFHEO. We are required under the Charter Act to obtain approval of the Secretary of HUD for any new conventional mortgage program that is significantly different from those approved or engaged in prior to the 1992 amendment of the Charter Act through enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act). The Secretary must approve any new program unless the Charter Act does not authorize it or the Secretary finds that it is not in the public interest.

On June 13, 2006, HUD announced that it would conduct a review of our investments and holdings, including certain equity and debt investments classified in our consolidated financial statements as other assets/other liabilities, to determine whether our investment activities are consistent with our charter authority. We are fully cooperating with this review, but cannot predict the outcome of this review or whether it may require us to modify our investment approach or restrict our current business activities.

Housing Goals

The Secretary of HUD establishes annual housing goals pursuant to the 1992 Act for housing (1) for low- and moderate-income families, (2) in HUD-defined underserved areas, including central cities and rural areas, and (3) for low-income families in low-income areas and for very low-income families, which is referred to as special affordable housing. Each of these three goals is set as a percentage of the total number of dwelling units financed by eligible mortgage loan purchases. A dwelling unit may be counted in more than one category of goals. Included in eligible mortgage loan purchases are loans underlying our Fannie Mae MBS issuances, subordinate mortgage loans and refinanced mortgage loans. Several activities are excluded from eligible mortgage loan purchases, such as most purchases of non-conventional mortgage loans, equity investments (even if they facilitate low-income housing), mortgage loans secured by second homes and commitments to purchase or securitize mortgage loans at a later date. In addition, beginning in 2005, HUD also established three home purchase mortgage subgoals that measure our purchase or securitization of loans by the number of loans (not dwelling units) providing purchase money for owner-occupied single-family housing in metropolitan areas. We also have a subgoal for multifamily special affordable housing that is expressed as a dollar amount. Each year, we are required to submit an annual report on our performance in meeting our housing goals. We deliver the report to the Secretary of HUD as well as to the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs.

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On November 2, 2004, HUD published a final regulation amending its housing goals rule effective January 1, 2005. The regulation increased housing goal levels and also created the three new home purchase mortgage subgoals described above. The housing goals for the period 2002-2004 and the increased housing goals and new subgoals for the period 2005-2008 are shown below.

Housing Goals and Subgoals

	2008	2007	2006	2005	2002-2004
Housing goals:(1)					
Low- and moderate-income housing	56.0%	55.0%	53.0%	52.0%	50.0%
Underserved areas	39.0	38.0	38.0	37.0	31.0
Special affordable housing	27.0	25.0	23.0	22.0	20.0
Home purchase subgoals:(2)					
Low- and moderate-income housing	47.0%	47.0%	46.0%	45.0%	
Underserved areas	34.0	33.0	33.0	32.0	
Special affordable housing	18.0	18.0	17.0	17.0	
Multifamily minimum in special affordable housing subgoal ($ in billions)	$ 5.49	$ 5.49	$ 5.49	$ 5.49	$ 2.85

(1) Goals are expressed as a percentage of the total number of dwelling units financed by eligible mortgage loan purchases during the period.

(2) Home purchase subgoals measure our performance by the number of loans (not dwelling units) providing purchase money for owner-occupied single-family housing in metropolitan areas.

The following table compares our performance against the housing goals and subgoals for the years 2003 through 2006.

Housing Goals and Subgoals Performance

	2006		2005		2004		2003	
	Result(1)	Goal	Result(2)	Goal	Result(2)	Goal	Result(2)	Goal
Housing goals:(3)								
Low- and moderate-income housing	56.9%	53.0%	55.1%	52.0%	53.4%	50.0%	52.3%	50.0%
Underserved areas	43.6	38.0	41.4	37.0	33.5	31.0	32.1	31.0
Special affordable housing	27.8	23.0	26.3	22.0	23.6	20.0	21.2	20.0
Home purchase subgoals:(4)								
Low- and moderate-income	46.9%	46.0%	44.6%	45.0%				

housing								
Underserved areas	34.5	33.0	32.6	32.0				
Special affordable housing	17.9	17.0	17.0	17.0				
Multifamily minimum in special affordable housing subgoal ($ in billions)	$ 13.39	$ 5.49	$ 10.39	$ 5.49	$ 7.32	$ 2.85	$ 12.23	$ 2.85

(1) The source of this data is our Annual Housing Activities Report for 2006. HUD has not yet determined our results for 2006.

(2) The source of this data is HUD s analysis of data we submitted to HUD. Some results differ from the results we reported in our Annual Housing Activities Reports for 2005, 2004 and 2003. Actual results reflect the impact of provisions that allow us to estimate the affordability of units with missing income and rent data. Actual results for 2003 reflect the impact of incentive points for small multifamily and owner-occupied rental housing, which were no longer available starting in 2004.

(3) Goals are expressed as a percentage of the total number of dwelling units financed by eligible mortgage loan purchases during the period.

(4) Home purchase subgoals measure our performance by the number of loans (not dwelling units) providing purchase money for owner-occupied single-family housing in metropolitan areas.

As shown by the table above, we were able to meet our housing goals and subgoals in 2006, 2004 and 2003. In 2005, we met all three of our affordable housing goals: the low- and moderate-income housing goal, the underserved areas goal and the special affordable housing goal. We also met three of the four subgoals: the underserved areas home purchase subgoal, the special affordable home purchase subgoal, and the special affordable multifamily subgoal. We fell slightly short of the low- and moderate-income home purchase subgoal.

The affordable housing goals are subject to enforcement by the Secretary of HUD. HUD s regulations allow HUD to require us to submit a housing plan if we fail to meet our housing goals and HUD determines that achievement was feasible, taking into account market and economic conditions and our financial condition. The housing plan must describe the actions we will take to meet the goals in the next calendar year. If HUD determines that we have failed to submit a housing plan or to make a good faith effort to comply with the plan, HUD has the right to take certain administrative actions. The potential penalties for failure to comply with HUD s housing plan requirements are a cease-and-desist order and civil money penalties. Pursuant to the 1992 Act, the low- and moderate-income housing subgoal and the underserved areas subgoal are not enforceable by HUD. As noted above, we did not meet the low- and moderate-income home purchase subgoal in 2005. Because this subgoal is not enforceable, there is no penalty for failing to meet this subgoal.

These new housing goals and subgoals are designed to increase the amount of mortgage financing that we make available to target populations and geographic areas defined by the goals.

We have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet these increased housing goals and the subgoals. These strategies include entering into some purchase and securitization transactions with lower expected economic returns than our typical transactions. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD s goals and subgoals, which could increase our credit losses. The Charter Act explicitly authorizes us to undertake activities ... involving a reasonable economic return that may be less than the return earned on other activities in order to support the secondary market for housing for low- and moderate-income families.

We believe that we are making progress toward achieving our 2007 housing goals and subgoals. Meeting the higher goals and subgoals for 2007 is challenging, as increased home prices and higher interest rates have reduced housing affordability during the past several years. Since HUD set the home purchase subgoals in 2004, the affordable housing markets have experienced a dramatic change. Home Mortgage Disclosure Act data released in 2006 show that the share of the primary mortgage market serving low- and moderate-income borrowers declined in 2005, reducing our ability to purchase and securitize mortgage loans that meet the HUD subgoals. The National Association of REALTORS® housing affordability index has dropped from 130.7 in 2003 to 106.1 in 2006. Our housing goals and subgoals continue to increase in 2007 and 2008. If our efforts to meet the new housing goals and subgoals prove to be insufficient, we may need to take additional steps that could have an adverse effect on our profitability. See Item 1A Risk Factors for more information on how changes we are making to our business strategies in order to meet HUD s new housing goals and subgoals may reduce our profitability.

OFHEO Regulation

OFHEO is an independent office within HUD that is responsible for ensuring that we are adequately capitalized and operating safely in accordance with the 1992 Act. OFHEO has examination authority with respect to us, and we are required to submit to OFHEO annual and quarterly reports on our financial condition and results of operations. OFHEO is authorized to levy annual assessments on Fannie Mae and Freddie Mac, to the extent authorized by Congress, to cover OFHEO s reasonable expenses. OFHEO s formal enforcement powers include the power to impose temporary and final cease-and-desist orders and civil monetary penalties on us and our directors and executive officers. OFHEO also may use other informal supervisory procedures of the type that are generally used by federal bank regulatory agencies.

OFHEO Consent Order

In 2003, OFHEO commenced a special examination of our accounting policies and practices, internal controls, financial reporting, corporate governance, and other matters. On May 23, 2006, concurrently with OFHEO s release of its final report of the special examination, we agreed to OFHEO s issuance of a consent order that

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resolved open matters relating to their investigation of us. Under the consent order, we neither admitted nor denied any wrongdoing and agreed to make changes and take actions in specified areas, including our accounting practices, capital levels and activities, corporate governance, Board of Directors, internal controls, public disclosures, regulatory reporting, personnel and compensation practices. We also agreed to continue to maintain a 30% capital surplus over our statutory minimum capital requirement until the Director of OFHEO, in his discretion, determines the requirement should be modified or allowed to expire, taking into account factors such as resolution of our accounting and internal control issues.

We also agreed not to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO for December 31, 2005 ($727.75 billion), except in limited circumstances at OFHEO s discretion. We may propose to OFHEO increases in the size of our portfolio to respond to disruptions in the mortgage markets. We submitted an updated business plan to OFHEO on February 28, 2007 that included an update on our progress in remediating our internal control deficiencies, completing the requirements of the consent order and other matters. OFHEO reviewed our business plan and has directed us to maintain compliance with the $727.75 billion portfolio cap. Until the Director of OFHEO has determined that modification or expiration of the limitation is appropriate, we will remain subject to this limitation on portfolio growth.

As part of the OFHEO consent order, our Board of Directors agreed to review all individuals who at the time of the review were affiliated with us, including Board members, and who were mentioned in OFHEO s final report of the special examination as participating in any misconduct for suitability to remain in their positions or for other remedial actions. The Board created a special committee made up of independent Board members, none of which had joined the Board prior to December 2004, to conduct this review. In October 2006, the special committee completed its review and reported its findings and recommendations to OFHEO. We have since implemented the actions recommended in the special committee s report to OFHEO.

In addition, as part of the OFHEO consent order, we agreed to pay a $400 million civil penalty, with $50 million payable to the U.S. Treasury and $350 million payable to the SEC for distribution to stockholders pursuant to the Fair Funds for Investors provision of the Sarbanes-Oxley Act of 2002. We have paid this civil penalty in full.

Capital Requirements

As part of its responsibilities under the 1992 Act, OFHEO has regulatory authority as to the capital requirements established by the 1992 Act, issuing regulations on capital adequacy and enforcing capital standards. The 1992 Act capital standards include minimum and critical capital requirements calculated as specified percentages of our assets and our off-balance sheet obligations, such as outstanding guaranties. In addition, the 1992 Act capital requirements include a risk-based capital requirement that is calculated as the amount of capital needed to withstand a severe ten-year stress period characterized by extreme movements in interest rates and simultaneous severe credit losses. Moreover, to allow for management and operations risks, an additional 30% is added to the amount necessary to withstand the ten-year stress period. On a quarterly basis, we are required by regulation to report to OFHEO on the level of our capital and whether we are in compliance with the capital requirements established by OFHEO. We also provide weekly and monthly reports to OFHEO on our current capital standing.

Compliance with the capital requirements could limit our ability to make investments or provide mortgage guaranties and also could restrict our ability to make payments on our qualifying subordinated debt or pay dividends on our preferred and common stock. OFHEO is permitted or required to take remedial action if we fail to meet our capital requirements, depending on the requirement we fail to meet. We are required to submit a capital restoration plan if OFHEO classifies us as significantly undercapitalized. As described below, we currently operate under a capital restoration plan. Even if we meet our capital requirements, OFHEO has the ability to take additional supervisory actions if the Director determines that we have failed to make reasonable efforts to comply with that plan or are engaging in unapproved conduct that could result in a rapid depletion of our core capital, or if the value of the property securing mortgage loans we hold or have securitized has decreased significantly.

The 1992 Act gives OFHEO the authority, after following prescribed procedures, to appoint a conservator. Under OFHEO s regulations, appointment of a conservator is mandatory, with limited exceptions, if we are critically undercapitalized (that is, our core capital is less than our required critical capital). Appointment of a conservator is discretionary under OFHEO s rules if we are significantly undercapitalized (that is, our core capital is less than our required minimum capital), and alternative remedies are unavailable. The 1992 Act and OFHEO s rules also specify other grounds for appointing a conservator.

In December 2004, OFHEO determined that we were significantly undercapitalized as of September 30, 2004. We submitted, and in February 2005, OFHEO approved, a capital restoration plan intended to comply with OFHEO s directive that we achieve a 30% surplus over our statutory minimum capital requirement by September 30, 2005. OFHEO announced on November 1, 2005 that we had achieved a 30% surplus over our minimum capital requirement as of September 30, 2005. Under our May 2006 consent order with OFHEO, we agreed to continue to maintain a 30% capital surplus over our statutory minimum capital requirement until the Director of OFHEO, in his discretion, determines the requirement should be modified or allowed to expire, taking into account factors such as resolution of accounting and internal control issues. For additional information on our capital requirements, see Item 7 MD&A Liquidity and Capital Management Capital Management Capital Adequacy Requirements.

Dividend Restrictions

Our capital requirements under the 1992 Act and as administered by OFHEO may restrict the ability of our Board of Directors to declare dividends, authorize repurchases of our preferred or common stock, or approve any other capital distributions. If such an action would decrease our total capital below the risk-based capital requirement or our core capital below the minimum capital requirement, we may not make the distribution without the approval of OFHEO.

In addition, under our May 2006 consent order with OFHEO, we agreed to the following additional restrictions relating to our capital distributions:

- as long as the capital restoration plan is in effect, we must seek the approval of the Director of OFHEO before engaging in any transaction that could have the effect of reducing our capital surplus below an amount equal to 30% more than our statutory minimum capital requirement; and

- we must submit a written report to OFHEO detailing the rationale and process for any proposed capital distribution before making the distribution.

Refer to Item 7 MD&A Liquidity and Capital Management Capital Management Capital Adequacy Requirements for a description of our statutory capital requirements and our core capital, total capital and other capital classification measures as of December 31, 2005 and 2004.

Recent Legislative Developments and Possible Changes in Our Regulations

The U.S. Congress continues to consider legislation that would change the regulatory framework under which we, Freddie Mac and the Federal Home Loan Banks operate. On March 29, 2007, the House Financial Services Committee approved a bill that would establish a new, independent regulator for us and the other GSEs, with broad authority over both safety and soundness and mission. The bill, if enacted into law, would affect Fannie Mae in significant ways, including:

- authorizing the regulator to limit the size and composition of our mortgage investment portfolio;

authorizing the regulator to increase the level of our required capital;

changing the approval process for products and activities and expanding the extent of regulatory oversight of us and our officers, directors and employees;

changing the method for enforcing compliance with housing goals; and

authorizing, and in some instances requiring, the appointment of a receiver if the company becomes critically undercapitalized.

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In addition, the House bill would require us and Freddie Mac to contribute an amount equal to 1.2 basis points of our average total mortgage portfolios (including whole loans and securitized obligations, whether held in portfolio or sold in any form) to a fund to support affordable housing that would be managed by the new GSE regulator.

As of the date of this filing, the only GSE reform bill that has been introduced in the Senate is S. 1100, co-sponsored by four Republican members of the Senate Committee on Banking, Housing, and Urban Affairs. This bill is substantially similar to a bill that was approved by the Committee in July 2005, and differs from the House bill in a number of respects. It is expected that the Democratic Chairman of the Committee will bring his own version of GSE reform legislation to the Committee, but the timing is uncertain. Further, we cannot predict the content of any Senate bill that may be introduced or its prospects for Committee approval or passage by the full Senate.

Even if bills for GSE regulatory oversight reform are passed by both the House and the Senate, the specific provisions of any legislation of this type, as well as the timing for enactment of such legislation, are uncertain. We support any legislation that would improve our effectiveness in increasing liquidity and lowering the cost of borrowing in the mortgage market and, as a result, expanding access to housing and increasing opportunities for homeownership.

As Fannie Mae has testified before Congress, we continue to support legislation that would:

- create a single independent, well-funded regulator that combines safety and soundness supervision with authority over our mission;
- provide the regulator with bank-like regulatory authority to adjust capital levels and on-balance sheet activities, to the extent needed to ensure safe and sound operations;
- provide the regulator with bank-like supervisory authorities, including prompt corrective action powers and authority over our activities;
- provide a structure for housing goals that includes an affordable housing fund administered by the GSEs that strengthens our housing and liquidity mission.

It is possible, however, that the enactment of legislation could have a material adverse effect on our earnings and the prospects for our business. Refer to Item 1A Risk Factors for a description of how the changes in the regulation of our business contemplated by these GSE reform bills or other legislative proposals could materially adversely affect our business and earnings.

EMPLOYEES

As of December 31, 2005, we employed approximately 5,600 personnel, including full-time and part-time employees, term employees and employees on leave. During 2005 and 2006, we increased the number of our employees, both as part of significantly improving our accounting practices, risk management, internal controls and corporate governance, and as appropriate to complete the restatement of our previously issued consolidated financial statements. As of March 31, 2007, we employed approximately 6,600 personnel, including full-time and part-time employees, term employees and employees on leave.

WHERE YOU CAN FIND ADDITIONAL INFORMATION

We file reports, proxy statements and other information with the SEC. We make available free of charge through our Web site our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all other SEC reports and amendments to those reports as soon as reasonably practicable after we electronically file the material with, or furnish it to, the SEC. Our Web site address is www.fanniemae.com. Materials that we file with the SEC are also available from the SEC s Web site, www.sec.gov. In addition, these materials may be inspected, without charge, and copies may be obtained at prescribed rates, at the SEC s Public Reference Room at 100 F Street, NE, Room 1580, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. You may also request

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copies of any filing from us, at no cost, by telephone at (202) 752-7000 or by mail at 3900 Wisconsin Avenue, NW, Washington, DC 20016.

Effective March 31, 2003, we voluntarily registered our common stock with the SEC under Section 12(g) of the Exchange Act. Our common stock, as well as the debt, preferred stock and mortgage-backed securities we issue, are exempt from registration under the Securities Act of 1933 and are exempted securities under the Exchange Act. The voluntary registration of our common stock does not affect the exempt status of the debt, equity and mortgage-backed securities that we issue.

With regard to OFHEO s regulation of our activities, you may obtain materials from OFHEO s Web site, www.ofheo.gov. These materials include the September 2004 interim report of OFHEO s findings of its special examination and the May 2006 final report on its findings.

We are providing our Web site address and the Web site addresses of the SEC and OFHEO solely for your information. Information appearing on our Web site or on the SEC s Web site or OFHEO s Web site is not incorporated into this Annual Report on Form 10-K except as specifically stated in this Annual Report on Form 10-K.

FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements, which are statements about matters that are not historical facts. In addition, our senior management may from time to time make forward-looking statements orally to analysts, investors, the news media and others. Forward-looking statements often include words such as expects, anticipates, intends, plans, believes, seeks, estimates, will, would, should, could, may, or similar words. Amo forward-looking statements in this report are statements relating to:

- our expectation that we will file our 2006 Form 10-K by the end of 2007;
- our expectations regarding industry and economic trends, including our expectations that:
  - growth in total U.S. residential mortgage debt outstanding will continue at a slower pace in 2007, as the housing market cools further and average home prices possibly decline modestly;
  - the continuation of positive demographic trends, such as stable household formation rates and a growing economy, will help mitigate the slowdown in the growth in residential mortgage debt outstanding, but are unlikely to offset the slowdown in the short- to medium-term;
  - average home prices could go down in 2007;
  - over the next decade, demographic demand (primarily from stable household formation rates, a positive age structure of the population for homebuying and rising homeownership rates because of the high level of immigration over the past 25 years) will be at a level that should lead to a fundamentally strong mortgage market, and will support continued long-term demand for new capital to finance the substantial and sustained housing finance needs of American homebuyers;
  - guidance by depository institution regulators will likely slow significantly the growth of subprime and Alt-A mortgage originations, which have represented an elevated level of market activity by historical standards in recent years;

our expectation that, when we expect to earn returns greater than our cost of equity capital, we generally will be an active purchaser of mortgage loans and mortgage-related securities, and that when few opportunities exist to earn returns above our cost of equity capital, we generally will be a less active purchaser, and may be a net seller, of mortgage loans and mortgage-related securities;

our expectation that we will be an active purchaser of less liquid forms of mortgage loans and mortgage-related securities even in periods of high market demand for mortgage assets;

our expectation that private-label issuers of mortgage-related securities will continue to provide significant competition for our Single-Family and HCD businesses;

our expectation that the costs associated with the preparation of our post-2004 consolidated financial statements and periodic SEC reports will continue to have a substantial impact on administrative expenses at least until we are current in filing our periodic financial reports with the SEC;

our expectation that our recently implemented cost-cutting measures will reduce our administrative expenses by approximately $200 million for 2007 as compared to 2006, and our expectation that we will reduce our administrative expenses, excluding costs associated with returning to timely financial reporting, to approximately $2 billion per year in 2008;

our expectation that, based on the composition of our derivatives, we generally expect to report decreases in the aggregate fair value of our derivatives as interest rates decrease;

our expectation that, as a result of the variety of ways in which we record financial instruments in our consolidated financial statements, our earnings will vary, perhaps substantially, from period to period and result in volatility in our stockholders equity and regulatory capital;

our belief that the estimated fair value of our derivatives may fluctuate substantially from period to period because of changes in interest rates, expected interest rate volatility and our derivative activity;

our expectation that we will experience high levels of period to period volatility in our results of operations and financial condition as part of our normal business activities, primarily due to changes in market conditions that result in periodic fluctuations in the estimated fair value of our derivatives;

our expectation of the continued strength of our quarterly fee income, moderate increases in our provision for credit losses and somewhat lower derivative fair value losses, as interest rates have generally trended up since the end of 2005 and remain at overall higher levels;

our expectation of a reduction in our net interest income and net interest yield in 2006 as a result of the decrease in the volume of our interest-earning assets and the decline in the spread between the average yield on these assets and our borrowing costs that we began experiencing at the end of 2004;

our expectation that net interest income will fluctuate based on changes in interest rates and changes in the amount and composition of our interest-earning assets and interest-bearing liabilities;

our expectation that unrealized gains and losses on trading securities will fluctuate each period with changes in volumes, interest rates and market prices;

our belief that the continued upward trend in interest rates during 2006, which caused a further decline in the fair value of our mortgage-related securities, is likely to result in our recognition of material other-than-temporary impairment charges in 2006 for impaired securities that we have identified for possible sale or that we sold prior to recovery of the impairment;

our intent to hold certain temporarily impaired securities until recovery;

our expectation that in normal market conditions, our selling activity will represent a modest portion of the total changes in the total portfolio for the year;

our expectation that tax credits and net operating losses resulting from our investments in LIHTC partnerships, which reduce our federal income tax liability, will grow in the future, and that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the entire tax benefit;

our intent to use the remainder of unused tax credits received in 2005 to reduce our income tax liability in future years;

our intent to continue to invest in LIHTC partnerships, and our expectation that our increased investments in LIHTC partnerships in 2006 will generate additional net operating losses and tax credits in the future;

our belief that the guaranty fee income generated from future business activity will largely replace any guaranty fee income lost as a result of mortgage prepayments;

our expectation that loans that permit a borrower to defer principal or interest payments, such as negative-amortizing and interest-only loans, will default more often than traditional mortgage loans;

our current belief that we do not have credit concerns on multifamily properties related to the Gulf Coast Hurricanes Katrina and Rita;

our belief that our credit exposure to the subprime mortgage loans underlying the private-label mortgage-related securities in our portfolio is limited because we have focused our purchases on the highest-rated tranches of these securities to date;

our belief that our credit losses will increase and serious delinquencies may trend upward, as a result of the sharp decline in the rate of home price appreciation during 2006 and the possibility of home price declines in 2007;

our expectation of increasing foreclosure and REO incidence and credit losses in the Midwestern states, in light of the continued weakness of economic fundamentals, such as employment levels and lack of home price appreciation;

our expectation that our short-term and long-term funding needs and uses of cash in 2007 and 2008 will remain generally consistent with our needs during 2005 and 2006;

our expectation that, over the long term, our funding needs and sources of liquidity will remain relatively consistent with current needs and sources;

our belief that we continue to meet our regulatory capital requirements;

our intent to consider an increase in our issuance of debt in future years if we decide to increase our purchase of mortgage assets following the modification or expiration of the current limitation on the size of our mortgage portfolio;

our expectation that the outcome of the current Financial Accounting Standards Board (FASB) assessment of what activities a QSPE may perform might affect the entities we consolidate in future periods;

our belief that the measures that we have implemented to remediate the material weaknesses in internal control over financial reporting have had a material impact on our internal control over financial reporting since December 31, 2004;

our expectation that there will not be any change in our ability to borrow funds through the issuance of debt securities in the capital markets in the foreseeable future;

our expectation that our internal control environment will continue to be modified and enhanced in order to enable us to file periodic reports with the SEC on a current basis in the future;

our intention to continue to make significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet HUD s increased housing goals and subgoals;

our belief that we achieved all of our housing goals for 2006, and that we are making progress toward our 2007 housing goals and subgoals;

our intent that, in the event that we were required to make payments under Fannie Mae MBS guaranties, we would pursue recovery of these payments by exercising our rights to the collateral backing the underlying loans or through available credit enhancements (which includes all recourse with third parties and mortgage insurance);

our expectation that we will experience periodic fluctuations in the estimated fair value of our net assets due to our business activity and changes in market conditions, including changes in interest rates, changes in relative spreads between our mortgage assets and debt, and changes in implied volatility;

our expectation that changes in implied volatility, and relative changes between mortgage OAS and debt OAS are the market conditions that will have the most significant impact on the fair value of our net assets;

our expectation that the reduction in the size of our mortgage portfolio and higher administrative expenses will continue to negatively impact our earnings in 2006 and 2007;

our belief that we have defenses to the claims in the lawsuits pending against us and our intention to defend these lawsuits vigorously;

our intention to continue to work on improving our internal controls and procedures relating to the management of operational risk; and

descriptions of assumptions underlying or relating to any of the foregoing.

Forward-looking statements reflect our management s expectations or predictions of future conditions, events or results based on various assumptions and management s estimates of trends and economic factors in the markets in which we are active, as well as our business plans. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. Our actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in these forward-looking statements. There are a number of factors that could cause actual conditions, events or results to differ materially from those described in the forward-looking statements contained in this report. A discussion of factors that could cause actual conditions, events or results to differ materially from those expressed in any forward-looking statements appears in Item 1A Risk Factors.

Readers are cautioned not to place undue reliance on forward-looking statements in this report or that we make from time to time, and to consider carefully the factors discussed in Item 1A Risk Factors in evaluating these forward-looking statements. These forward-looking statements are representative only as of the date they are made, and we undertake no obligation to update any forward-looking statement as a result of new information, future events or otherwise.

GLOSSARY OF TERMS USED IN THIS REPORT

Terms used in this report have the following meanings, unless the context indicates otherwise.

Agency issuers refers to the government-sponsored enterprises Fannie Mae and Freddie Mac, as well as Ginnie Mae.

Alt-A mortgage generally refers to a loan underwritten with lower or alternative documentation than a full documentation mortgage loan and may include other alternative product features. As a result, Alt-A mortgage loans generally have a higher risk of default than full documentation mortgage loans.

ARM *or* *adjustable-rate mortgage* refers to a mortgage loan with an interest rate that adjusts periodically over the life of the mortgage based on changes in a specified index.

Business volume *or* *new business acquisitions* refers to the sum in any given period of the unpaid principal balance of: (1) the mortgage loans and mortgage-related securities we purchase for our investment portfolio; and (2) the mortgage loans we securitize into Fannie Mae MBS that are acquired by third parties. It excludes mortgage loans we securitize from our portfolio.

Charter Act or *our charter* refers to the Federal National Mortgage Association Charter Act, 12 U.S.C. §1716 *et seq.*

Conforming mortgage refers to a conventional single-family mortgage loan with an original principal balance that is equal to or less than the applicable conforming loan limit, which is the applicable maximum original principal balance for a mortgage loan that we are permitted by our charter to purchase or securitize. The conforming loan limit is established each year by OFHEO based on the national average price of a one-family residence. The current conforming loan limit for a one-family residence in most geographic areas is $417,000.

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Conventional mortgage refers to a mortgage loan that is not guaranteed or insured by the U.S. government or its agencies, such as the VA, FHA or RHS.

Conventional single-family mortgage credit book of business refers to the sum of the unpaid principal balance of: (1) the conventional single-family mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie Mae mortgage-related securities backed by conventional single-family mortgage loans we hold in our investment portfolio; (3) Fannie Mae MBS backed by conventional single-family mortgage loans that are held by third parties; and (4) credit enhancements that we provide on conventional single-family mortgage assets.

Core capital refers to a statutory measure of our capital that is the sum of the stated value of our outstanding common stock (common stock less treasury stock), the stated value of our outstanding non-cumulative perpetual preferred stock, our paid-in capital and our retained earnings, as determined in accordance with GAAP.

Credit enhancement refers to a method to reduce credit risk by requiring collateral, letters of credit, mortgage insurance, corporate guaranties, or other agreements to provide an entity with some assurance that it will be recompensed to some degree in the event of a financial loss.

Critical capital requirement refers to the amount of core capital below which we would be classified by OFHEO as critically undercapitalized and generally would be required to be placed in conservatorship. Our critical capital requirement is generally equal to the sum of: (1) 1.25% of on-balance sheet assets; (2) 0.25% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and (3) up to 0.25% of other off-balance sheet obligations.

Delinquency refers to an instance in which a principal or interest payment on a mortgage loan has not been made in full by the due date.

Derivative refers to a financial instrument that derives its value based on changes in an underlying, such as security or commodity prices, interest rates, currency rates or other financial indices. Examples of derivatives include futures, options and swaps.

Duration refers to the sensitivity of the value of a security to changes in interest rates. The duration of a financial instrument is the expected percentage change in its value in the event of a change in interest rates of 100 basis points.

Fannie Mae mortgage-backed securities or *Fannie Mae MBS* generally refer to those mortgage-related securities that we issue and with respect to which we guarantee to the related trusts that we will supplement amounts received by the MBS trust as required to permit timely payment of principal and interest on the related Fannie Mae MBS. We also issue some forms of mortgage-related securities for which we do not provide this guaranty. The term Fannie Mae MBS refers to all forms of mortgage-related securities that we issue, including single-class Fannie Mae MBS and multi-class Fannie Mae MBS.

Fixed-rate mortgage refers to a mortgage loan with an interest rate that does not change during the entire term of the loan.

GAAP refers to generally accepted accounting principles in the United States.

GSEs refers to government-sponsored enterprises such as Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

HUD refers to the Department of Housing and Urban Development.

Implied volatility refers to the market s expectation of potential changes in interest rates.

Interest-only loan refers to a mortgage loan that allows the borrower to pay only the monthly interest due, and none of the principal, for a fixed term. After the end of that term the borrower can choose to refinance, pay the principal balance in a lump sum, or begin paying the monthly scheduled principal due on the loan, which results in a higher monthly payment at that time. Interest-only loans can be adjustable-rate or fixed-rate mortgage loans.

Interest rate swap refers to a transaction between two parties in which each agrees to exchange payments tied to different interest rates or indices for a specified period of time, generally based on a notional principal amount. An interest rate swap is a type of derivative.

Intermediate-term mortgage refers to a mortgage loan with a contractual maturity at the time of purchase equal to or less than 15 years.

LIHTC partnerships refer to low-income housing tax credit limited partnerships or limited liability companies. For a description of these partnerships, refer to Business Segments Housing and Community Development Community Investment Group above.

Liquid assets refers to our holdings of non-mortgage investments, cash and cash equivalents, and funding agreements with our lenders, including advances to lenders and repurchase agreements.

Loans, mortgage loans and *mortgages* refer to both whole loans and loan participations, secured by residential real estate, cooperative shares or by manufactured housing units.

Loan-to-value ratio or *LTV ratio* refers to the ratio, at any point in time, of the unpaid principal amount of a borrower s mortgage loan to the value of the property that serves as collateral for the loan (expressed as a percentage).

Minimum capital requirement refers to the amount of core capital below which we would be classified by OFHEO as undercapitalized. Our minimum capital requirement is generally equal to the sum of: (1) 2.50% of on-balance sheet assets; (2) 0.45% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and (3) up to 0.45% of other off-balance sheet obligations.

Mortgage assets, when referring to our assets, refers to both mortgage loans and mortgage-related securities we hold in our portfolio.

Mortgage credit book of business or book of business refers to the sum of the unpaid principal balance of: (1) the mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie Mae mortgage-related securities we hold in our investment portfolio; (3) Fannie Mae MBS that are held by third parties; and (4) credit enhancements that we provide on mortgage assets.

Mortgage-related securities or *mortgage-backed securities* refer generally to securities that represent beneficial interests in pools of mortgage loans or other mortgage-related securities. These securities may be issued by Fannie Mae or by others.

Multifamily mortgage loan refers to a mortgage loan secured by a property containing five or more residential dwelling units.

Multifamily business volume refers to the sum in any given period of the unpaid principal balance of: (1) the multifamily mortgage loans we purchase for our investment portfolio; (2) the multifamily mortgage loans we securitize into Fannie Mae MBS; and (3) credit enhancements that we provide on our multifamily mortgage assets.

Multifamily mortgage credit book of business refers to the sum of the unpaid principal balance of: (1) the multifamily mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie Mae mortgage-related securities backed by multifamily mortgage loans we hold in our investment portfolio; (3) Fannie Mae MBS backed by multifamily mortgage loans that are held by third parties; and (4) credit enhancements that we provide on multifamily mortgage assets.

Negative-amortizing loan refers to a mortgage loan that allows the borrower to make monthly payments that are less than the interest actually accrued for the period. The unpaid interest is added to the principal balance of the loan, which increases the outstanding loan balance. Negative-amortizing loans are typically adjustable-rate mortgage loans.

Net mortgage portfolio assets refers to the unpaid principal balance of our mortgage assets, net of market valuation adjustments, impairments, allowance for loan losses, and amortized premiums and discounts.

Notional principal amount refers to the hypothetical dollar amount in an interest rate swap transaction on which exchanged payments are based. The notional principal amount in an interest rate swap transaction generally is not paid or received by either party to the transaction and is typically significantly greater than the potential market or credit loss that could result from such transaction.

OFHEO refers to the Office of Federal Housing Enterprise Oversight, our safety and soundness regulator.

Option-adjusted spread or *OAS* refers to the incremental expected return between a security, loan or derivative contract and a benchmark yield curve (typically, U.S. Treasury securities, LIBOR and swaps, or agency debt securities). The OAS provides explicit consideration of the variability in the security s cash flows across multiple interest rate scenarios resulting from any options embedded in the security, such as prepayment options. For example, the OAS of a mortgage that can be prepaid by the homeowner without penalty is typically lower than a nominal yield spread to the same benchmark because the OAS reflects the exercise of the prepayment option by the homeowner, which lowers the expected return of the mortgage investor. In other words, OAS for mortgage loans is a risk-adjusted spread after consideration of the prepayment risk in mortgage loans. The market convention for mortgages is typically to quote their OAS to swaps. The OAS of our debt and derivative instruments are also frequently quoted to swaps. The OAS of our net mortgage assets is therefore the combination of these two spreads to swaps and is the option-adjusted spread between our assets and our funding and hedging instruments.

Outstanding Fannie Mae MBS refers to the total unpaid principal balance of Fannie Mae MBS that is held by third-party investors and held in our mortgage portfolio.

Private-label issuers or *non-agency issuers* refers to issuers of mortgage-related securities other than agency issuers Fannie Mae, Freddie Mac and Ginnie Mae.

Private-label securities or *non-agency securities* refers to mortgage-related securities issued by entities other than agency issuers Fannie Mae, Freddie Mac or Ginnie Mae.

Qualifying subordinated debt refers to our subordinated debt that contains an interest deferral feature that requires us to defer the payment of interest for up to five years if either: (1) our core capital is below 125% of our critical capital requirement; or (2) our core capital is below our minimum capital requirement and the U.S. Secretary of the Treasury, acting on our request, exercises his or her discretionary authority pursuant to Section 304(c) of the Charter Act to purchase our debt obligations.

REO refers to real-estate owned by Fannie Mae, generally because we have foreclosed on the property or obtained the property through a deed in lieu of foreclosure.

Reverse mortgage refers to a financial tool that provides seniors with funds from the equity in their homes. Generally, no borrower payments are made on a reverse mortgage until the borrower moves or the property is sold. The final repayment obligation is designed not to exceed the proceeds from the sale of the home.

Risk-based capital requirement refers to the amount of capital necessary to absorb losses throughout a hypothetical ten-year period marked by severely adverse circumstances. Refer to Item 7 MD&A Liquidity and Capital Management Capital Management Capital Adequacy Requirements Statutory Risk-Based Capital Requirements for a detailed definition of our statutory risk-based capital requirement.

Secondary mortgage market refers to the financial market in which residential mortgages and mortgage-related securities are bought and sold.

Single-family mortgage loan refers to a mortgage loan secured by a property containing four or fewer residential dwelling units.

Single-family business volume refers to the sum in any given period of the unpaid principal balance of: (1) the single-family mortgage loans that we purchase for our investment portfolio; and (2) the single-family mortgage loans that we securitize into Fannie Mae MBS.

Single-family mortgage credit book of business refers to the sum of the unpaid principal balance of: (1) the single-family mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie

Mae mortgage-related securities backed by single-family mortgage loans we hold in our investment portfolio; (3) Fannie Mae MBS backed by single-family mortgage loans that are held by third parties; and (4) credit enhancements that we provide on single-family mortgage assets.

Subprime mortgage generally refers to a mortgage loan made to a borrower with a weaker credit profile than that of a prime borrower. As a result of the weaker credit profile, subprime borrowers have a higher likelihood of default than prime borrowers. Subprime mortgage loans are often originated by lenders specializing in this type of business, using processes unique to subprime loans. In reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders or, for the original or resecuritized private-label, mortgage-related securities that we hold in our portfolio, if the securities were labeled as subprime when sold.

Swaptions refers to options on interest rate swaps in the form of contracts granting an option to one party and creating a corresponding commitment from the counterparty to enter into specified interest rate swaps in the future. Swaptions are usually traded in the over-the-counter market and not through an exchange.

Total capital refers to a statutory measure of our capital that is the sum of core capital plus the total allowance for loan losses and reserve for guaranty losses in connection with Fannie Mae MBS, less the specific loss allowance (that is, the allowance required on individually-impaired loans).

Yield curve or *shape of the yield curve* refers to a graph showing the relationship between the yields on bonds of the same credit quality with different maturities. For example, a normal or positive sloping yield curve exists when long-term bonds have higher yields than short-term bonds. A flat yield curve exists when yields are relatively the same for short-term and long-term bonds. A steep yield curve exists when yields on long-term bonds are significantly higher than on short-term bonds. An inverted yield curve exists when yields on long-term bonds are lower than yields on short-term bonds.

Item 1A. Risk Factors

This section identifies specific risks that should be considered carefully in evaluating our business. The risks described in Company Risks are specific to us and our business, while those described in Risks Relating to Our Industry relate to the industry in which we operate. Any of these risks could adversely affect our business, results of operations, cash flow or financial condition. Although we believe that these risks represent the material risks relevant to us, our business and our industry, new material risks may emerge that we are currently unable to predict. As a result, this description of the risks that affect our business and our industry is not exhaustive. The risks discussed below could cause our actual results to differ materially from our historical results or the results contemplated by the forward-looking statements contained in this report.

COMPANY RISKS

Competition in the mortgage and financial services industries, and the need to develop, enhance and implement strategies to adapt to changing trends in the mortgage industry and capital markets, may adversely affect our business and earnings.

Increasing Competition. We compete to acquire mortgage loans for our mortgage portfolio or for securitization based on a number of factors, including our speed and reliability in closing transactions, our products and services, the liquidity of Fannie Mae MBS, our reputation and our pricing. We face increasing competition in the secondary mortgage market from other GSEs and from large commercial banks, savings and loan institutions, securities dealers, investment funds, insurance companies and other financial institutions. In addition, increasing consolidation within the financial services industry has created larger private financial institutions, which has increased pricing pressure. The recent decreased rate of growth in U.S. residential mortgage debt outstanding in 2006 and 2007 also has increased competition in the secondary mortgage market by decreasing the number of new mortgage loans available for purchase. This increased competition may adversely affect our business and earnings.

Potential Decrease in Earnings Resulting from Changes in Industry Trends. The manner in which we compete and the products for which we compete are affected by changing trends in our industry. If we do not effectively respond to these trends, or if our strategies to respond to these trends are not as successful as our prior business strategies, our business, earnings and total returns could be adversely affected. For example, in recent years, an increasing proportion of single-family mortgage loan originations has consisted of non-traditional mortgages such as interest-only mortgages, negative-amortizing mortgages and subprime mortgages, while demand for traditional 30-year fixed-rate mortgages, which represents the largest portion of our business volume, has decreased. We did not participate in large amounts of these non-traditional mortgages in 2004, 2005 and 2006 because we determined that the pricing of these mortgages often offered insufficient compensation for the additional credit risk associated with these mortgages. These trends and our decision not to participate in large amounts of these non-traditional mortgages contributed to a significant loss in our share of new single-family mortgage-related securities issuances to private-label issuers during this period, with our market share decreasing from 45.0% in 2003 to 29.2% in 2004, 23.5% in 2005 and 23.7% in 2006.

We have modified and enhanced a number of our strategies as part of our ongoing efforts to adapt to recent changes in the industry. For example, our Capital Markets group focused on buying and holding mortgage assets to maturity prior to 2005. Beginning in 2005, however, in response to both our capital plan requirements and market conditions at that time, our Capital Markets group engaged in more active management of our portfolio as we continued to purchase and hold assets but also began to look for appropriate opportunities to sell mortgage assets and accelerate our realization of spread income, with the dual goals of supporting our chartered purpose of providing liquidity to the secondary mortgage market and maximizing long-term total returns, subject to various constraints on our purchases and sales of mortgage assets, as discussed in more detail below. In addition, we have been working with our lender customers to support a broad range of mortgage products, including subprime products, while closely monitoring credit risk and pricing dynamics across the full spectrum of mortgage product types.

We may not be able to execute successfully any new or enhanced strategies that we adopt. For example, the ability of our Capital Markets group to maximize long-term total returns from its investment activities is constrained by the limitation on the size of our portfolio under the OFHEO consent order; our risk parameters; operational limitations, including limitations relating to our current operating systems; regulatory limitations; and our intent to hold certain temporarily impaired assets until recovery and achieve certain tax consequences. In addition, our strategies, even if fully implemented, may not increase our share of the secondary mortgage market, our revenues or our total returns. A description of our method for assessing available-for-sale securities for other-than-temporary impairment is described in more detail in Item 7 MD&A Consolidated Results of Operations Investment Losses, Net.

Material weaknesses and other control deficiencies relating to our internal controls could result in errors in our reported results and could have a material adverse effect on our operations, investor confidence in our business and the trading prices of our securities.

Management s assessment of our internal control over financial reporting as of December 31, 2005 identified several material weaknesses in our internal control over financial reporting. As described in Item 9A Controls and Procedures Remediation Activities and Changes in Internal Control Over Financial Reporting, we have not remediated material weaknesses in our financial reporting process, access controls for information technology applications and infrastructure, pricing controls, and multifamily lender loss sharing modifications. Until they are remediated, these material weaknesses could lead to errors in our reported financial results and could have a material adverse effect on our operations, investor confidence in our business and the trading prices of our securities. In addition, we have not filed our 2006 Form 10-K and we are not able at this time to file our periodic reports with the SEC on a timely basis. We believe that we will not have remediated the material weakness relating to our disclosure controls and procedures until we are able to file required reports with the SEC and the NYSE on a timely basis.

In the future, we may identify further material weaknesses or significant deficiencies in our internal control over financial reporting that we have not discovered to date. In addition, we cannot be certain that we will be able to maintain adequate controls over our financial processes and reporting in the future.

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The lack of current financial and operating information about the company, along with the restatement of our consolidated financial statements and related events, have had, and likely will continue to have, a material adverse effect on our business and reputation.

We have become subject to several significant risks since our announcement in December 2004 that we would restate our previously filed consolidated financial statements. The 2004 Form 10-K that we filed in December 2006, which included restated consolidated financial statements for the years ended December 31, 2003 and 2002, was our first periodic report for periods after June 30, 2004. Our need to restate our historical financial statements and the delay in producing both restated and more current consolidated financial statements has resulted in several risks to our business, as discussed in the following paragraphs.

Risks Relating to Lack of Current Information about our Business. Material information about our current operating results and financial condition is unavailable because of the delay in filing our periodic financial reports for periods after December 31, 2005 with the SEC. As a result, investors do not have access to full information about the current state of our business. When this information becomes available to investors, it may result in an adverse effect on the trading price of our common stock.

Risks Relating to Suspension and Delisting of Our Securities from the NYSE. The delay in filing our 2006 Form 10-K with the SEC could cause the NYSE to commence suspension and delisting proceedings of our common stock. Pursuant to the NYSE s rules, if we do not file our 2006 Form 10-K by February 29, 2008 (twelve months after its due date), the NYSE will be required to commence suspension and delisting proceedings of our listed securities. If the NYSE were to delist our common stock it likely would result in a significant decline in the trading price, trading volume and liquidity of our common stock and the seven series of our preferred stock currently listed on the NYSE. In addition, we expect that the suspension and delisting of our common stock would be likely to lead to decreases in analyst coverage and market-making activity relating to our common stock, as well as reduced information about trading prices and volume.

Risks Associated with Pending Civil Litigation. We are subject to pending civil litigation that, if decided against us, could require us to pay substantial judgments or settlement amounts or provide for other relief, as discussed in Item 3 Legal Proceedings.

Reputational Risks and Other Risks Relating to Negative Publicity. We have been subject to continuing negative publicity as a result of our recent restatement of prior period financial statements and related problems, which we believe has contributed to significant declines in the price of our common stock. Continuing negative publicity could increase our cost of funds and also could adversely affect our customer relationships and the trading price of our stock. Negative publicity associated with our accounting restatement and related problems also has resulted in increased regulatory and legislative scrutiny of our business.

Decrease in Common Stock Dividends and Limitation on Our Ability to Increase Our Dividend Payments. In January 2005, in an effort to accelerate our achievement of a 30% capital surplus over our minimum capital requirement as required by OFHEO, we reduced our previous quarterly common stock dividend rate by 50%, from $0.52 per share to $0.26 per share. Under our May 2006 consent order with OFHEO, we are required to continue to operate under the capital restoration plan that OFHEO approved in February 2005. Our consent order with OFHEO also requires us to provide OFHEO with prior notice of any planned dividend and a description of the rationale for its payment. In addition, our Board of Directors is not permitted to increase the dividend at any time if payment of the increased dividend would reduce our capital surplus to less than 30% above our minimum capital requirement. In December 2006, the Board of Directors increased the common stock dividend to $0.40 per share and on May 1, 2007 increased the dividend to $0.50 per share.

We are subject to credit risk relating to the mortgage loans that we purchase or that back our Fannie Mae MBS, and any resulting delinquencies and credit losses could adversely affect our financial condition and results of operations.

Borrowers of mortgage loans that we purchase or that back our Fannie Mae MBS may fail to make the required payments of principal and interest on those loans, exposing us to the risk of credit losses. In addition, due to the current competitive dynamics of the mortgage market, we have recently increased our purchase and securitization of loans that pose a higher credit risk, such as negative-amortizing loans, interest-only loans and subprime mortgage loans. We also have increased the proportion of reduced documentation loans that we purchase or that back our Fannie Mae MBS.

For example, negative-amortizing adjustable-rate mortgages (ARMs) represented approximately 3% of our conventional single-family business volume in both 2005 and 2006. Interest-only ARMs represented approximately 9% of our conventional single-family business volume in both 2005 and 2006. We estimate that negative-amortizing ARMs and interest-only ARMs together represented approximately 6% of our conventional single-family mortgage credit book of business as of December 31, 2005 and 2006. We also estimate that subprime loans represented approximately 2.2% of our single-family mortgage credit book of business as of December 31, 2006, of which approximately 0.2% consisted of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans and approximately 2% consisted of private-label mortgage-related securities backed by subprime mortgage loans and, to a lesser extent, resecuritizations of private-label mortgage-related securities backed by subprime mortgage loans.

The increase in our exposure to credit risk resulting from the increase in these loans with higher credit risk may cause us to experience increased delinquencies and credit losses in the future, which could adversely affect our financial condition and results of operations. A discussion of how we manage mortgage credit risk and a description of the risk characteristics of our mortgage credit book of business is included in Item 7 MD&A Risk Management Credit Risk Management Mortgage Credit Risk Management.

Changes in interest rates could have a material adverse effect on our financial condition and our earnings.

We fund our operations primarily through the issuance of debt and invest our funds primarily in mortgage-related assets that permit the mortgage borrowers to prepay the mortgages at any time. These business activities expose us to market risk, which is the risk of loss from adverse changes in market conditions. Our most significant market risks are interest rate risk and option-adjusted spread risk. Interest rate risk is the risk of changes in our long-term earnings or in the value of our net assets due to changes in interest rates. Changes in interest rates affect both the value of our mortgage assets and prepayment rates on our mortgage loans. Changes in interest rates could have a material adverse impact on our business results and financial condition, including asset impairments or losses on assets sold, particularly if actual conditions differ significantly from our expectations.

Our ability to manage interest rate risk depends on our ability to issue debt instruments with a range of maturities and other features at attractive rates and to engage in derivative transactions. We must exercise judgment in selecting the amount, type and mix of debt and derivative instruments that will most effectively manage our interest rate risk. The amount, type and mix of financial instruments we select may not offset possible future changes in the spread between our borrowing costs and the interest we earn on our mortgage assets. A discussion of how we manage interest rate risk is included in Item 7 MD&A Risk Management Interest Rate Risk Management and Other Market Risks.

Option-adjusted spread risk is the risk that the option-adjusted spreads on our mortgage assets relative to those on our funding and hedging instruments (referred to as the OAS of our net assets) may increase or decrease. These increases or decreases may be a result of market supply and demand dynamics, including credit pricing basis risk between our assets and swaps and between swaps and our funding and hedging instruments. A widening of the OAS of our net mortgage assets typically causes a decline in the fair value of the company. A narrowing of the OAS of our net mortgage assets will reduce our opportunities to acquire mortgage assets and therefore could have a material adverse effect on our future earnings and financial condition. We do not attempt to actively manage or hedge the impact of changes in the OAS of our net mortgage assets after we purchase mortgage assets except through asset monitoring and disposition.

We make significant use of business and financial models to manage risk, although we recognize that models are inherently imperfect predictors of actual results because they are based on assumptions about factors such as future loan demand, prepayment speeds and other factors that may overstate or understate future experience. Our business could be adversely affected if our models fail to produce reliable results.

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Our ability to operate our business, meet our obligations and generate net interest income depends primarily on our ability to issue substantial amounts of debt frequently and at attractive rates.

The issuance of short-term and long-term debt securities in the domestic and international capital markets is our primary source of funding for purchasing assets for our mortgage portfolio and repaying or refinancing our existing debt. Moreover, our primary source of revenue is the net interest income we earn from the difference, or spread, between our borrowing costs and the return that we receive on our mortgage assets. Our ability to obtain funds through the issuance of debt, and the cost at which we are able to obtain these funds, depends on many factors, including:

- our corporate and regulatory structure, including our status as a GSE;
- legislative or regulatory actions relating to our business, including any actions that would affect our GSE status;
- rating agency actions relating to our credit ratings;
- our financial results and changes in our financial condition;
- significant events relating to our business or industry;
- the public s perception of the risks to and financial prospects of our business or industry;
- the preferences of debt investors;
- the breadth of our investor base;
- prevailing conditions in the capital markets;
- foreign exchange rates;
- interest rate fluctuations; and
- general economic conditions in the United States and abroad.

In addition, the other GSEs, such as Freddie Mac and the Federal Home Loan Banks, also issue significant amounts of AAA-rated agency debt to fund their operations, which may negatively affect the prices we are able to obtain for these securities.

Approximately 49.1% of the Benchmark Notes we issued in 2006 were purchased by non-U.S. investors, including both private institutions and non-U.S. governments and government agencies. Accordingly, a significant reduction in the purchase of our debt securities by non-U.S. investors could have a material adverse effect on both the amount of debt securities we are able to issue and the price we are able to obtain for these securities. Many of the factors that affect the amount of our securities that foreign investors purchase, including economic downturns in the countries where these investors are located, currency exchange rates and changes in domestic or foreign fiscal or monetary policies, are outside our control.

If we are unable to issue debt securities at attractive rates in amounts sufficient to operate our business and meet our obligations, it would have a material adverse effect on our liquidity, financial condition and results of operations. A description of how we obtain funding for our business by issuing debt securities in the capital markets is contained in Item 7 MD&A Liquidity and Capital Management Liquidity Debt Funding. For a description of how we manage liquidity risk, see Item 7 MD&A Liquidity and Capital Management Liquidity Liquidity Risk Management.

On June 13, 2006, the U.S. Department of the Treasury announced that it would undertake a review of its process for approving our issuances of debt, which could adversely impact our flexibility in issuing debt securities in the future. We cannot predict whether the outcome of this review will materially impact our current business activities.

A decrease in our current credit ratings would have an adverse effect on our ability to issue debt on acceptable terms, which would adversely affect our liquidity and our results of operations.

Our borrowing costs and our broad access to the debt capital markets depend in large part on our high credit ratings. Our senior unsecured debt currently has the highest credit rating available from Moody s Investors Service (Moody s), Standard & Poor s, a division of The McGraw-Hill Companies (Standard & Poor s), and Fitch Ratings (Fitch). These ratings are subject to revision or withdrawal at any time by the rating agencies. Any reduction in our credit ratings could increase our borrowing costs, limit our access to the capital markets and trigger additional collateral requirements in derivative contracts and other borrowing arrangements. A substantial reduction in our credit ratings would reduce our earnings and materially adversely affect our liquidity, our ability to conduct our normal business operations and our competitive position. A description of our credit ratings and current ratings outlook is included in Item 7 MD&A Liquidity and Capital Management Liquidity Credit Ratings and Risk Ratings.

We depend on our institutional counterparties to provide services that are critical to our business, and our financial condition and results of operations may be adversely affected by defaults by our institutional counterparties.

We face the risk that our institutional counterparties may fail to fulfill their contractual obligations to us. Our primary exposure to institutional counterparty risk is with our mortgage insurers, mortgage servicers, depository institutions, lender customers, dealers that commit to sell mortgage pools or loans to us, issuers of investments held in our liquid investment portfolio, and derivatives counterparties. The products or services that these counterparties provide are critical to our business operations and a default by a counterparty with significant obligations to us could adversely affect our financial condition and results of operations. A discussion of how we manage institutional counterparty credit risk is included in Item 7 MD&A Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management.

Mortgage Insurers. Mortgage insurers may provide primary mortgage insurance or pool mortgage insurance. Primary mortgage insurance is insurance on an individual loan, while pool mortgage insurance is insurance that applies to a defined group of loans. A mortgage insurer could fail to fulfill its obligation to reimburse us for claims under our mortgage insurance policies, which would require us to bear the full loss of the borrower default on the mortgage loans. As of December 31, 2005, we were the beneficiary of primary mortgage insurance coverage on $263.1 billion, and the beneficiary of pool mortgage insurance coverage on $71.7 billion, of single-family loans, including conventional and government loans, held in our portfolio or underlying Fannie Mae MBS, which represented approximately 13% and 4%, respectively, of our single-family mortgage credit book of business.

Mortgage Servicers. One or more of our mortgage servicers could fail to fulfill its mortgage loan servicing obligations, which include collecting payments from borrowers under the mortgage loans that we own or that back our Fannie Mae MBS, paying taxes and insurance on the properties secured by the mortgage loans, monitoring and reporting loan delinquencies, and repurchasing any loans that are subsequently found to have not met our underwriting criteria. In that event, we could incur credit losses associated with loan delinquencies or penalties for late payment of taxes and insurance on the properties that secure the mortgage loans serviced by that mortgage servicer. In addition, we likely would be forced to incur the costs necessary to replace the defaulting mortgage servicer. These events would result in a decrease in our net income. As of December 31, 2005, our ten largest single-family mortgage servicers serviced 72% of our single-family mortgage credit book of business, and Countrywide Financial Corporation, which is our largest single-family mortgage servicer, serviced 22% of the single-family mortgage credit book of business. Accordingly, the effect of a default by any one of these servicers could result in a more significant decrease in our net income than if our loans were serviced by a more diverse group of servicers.

Lender Risk-Sharing Agreements. We enter into risk-sharing agreements with some of our lender customers that require them to reimburse us for losses under the loans that are the subject of those agreements. A lender s default in its obligation to reimburse us could decrease our net income.

Custodial Depository Institutions. In connection with our mortgage servicers obligations to collect funds from borrowers and make payments to us relating to the properties securing the mortgage loans, the servicers deposit borrower payments in a depository institution that the servicer selects. In the event that one or more of these depository institutions becomes insolvent, or if the funds it holds become subject to claims of the institution s creditors, both we and the servicer may be unable to access the funds held by the depository institution. In that event, we would be unable to make required payments to holders of Fannie Mae MBS using the funds that are owed to us but in the possession of the depository institution and instead would be required to use other funds or funding sources to makes the required payments. The need to fund required payments from alternative sources could have an adverse effect on our net income, depending on the amount involved and when and whether we are able to regain possession of the amounts held by the depository institution.

Agreements with Dealers and Mortgage Originators and Investors. We enter into agreements with dealers under which they commit to deliver pools of mortgages to us at an agreed-upon date and price. We commit to sell Fannie Mae MBS based in part on these commitments. If a dealer defaults in its commitment obligation, it could cause us to default in our obligation to deliver the Fannie Mae MBS on our commitment date or may force us to replace the loans at a higher cost in order to meet our commitment. Similarly, we enter into agreements with mortgage originators and mortgage investors to purchase or sell mortgage loans or mortgage-related securities. If the originator or investor fails to deliver mortgage assets or pay the fee otherwise required to fulfill its obligations under the agreement, we may be unable to sell or purchase equivalent mortgage loans or mortgage-related securities or to purchase or sell them on equally favorable terms, which would decrease or eliminate the profit or fees we expected to earn from the transaction.

Liquid Investment Portfolio Issuers. The primary credit exposure associated with investments held in our liquid investment portfolio is that the issuers of these investments will not repay principal and interest in accordance with the contractual terms. The failure of these issuers to make these payments could have a material adverse effect on our business results.

Derivatives Counterparties. If a derivatives counterparty defaults on payments due to us, we may need to enter into a replacement derivative contract with a different counterparty at a higher cost or we may be unable to obtain a replacement contract. As of December 31, 2005, we had 21 interest rate and foreign currency derivatives counterparties. Seven of these counterparties accounted for approximately 79% of the total outstanding notional amount of our derivatives contracts, and each of these seven counterparties accounted for between approximately 6% and 17% of the total outstanding notional amount. The insolvency of one of our largest derivatives counterparties combined with an adverse move in the market before we are able to transfer or replace the contracts could adversely affect our financial condition and results of operations. A discussion of how we manage the credit risk posed by our derivatives transactions and a detailed description of our derivatives credit exposure is contained in Item 7 MD&A Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management Derivatives Counterparties.

Our business faces significant operational risks and an operational failure could materially adversely affect our business.

Shortcomings or failures in our internal processes, people or systems could have a material adverse effect on our risk management, liquidity, financial condition and results of operations; disrupt our business; and result in legislative or regulatory intervention, damage to our reputation and liability to customers. For example, our business is dependent on our ability to manage and process, on a daily basis, a large number of transactions across numerous and diverse markets. These transactions are subject to various legal and regulatory standards. We rely on the ability of our employees and our internal financial, accounting, cash management, data processing and other operating systems, as well as technological systems operated by third parties, to process these transactions and to manage our business. As a result of events that are wholly or partially beyond our control, these employees or third parties could engage in improper or unauthorized actions, or these systems could fail to operate properly. In the event of a breakdown in the operation of our or a third party s systems, or improper actions by employees or third parties, we could experience financial losses, business disruptions, legal and regulatory sanctions, and reputational damage.

Because we use a process of delegated underwriting for the single-family mortgage loans we purchase and securitize, we do not independently verify most borrower information that is provided to us. This exposes us to mortgage fraud risk, which is the risk that one or more of the parties involved in a transaction (the borrower, seller, broker, appraiser, title agent, lender or servicer) will misrepresent the facts about a mortgage loan. We may experience financial losses and reputational damage as a result of mortgage fraud.

In addition, our operations rely on the secure processing, storage and transmission of a large volume of private borrower information, such as names, residential addresses, social security numbers, credit rating data and

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other consumer financial information. Despite the protective measures we take to reduce the likelihood of information breaches, this information could be exposed in several ways, including through unauthorized access to our computer systems, employee error, computer viruses that attack our computer systems, software or networks, accidental delivery of information to an unauthorized party and loss of unencrypted media containing this information. Any of these events could result in significant financial losses, legal and regulatory sanctions, and reputational damage. A description of our risk management programs for mortgage fraud and information security is included in Item 7 MD&A Risk Management Operational Risk Management.

We have several key lender customers, and the loss of business volume from any one of these customers could adversely affect our business, market share and results of operations.

Our ability to generate revenue from the purchase and securitization of mortgage loans depends on our ability to acquire a steady flow of mortgage loans from the originators of those loans. We acquire a significant portion of our single-family mortgage loans from several large mortgage lenders. During 2005, our top five lender customers accounted for approximately 49% and 38% of our single-family and multifamily business volumes, respectively. In addition, during 2005, our largest lender customer accounted for approximately 25% of our single-family business volume and 10% of our multifamily business volume, respectively. Accordingly, maintaining our current business relationships and business volumes with our top lender customers is critical to our business. If any of our key lender customers significantly reduces the volume of mortgage loans that the lender delivers to us or that we are willing to buy from them, we could lose significant business volume that we might be unable to replace. The loss of business from any one of our key lender customers could adversely affect our business, market share and results of operations. In addition, a significant reduction in the volume of mortgage loans that we securitize could reduce the liquidity of Fannie Mae MBS, which in turn could have an adverse effect on their market value.

Our business is subject to laws and regulations that may restrict our ability to compete optimally. In addition, legislation that would change the regulation of our business could, if enacted, reduce our competitiveness and adversely affect our results of operations and financial condition. The impact of existing regulation on our business is significant, and both existing and future regulation may adversely affect our business.

As a federally chartered corporation, we are subject to the limitations imposed by the Charter Act, extensive regulation, supervision and examination by OFHEO and HUD, and regulation by other federal agencies, such as the U.S. Department of the Treasury and the SEC. We are also subject to many laws and regulations that affect our business, including those regarding taxation and privacy. A description of the laws and regulations that affect our business is contained in Item 1 Business Our Charter and Regulation of Our Activities.

Regulation by OFHEO. OFHEO has broad authority to regulate our operations and management in order to ensure our financial safety and soundness. For example, to meet our capital plan requirements in 2005, we were required to make significant changes to our business in 2005, including reducing the size of our mortgage portfolio by approximately 20% and reducing our quarterly common stock dividend by 50%. Pursuant to our May 2006 consent order with OFHEO, we may not increase our net mortgage portfolio assets above $727.75 billion, except in limited circumstances at OFHEO s discretion. This reduction in the size of our mortgage portfolio contributed to a significant reduction in our net interest income for the year ended December 31, 2005, as compared to the years ended December 31, 2004 and 2003. In addition, we have incurred significant administrative expenses in connection with complying with our remediation obligations, resulting in a reduction in our earnings for the year ended December 31, 2005, as compared to the years ended December 31, 2004 and 2003. We expect this reduction in the size of our mortgage portfolio and higher administrative expenses to continue to have a negative impact on our earnings in 2006 and 2007. If we fail to comply with any of our agreements with OFHEO or with any OFHEO regulation, we may incur penalties and could be subject to further restrictions on our activities and operations, or to investigation and enforcement actions by OFHEO.

Regulation by HUD and Charter Act Limitations. HUD supervises our compliance with the Charter Act, which defines our permissible business activities. For example, our business is limited to the U.S. housing finance sector and we may not purchase loans in excess of our conforming loan limits, which are currently

$417,000 for a one-family mortgage loan in most geographic regions and may be lower after 2007. As a result of these limitations on our ability to diversify our operations, our financial condition and earnings depend almost entirely on conditions in a single sector of the U.S. economy, specifically, the U.S. housing market. Our substantial reliance on conditions in the U.S. housing market may adversely affect the investment returns we are able to generate. In addition, the Secretary of HUD must approve any new Fannie Mae conventional mortgage program that is significantly different from those approved or engaged in prior to the enactment of the 1992 Act. As a result, we have only limited ability to respond quickly to changes in market conditions by offering new programs in response to these changes. These restrictions on our business operations may negatively affect our ability to compete successfully with other companies in the mortgage industry from time to time, which in turn may adversely affect our market share, our earnings and our financial condition. As described below under To meet HUD s new housing goals and subgoals, we enter into transactions that may reduce our profitability, we are also subject to housing goals established by HUD, which require that a specified portion of our business relate to the purchase or securitization of mortgages for low- and moderate-income housing, underserved areas and special affordable housing. Meeting these goals may adversely affect our profitability.

Legislative Proposals. The U.S. Congress continues to consider legislation that, if enacted, could materially restrict our operations and adversely affect our business and our earnings. On March 29, 2007, the House Financial Services Committee approved a bill that would establish a new, independent regulator for us and the other GSEs, with broad authority over both safety and soundness and mission. The bill, if enacted into law, would affect us in significant ways, including:

- authorizing the regulator to limit the size and composition of our mortgage investment portfolio;
- authorizing the regulator to increase the level of our required capital;
- changing the approval process for products and activities and expanding the extent of regulatory oversight of us and our officers, directors and employees;
- changing the method for enforcing compliance with housing goals; and
- authorizing, and in some instances requiring, the appointment of a receiver if we become critically undercapitalized.

In addition, the House bill would require us and Freddie Mac to contribute an amount equal to 1.2 basis points of our average total mortgage portfolios (including whole loans and securitized obligations, whether held in portfolio or sold in any form) to a fund to support affordable housing. Unlike the bill that passed the House in October 2005, the new bill would require annual contributions to the fund regardless of the amount of profit, if any, that we or Freddie Mac generate during the preceding year. In addition, the fund would be managed by the new GSE regulator rather than by the GSEs.

As of the date of this filing, the only GSE reform bill that has been introduced in the Senate is S. 1100, co-sponsored by four Republican members of the Senate Committee on Banking, Housing, and Urban Affairs. This bill is substantially similar to a bill that was approved by the Committee in July 2005, and differs from the House bill in a number of respects. It is expected that the Democratic Chairman of the Committee will bring his own version of GSE reform legislation to the Committee, but the timing is uncertain. Further, we cannot predict the content of any Senate bill that may be introduced or its prospects for Committee approval or passage by the full Senate.

Enactment of GSE legislation similar to these bills could significantly increase the costs of our compliance with regulatory requirements and limit our ability to compete effectively in the market, resulting in a material adverse effect on our business and earnings, our ability to fulfill our mission, and our ability to recruit and retain qualified officers and directors. We cannot predict the prospects for the enactment, timing or content of any legislation in the 110th Congress, the form any enacted legislation might take, or its impact on our financial condition or results of operations.

Changes in Existing Regulations or Regulatory Practices. Our business and earnings could also be materially affected by changes in the regulation of our business made by any one or more of our existing regulators. A regulator may change its current process for regulating our business, change its current interpretations of our

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regulatory requirements or exercise regulatory authority over our business beyond current practices, and any of these changes could have a material adverse effect on our business and earnings. For example, in the late summer of 2006, HUD commenced a review of specified investments and holdings to determine whether our investment activities are consistent with our charter authority. We cannot predict the outcome of this review, which currently is ongoing, or whether HUD will seek to restrict our current business activities as a result of this or other reviews.

To meet HUD s new housing goals and subgoals, we enter into transactions that may reduce our profitability.

HUD has established housing goals and subgoals for our business. HUD s housing goals require that a specified portion of our business relate to the purchase or securitization of mortgage loans that finance housing for low- and moderate-income households, housing in underserved areas and qualified housing under the definition of special affordable housing. HUD has increased our housing goals for 2005 through 2008, and has created new purchase money mortgage subgoals effective beginning in 2005 that also increase over the 2005 to 2008 period. These changes in our housing goals and subgoals, together with increases in home prices and a decrease in our share of the secondary mortgage market in recent years, have made it increasingly challenging to meet our housing goals and subgoals.

As a result, meeting the increased housing goals and subgoals established by HUD for 2007 and future years may reduce our profitability. In order to obtain business that contributes to our new housing goals and subgoals, we have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies. These strategies include entering into some purchase and securitization transactions with lower expected economic returns than our typical transactions. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD s goals and subgoals, which could increase our credit losses.

The specific housing goals and subgoals levels for 2005 through 2008, as well as our performance against these goals in 2005 and 2006, are described in Item 1 Business Our Charter and Regulation of Our Activities Regulation and Oversight of Our Activities HUD Regulation Housing Goals. Several of HUD s housing goals and subgoals increase in 2007. Accordingly, it is possible that we may not meet one or more of our 2007 housing goals or subgoals. Meeting the higher subgoals for 2007 is particularly challenging because increased home prices and higher interest rates have reduced housing affordability during the past several years. Since HUD set the home purchase subgoals in 2004, the affordable housing markets have experienced a dramatic change. Home Mortgage Disclosure Act data released in 2006 show that the share of the primary mortgage market serving low- and moderate-income borrowers declined in 2005, reducing our ability to purchase and securitize mortgage loans that meet the HUD subgoals. If our efforts to meet the new housing goals and subgoals in 2007 and future years prove to be insufficient, we may need to take additional steps that could have an adverse effect on our profitability.

In many cases, our accounting policies and methods, which are fundamental to how we report our financial condition and results of operations, require management to make estimates and rely on the use of models about matters that are inherently uncertain.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. Our management must exercise judgment in applying many of these accounting policies and methods so that these policies and methods comply with U.S. generally accepted accounting principles (GAAP) and reflect management s judgment of the most appropriate manner to report our financial condition and results of operations. In some cases, management must select the appropriate accounting policy or method from two or more alternatives, any of which might be reasonable under the circumstances but might affect the amount of assets, liabilities, revenues and expenses that we report. See Notes to Consolidated Financial Statements Note 1, Summary of Significant Accounting Policies for a description of our significant accounting policies.

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We have identified the following four accounting policies as critical to the presentation of our financial condition and results of operations:

- estimating the fair value of financial instruments;
- amortizing cost basis adjustments on mortgage loans and mortgage-related securities held in our portfolio and underlying outstanding Fannie Mae MBS using the effective interest method;
- determining our allowance for loan losses and reserve for guaranty losses; and
- determining whether an entity in which we have an ownership interest is a variable interest entity and whether we are the primary beneficiary of that variable interest entity and therefore must consolidate the entity.

We believe these policies are critical because they require management to make particularly subjective or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. Due to the complexity of these critical accounting policies, our accounting methods relating to these policies involve substantial use of models. Models are inherently imperfect predictors of actual results because they are based on assumptions, including assumptions about future events, and actual results could differ significantly. More information about these policies is included in Item 7 MD&A Critical Accounting Policies and Estimates.

The occurrence of a major natural or other disaster in the United States could increase our delinquency rates and credit losses or disrupt our business operations and lead to financial losses.

The occurrence of a major natural disaster, terrorist attack or health epidemic in the United States could increase our delinquency rates and credit losses in the affected region or regions, which could have a material adverse effect on our financial condition and results of operations. For example, we experienced an increase in our delinquency rates and credit losses as a result of Hurricane Katrina. In addition, as of December 31, 2006, approximately 16% of the gross unpaid principal balance of the conventional single-family loans we held or securitized in Fannie Mae MBS and approximately 26% of the gross unpaid principal balance of the multifamily loans we held or securitized in Fannie Mae MBS were concentrated in California. Due to this geographic concentration in California, a major earthquake or other disaster in that state could lead to significant increases in delinquency rates and credit losses.

Despite the contingency plans and facilities that we have in place, our ability to conduct business also may be adversely affected by a disruption in the infrastructure that supports our business and the communities in which we are located. Potential disruptions may include those involving electrical, communications, transportation and other services we use or that are provided to us. Substantially all of our senior management and investment personnel work out of our offices in the Washington, DC metropolitan area. If a disruption occurs and our senior management or other employees are unable to occupy our offices, communicate with other personnel or travel to other locations, our ability to service and interact with each other and with our customers may suffer, and we may not be successful in implementing contingency plans that depend on communication or travel. A description of our disaster recovery plans and facilities in the event of a disruption of this type is included in Item 7 MD&A Risk Management Operational Risk Management.

We are subject to pending civil litigation that, if decided against us, could require us to pay substantial judgments, settlements or other penalties.

A number of lawsuits have been filed against us and certain of our current and former officers and directors relating to our accounting restatement. These suits are currently pending in the U.S. District Court for the District of Columbia and fall within three primary categories: a consolidated shareholder class action lawsuit, a consolidated shareholder derivative lawsuit and a consolidated Employee Retirement Income Security Act of 1974 (ERISA)-based class action lawsuit. We may be required to pay substantial judgments, settlements or other penalties and incur significant expenses in connection with the consolidated shareholder class action and consolidated ERISA-based class action, which could have a material adverse effect on our business, results of operations and cash flows. In addition, our current and former directors, officers and employees may be entitled to reimbursement for the costs and expenses of these lawsuits pursuant to our indemnification obligations with those persons. We are also a party to several other lawsuits that, if decided against us, could require us to pay substantial judgments, settlements or other penalties. These include a proposed class action lawsuit alleging violations of federal and state antitrust laws and state consumer protection laws in connection with the setting of our guaranty fees and a proposed class action lawsuit alleging that we violated purported fiduciary duties with respect to certain escrow accounts for FHA-insured multifamily mortgage loans. We are unable at this time to estimate our potential liability in these matters. We expect all of these lawsuits to be time-consuming, and they may divert management s attention and resources from our ordinary business operations. More information regarding these lawsuits is included in Item 3 Legal Proceedings and Notes to Consolidated Financial Statements Note 19, Commitments and Contingencies.

RISKS RELATING TO OUR INDUSTRY

Changes in general market and economic conditions in the United States and abroad may adversely affect our financial condition and results of operations.

Our financial condition and results of operations may be adversely affected by changes in general market and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, the value of the U.S. dollar as compared to foreign currencies, fluctuations in both the debt and equity capital markets, employment growth and unemployment rates and the strength of the U.S. national economy and local economies. These conditions are beyond our control, and may change suddenly and dramatically.

Changes in market and economic conditions could adversely affect us in many ways, including the following:

- fluctuations in the global debt and equity capital markets, including sudden and unexpected changes in short-term or long-term interest rates, could decrease the fair value of our mortgage assets, derivatives positions and other investments, negatively affect our ability to issue debt at attractive rates, and reduce our net interest income; and

- an economic downturn or rising unemployment in the United States could decrease homeowner demand for mortgage loans and increase the number of homeowners who become delinquent or default on their mortgage loans. An increase in delinquencies or defaults would likely result in a higher level of credit losses, which would adversely affect our earnings. Also, decreased homeowner demand for mortgage loans could reduce our guaranty fee income, net interest income and the fair value of our mortgage assets. An economic downturn could also increase the risk that our counterparties will default on their obligations to us, increasing our liabilities and reducing our earnings.

A decline in U.S. housing prices or in activity in the U.S. housing market could negatively impact our earnings and financial condition.

U.S. housing prices have risen significantly in recent years. As described above, this period of extraordinary home price appreciation may have ended. The rate of home price appreciation has slowed, and we believe that a modest decline in national home prices, on average, could occur in 2007. Declines in housing prices could result in increased delinquencies or defaults on the mortgage loans we own or that back our guaranteed Fannie Mae MBS. Further, a significant portion of mortgage loans made in recent years contain adjustable-rate terms in which the interest rates are likely to increase dramatically after an initial period in which the rates are fixed. A substantial number of these adjustable-rate mortgage loans are expected to reset in 2007 and 2008 and will require significant increases in monthly payments, which also could lead to increased delinquencies or defaults. In addition, the prevalence of loans made based on limited or no credit and income documentation also increases the likelihood of future increases in delinquencies or defaults on mortgage loans. An increase in delinquencies or defaults likely will result in a higher level of credit losses, which in turn will adversely affect our earnings. In addition, housing price declines would reduce the fair value of our mortgage assets.

Our business volume is affected by the rate of growth in total U.S. residential mortgage debt outstanding and the size of the U.S. residential mortgage market. Recently, the rate of growth in total U.S. residential mortgage debt outstanding has slowed, a trend that could be exacerbated if recent increases in delinquencies and defaults

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continue to reduce the number of mortgage lenders operating in the market. A decline in this growth rate reduces the number of mortgage loans available for us to purchase or securitize, which in turn could lead to a reduction in our net interest income and guaranty fee income.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We own our principal office, which is located at 3900 Wisconsin Avenue, NW, Washington, DC, as well as additional Washington, DC facilities at 3939 Wisconsin Avenue, NW and 4250 Connecticut Avenue, NW. We also own two office facilities in Herndon, Virginia, as well as two additional facilities located in Reston, Virginia, and Urbana, Maryland. These owned facilities contain a total of approximately 1,460,000 square feet of space. We lease the land underlying the 4250 Connecticut Avenue building pursuant to a ground lease that automatically renews on July 1, 2029 for an additional 49 years unless we elect to terminate the lease by providing notice to the landlord of our decision to terminate at least one year prior to the automatic renewal date. In addition, we lease approximately 375,000 square feet of office space at 4000 Wisconsin Avenue, NW, which is adjacent to our principal office. The present lease for 4000 Wisconsin Avenue expires in 2008, and we have the option to extend the lease for up to 10 additional years, in 5-year increments. We also lease an additional approximately 470,000 square feet of office space at six locations in Washington, DC, suburban Virginia and Maryland. We maintain approximately 454,000 square feet of office space in leased premises in Pasadena, California; Atlanta, Georgia; Chicago, Illinois; Philadelphia, Pennsylvania; and Dallas, Texas. In addition, we lease offices for 60 Fannie Mae Community Business Centers and satellite offices around the United States, which work with cities, rural areas and underserved communities.

Item 3. Legal Proceedings

This item describes the material legal proceedings, examinations and other matters that: (1) were pending as of December 31, 2005; (2) were terminated during the period from January 1, 2005 through the filing of this report; or (3) are pending as of the filing of this report. Thus, the description of a matter may include developments that occurred since December 31, 2005, as well as those that occurred during 2005. The matters include legal proceedings relating to the restatement of our consolidated financial statements, such as class action and individual securities lawsuits, shareholder derivative actions and governmental proceedings, class action lawsuits alleging antitrust violations and abuse of escrow accounts, and a lawsuit we filed against KPMG LLP, our former outside auditor.

As described below, a number of lawsuits have been filed against us and certain of our current and former officers and directors relating to the accounting matters discussed in our SEC filings and OFHEO s interim and final reports, and in the report issued by the law firm of Paul, Weiss, Rifkind, Wharton & Garrison LLP (Paul Weiss) on the results of its independent investigation. These lawsuits currently are pending in the U.S. District Court for the District of Columbia and fall within three primary categories: (1) a consolidated shareholder class action, which includes cross-claims filed by KPMG, (2) a consolidated shareholder derivative lawsuit, and (3) a consolidated ERISA-based class action lawsuit. In addition, the Department of Labor is conducting a review of our Employee Stock Ownership Plan (ESOP).

In 2003, OFHEO commenced its special examination of us. The SEC and the U.S. Attorney s Office for the District of Columbia also commenced investigations against us relating to matters discussed in the OFHEO reports. On May 23, 2006, we reached a settlement with OFHEO and the SEC. In August 2006, we were advised by the U.S. Attorney s Office for the District of Columbia that it was discontinuing its investigation of us and does not plan to file charges against us.

Presently, we are also a defendant in a proposed class action lawsuit alleging violations of federal and state antitrust laws and state consumer protection laws in connection with the setting of our guaranty fees. In addition, we are a defendant in a proposed class action lawsuit alleging that we violated purported fiduciary duties with respect to certain escrow accounts for FHA-insured multifamily mortgage loans. We have also filed

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a lawsuit against our former auditor, KPMG LLP, asserting state law negligence and breach of contract claims related to certain audit and other services provided by KPMG.

We are involved in a number of legal and regulatory proceedings that arise in the ordinary course of business. For example, we are involved in legal proceedings that arise in connection with properties acquired either through foreclosure on properties securing delinquent mortgage loans we own or through our receipt of deeds to those properties in lieu of foreclosure. Claims related to possible tort liability occur from time to time, primarily in the case of single-family REO property.

From time to time, we are also a party to legal proceedings arising from our relationships with our sellers and servicers. Litigation can result from disputes with lenders concerning their loan origination or servicing obligations to us, or can result from disputes concerning termination by us (for a variety of reasons) of a lender s authority to do business with us as a seller and/or servicer. In addition, loan servicing and financing issues sometimes result in claims, including potential class actions, brought against us by borrowers.

We also are a party to legal proceedings arising from time to time from the conduct of our business and administrative functions, including contractual disputes and employment-related claims.

Litigation claims and proceedings of all types are subject to many factors that generally cannot be predicted accurately. For additional information on these proceedings, see Notes to Consolidated Financial Statements Note 19, Commitments and Contingencies.

RESTATEMENT-RELATED MATTERS

Securities Class Action Lawsuits

In re Fannie Mae Securities Litigation

Beginning on September 23, 2004, 13 separate complaints were filed by holders of our securities against us, as well as certain of our former officers, in the U.S. District Court for the District of Columbia, the U.S. District Court for the Southern District of New York and the U.S. District Court for the Southern District of Ohio. The complaints in these lawsuits purport to have been made on behalf of a class of plaintiffs consisting of purchasers of Fannie Mae securities between April 17, 2001 and September 21, 2004. The complaints alleged that we and certain of our officers, including Franklin D. Raines, J. Timothy Howard and Leanne Spencer, made material misrepresentations and/or omissions of material facts in violation of the federal securities laws. Plaintiffs claims were based on findings contained in OFHEO s September 2004 interim report regarding its findings to that date in its special examination of our accounting policies, practices and controls.

All of the cases were consolidated and/or transferred to the U.S. District Court for the District of Columbia. A consolidated complaint was filed on March 4, 2005 against us and former officers Franklin D. Raines, J. Timothy Howard and Leanne Spencer. The court entered an order naming the Ohio Public Employees Retirement System and State Teachers Retirement System of Ohio as lead plaintiffs. The consolidated complaint generally made the same allegations as the individually-filed complaints, which is that we and certain of our former officers made false and misleading statements in violation of the federal securities laws in connection with certain accounting policies and practices. More specifically, the consolidated complaint alleged that the defendants made materially false and misleading statements in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and SEC Rule 10b-5 promulgated thereunder, largely with respect to accounting statements that were inconsistent with the GAAP requirements relating to hedge accounting and the amortization of premiums and discounts. Plaintiffs contend that the alleged fraud resulted in artificially inflated prices for our common stock. Plaintiffs seek compensatory damages, attorneys fees, and other fees and costs. Discovery commenced in this action following the denial of the motions to dismiss filed by us and the former officer defendants on February 10, 2006.

On April 17, 2006, the plaintiffs in the consolidated class action filed an amended consolidated complaint against us and former officers Franklin D. Raines, J. Timothy Howard and Leanne Spencer, that added purchasers of publicly traded call options and sellers of publicly traded put options to the putative class and sought to extend the end of the putative class period from September 21, 2004 to September 27, 2005. We and the individual defendants filed motions to dismiss addressing the extended class period and the deficiency of the additional accounting allegations. On August 14, 2006, while those motions were still pending, the plaintiffs filed a second amended complaint adding KPMG LLP and Goldman, Sachs & Co., Inc. as additional defendants and adding allegations based on the May 2006 report issued by OFHEO and the February 2006 report issued by Paul Weiss. Our answer to the second amended complaint was filed on January 16, 2007. Plaintiffs filed a motion for class certification on May 17, 2006 and briefing on the motion was completed on March 12, 2007.

On April 16, 2007, KPMG filed cross-claims against us for breach of contract, fraudulent misrepresentation, fraudulent inducement, negligent misrepresentation, and contribution. KPMG is seeking unspecified compensatory, consequential, restitutionary, rescissory, and punitive damages, including purported damages related to injury to KPMG s reputation, legal costs, exposure to legal liability, costs and expenses of responding to investigations related to our accounting, and lost fees. KPMG is also seeking attorneys fees, costs, and expenses. We believe we have defenses to these claims and intend to defend them vigorously.

In addition, two individual securities cases have been filed by institutional investor shareholders in the U.S. District Court for the District of Columbia. The first case was filed on January 17, 2006 by Evergreen Equity Trust, Evergreen Select Equity Trust, Evergreen Variable Annuity Trust and Evergreen International Trust against us and the following current and former officers and directors: Franklin D. Raines, J. Timothy Howard, Leanne Spencer, Thomas P. Gerrity, Anne M. Mulcahy, Frederick V. Malek, Taylor Segue, III, William Harvey, Joe K. Pickett, Victor Ashe, Stephen B. Ashley, Molly Bordonaro, Kenneth M. Duberstein, Jamie Gorelick, Manuel Justiz, Ann McLaughlin Korologos, Donald B. Marron, Daniel H. Mudd, H. Patrick Swygert and Leslie Rahl.

The second individual securities case was filed on January 25, 2006 by 25 affiliates of Franklin Templeton Investments against us, KPMG LLP, and all of the following current and former officers and directors: Franklin D. Raines, J. Timothy Howard, Leanne Spencer, Thomas P. Gerrity, Anne M. Mulcahy, Frederick V. Malek, Taylor Segue, III, William Harvey, Joe K. Pickett, Victor Ashe, Stephen B. Ashley, Molly Bordonaro, Kenneth M. Duberstein, Jamie Gorelick, Manuel Justiz, Ann McLaughlin Korologos, Donald B. Marron, Daniel H. Mudd, H. Patrick Swygert and Leslie Rahl.

The two related individual securities actions assert various federal and state securities law and common law claims against us and certain of our current and former officers and directors based upon essentially the same alleged conduct as that at issue in the consolidated shareholder class action, and also assert insider trading claims against certain former officers. Both cases seek compensatory and punitive damages, attorneys fees, and other fees and costs. In addition, the Evergreen plaintiffs seek an award of treble damages under state law.

On May 12, 2006, the individual securities plaintiffs voluntarily dismissed defendants Victor Ashe and Molly Bordonaro from both cases. On June 29, 2006 and then again on August 14 and 15, 2006, the individual securities plaintiffs filed first amended complaints and then second amended complaints seeking to address certain of the arguments made by the defendants in their original motions to dismiss and adding additional allegations regarding improper accounting practices. The second amended complaints each added Radian Group Inc. as a defendant. On August 17, 2006, we filed motions to dismiss certain claims and allegations of the individual securities plaintiffs second amended complaints, which motions are still pending. The individual plaintiffs seek to proceed independently of the potential class of shareholders in the consolidated shareholder class action, but the court has consolidated these cases as part of the consolidated shareholder class action for pretrial purposes and possibly through final judgment.

We believe we have defenses to the claims in these lawsuits and intend to defend these lawsuits vigorously.

Shareholder Derivative Lawsuits

In re Fannie Mae Shareholder Derivative Litigation

Beginning on September 28, 2004, ten plaintiffs filed twelve shareholder derivative actions (*i.e.*, lawsuits filed by shareholder plaintiffs on our behalf) in three different federal district courts and the Superior Court of the District of Columbia on behalf of the company against certain of our current and former officers and directors and against us as a nominal defendant. Plaintiffs contend that the defendants purposefully misapplied GAAP, maintained poor internal controls, issued a false and misleading proxy statement, and falsified documents to cause our financial performance to appear smooth and stable, and that Fannie Mae was harmed as a result. The claims are for breaches of the duty of care, breach of fiduciary duty, waste, insider trading, fraud, gross mismanagement, violations of the Sarbanes-Oxley Act of 2002 and unjust enrichment. Plaintiffs seek compensatory damages, punitive damages, attorneys fees, and other fees and costs, as well as injunctive relief related to the adoption by us of certain proposed corporate governance policies and internal controls.

All of these individual actions have been consolidated into the U.S. District Court for the District of Columbia and the court entered an order naming Pirelli Armstrong Tire Corporation Retiree Medical Benefits Trust and Wayne County Employees Retirement System as co-lead plaintiffs. A consolidated complaint was filed on September 26, 2005. The consolidated complaint named the following current and former officers and directors as defendants: Franklin D. Raines, J. Timothy Howard, Thomas P. Gerrity, Frederick V. Malek, Joe K. Pickett, Anne M. Mulcahy, Daniel H. Mudd, Kenneth M. Duberstein, Stephen B. Ashley, Ann McLaughlin Korologos, Donald B. Marron, Leslie Rahl, H. Patrick Swygert and John K. Wulff.

When document production commenced in *In re Fannie Mae Securities Litigation*, we agreed to simultaneously provide our document production from that action to the plaintiffs in the shareholder derivative action.

All of the defendants filed motions to dismiss the action on December 14, 2005. These motions were fully briefed but not ruled upon. In the interim, the plaintiffs filed an amended complaint on September 1, 2006, thus mooting the previously filed motions to dismiss. Among other things, the amended complaint added Goldman Sachs Group Inc., Goldman, Sachs & Co., Inc., Lehman Brothers Inc. and Radian Insurance Inc. as defendants, added allegations concerning the nature of certain transactions between these entities and Fannie Mae, added additional allegations from OFHEO s May 2006 report on its special examination and the Paul Weiss report, and added other additional details. The plaintiffs have since voluntarily dismissed those newly added third-party defendants. We filed motions to dismiss the first amended complaint on October 20, 2006, which motions are still pending.

ERISA Action

In re Fannie Mae ERISA Litigation (formerly David Gwyer v. Fannie Mae)

Three ERISA-based cases have been filed against us, our Board of Directors Compensation Committee, and against the following former and current officers and directors: Franklin D. Raines, J. Timothy Howard, Daniel H. Mudd, Vincent A. Mai, Stephen Friedman, Anne M. Mulcahy, Ann McLaughlin Korologos, Joe K. Pickett, Donald B. Marron, Kathy Gallo and Leanne Spencer.

On October 15, 2004, David Gwyer filed a class action complaint in the U.S. District Court for the District of Columbia. Two additional class action complaints were filed by other plaintiffs on May 6, 2005 and May 10, 2005. All of these cases were consolidated on May 24, 2005 in the U.S. District Court for the District of Columbia. A consolidated complaint was filed on June 15, 2005. The plaintiffs in the consolidated ERISA-based lawsuit purport to represent a class of participants in our ESOP between January 1, 2001 and the present. Their claims are based on alleged breaches of fiduciary duty relating to accounting matters discussed in our SEC filings and in OFHEO s interim report. Plaintiffs seek unspecified damages, attorneys fees, and other fees and costs, and other injunctive and equitable relief. We filed a motion to dismiss the consolidated complaint on June 29, 2005. Our motion and all of the other defendants motions to dismiss were fully briefed and argued on January 13, 2006. As of the date of this filing, these motions are still pending. When document production commenced in *In re Fannie Mae Securities Litigation*, we agreed to simultaneously provide our document production from that action to the plaintiffs in the ERISA actions.

We believe we have defenses to the claims in these lawsuits and intend to defend these lawsuits vigorously.

Department of Labor ESOP Investigation

In November 2003, the Department of Labor commenced a review of our ESOP and Retirement Savings Plan. The Department of Labor has concluded its investigation of our Retirement Savings Plan, but continues to review the ESOP. We continue to cooperate fully in this investigation.

RESTATEMENT-RELATED INVESTIGATIONS BY U.S. ATTORNEY S OFFICE, OFHEO AND THE SEC

U.S. Attorney s Office Investigation

In October 2004, we were told by the U.S. Attorney s Office for the District of Columbia that it was conducting an investigation of our accounting policies and practices. In August 2006, we were advised by the U.S. Attorney s Office for the District of Columbia that it was discontinuing its investigation of us and does not plan to file charges against us.

OFHEO and SEC Settlements

On May 23, 2006, we entered into comprehensive settlements with OFHEO and the SEC that resolved open matters related to their recent investigations of us.

OFHEO Special Examination and Settlement

In July 2003, OFHEO notified us that it intended to conduct a special examination of our accounting policies and internal controls, as well as other areas of inquiry. OFHEO began its special examination in November 2003 and delivered an interim report of its findings in September 2004. On May 23, 2006, OFHEO released its final report on its special examination. OFHEO s final report concluded that, during the period covered by the report (1998 to mid-2004), a large number of our accounting policies and practices did not comply with GAAP and we had serious problems in our internal controls, financial reporting and corporate governance. The final OFHEO report is available on our Web site (www.fanniemae.com) and on OFHEO s Web site (www.ofheo.gov).

Concurrently with OFHEO s release of its final report, we entered into comprehensive settlements that resolved open matters with OFHEO, as well as with the SEC (described below). As part of the OFHEO settlement, we agreed to OFHEO s issuance of a consent order. In entering into this settlement, we neither admitted nor denied any wrongdoing or any asserted or implied finding or other basis for the consent order. Under this consent order, in addition to the civil penalty described below, we agreed to undertake specified remedial actions to address the recommendations contained in OFHEO s final report, including actions relating to our corporate governance, Board of Directors, capital plans, internal controls, accounting practices, public disclosures, regulatory reporting, personnel and compensation practices. We also agreed not to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO for December 31, 2005 ($727.75 billion), except in limited circumstances at OFHEO s discretion. The consent order superseded and terminated both our September 27, 2004 agreement with OFHEO and the March 7, 2005 supplement to that agreement, and resolved all matters addressed by OFHEO s interim and final reports of its special examination. As part of the OFHEO settlement, we also agreed to pay a $400 million civil penalty, with $50 million payable to the U.S. Treasury and $350 million payable to the SEC for distribution to certain shareholders pursuant to the Fair Funds for Investors provision of the Sarbanes-Oxley Act of 2002. We have paid this civil penalty in full. This $400 million civil penalty, which has been recorded as an expense in our 2004 consolidated financial statements, is not deductible for tax purposes.

SEC Investigation and Settlement

Following the issuance of the September 2004 interim OFHEO report, the SEC informed us that it was investigating our accounting practices.

Concurrently, at our request, the SEC reviewed our accounting practices with respect to hedge accounting and the amortization of premiums and discounts, which OFHEO s interim report had concluded did not comply with GAAP. On December 15, 2004, the SEC s Office of the Chief Accountant announced that it had advised us to (1) restate our financial statements filed with the SEC to eliminate the use of hedge accounting, and (2) evaluate our accounting for the amortization of premiums and discounts, and restate our financial statements filed with the SEC if the amounts required for correction were material. The SEC s Office of the Chief Accountant also advised us to reevaluate the GAAP and non-GAAP information that we previously provided to investors.

On May 23, 2006, without admitting or denying the SEC s allegations, we consented to the entry of a final judgment requiring us to pay the civil penalty described above and permanently restraining and enjoining us from future violations of the anti-fraud, books and records, internal controls and reporting provisions of the federal securities laws. The settlement, which included the $400 million civil penalty described above, resolved all claims asserted against us in the SEC s civil proceeding. Our consent to the final judgment was filed as an exhibit to the Form 8-K that we filed with the SEC on May 30, 2006. The final judgment was entered by the U.S. District Court of the District of Columbia on August 9, 2006.

OTHER LEGAL PROCEEDINGS

Former CEO Arbitration

On September 19, 2005, Franklin D. Raines, our former Chairman and Chief Executive Officer, initiated arbitration proceedings against Fannie Mae before the American Arbitration Association. On April 10, 2006, the parties convened an evidentiary hearing before the arbitrator. The principal issue before the arbitrator was whether we were permitted to waive a requirement contained in Mr. Raines employment agreement that he provide six months notice prior to retiring. On April 24, 2006, the arbitrator issued a decision finding that we could not unilaterally waive the notice period, and that the effective date of Mr. Raines retirement was June 22, 2005, rather than December 21, 2004 (his final day of active employment). Under the arbitrator s decision, Mr. Raines election to receive an accelerated, lump-sum payment of a portion of his deferred compensation must now be honored. Moreover, we must pay Mr. Raines any salary and other compensation to which he would have been entitled had he remained employed through June 22, 2005, less any pension benefits that Mr. Raines received during that period. On November 7, 2006, the parties entered into a consent award, which partially resolved the issue of amounts due Mr. Raines. In accordance with the consent award, we paid Mr. Raines $2.6 million on November 17, 2006. By agreement, final resolution of the unresolved issues was deferred until after our accounting restatement results were announced. Each party had the right, within sixty days of the announcement of our accounting restatement results, to notify the arbitrator whether it believes that further proceedings are necessary. The parties have filed a request for an extension with the arbitrator.

Antitrust Lawsuits

In re G-Fees Antitrust Litigation

Since January 18, 2005, we have been served with 11 proposed class action complaints filed by single-family borrowers that allege that we and Freddie Mac violated the Clayton and Sherman Acts and state antitrust and consumer protection statutes by agreeing to artificially fix, raise, maintain or stabilize the price of our and Freddie Mac s guaranty fees. Two of these cases were filed in state courts. The remaining cases were filed in federal court. The two state court actions were voluntarily dismissed. The federal court actions were consolidated in the U.S. District Court for the District of Columbia. Plaintiffs filed a consolidated amended complaint on August 5, 2005. Plaintiffs in the consolidated action seek to represent a class of consumers whose loans allegedly contain a guarantee fee set by us or Freddie Mac between January 1, 2001 and the present. The consolidated amended complaint alleges violations of federal and state antitrust laws and state consumer protection and other laws. Plaintiffs seek unspecified damages, treble damages, punitive damages, and declaratory and injunctive relief, as well as attorneys fees and costs.

We and Freddie Mac filed a motion to dismiss on October 11, 2005. The motion to dismiss has been fully briefed and remains pending.

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We believe we have defenses to the claims in these lawsuits and intend to defend these lawsuits vigorously.

Escrow Litigation

Casa Orlando Apartments, Ltd., et al. v. Federal National Mortgage Association (formerly known as Medlock Southwest Management Corp., et al. v. Federal National Mortgage Association)

We are the subject of a lawsuit in which plaintiffs purport to represent a class of multifamily borrowers whose mortgages are insured under Sections 221(d)(3), 236 and other sections of the National Housing Act and are held or serviced by us. The complaint identified as a class low- and moderate-income apartment building developers who maintained uninvested escrow accounts with us or our servicer. Plaintiffs Casa Orlando Apartments, Ltd., Jasper Housing Development Company and the Porkolab Family Trust No. 1 allege that we violated fiduciary obligations that they contend we owe to borrowers with respect to certain escrow accounts and that we were unjustly enriched. In particular, plaintiffs contend that, starting in 1969, we misused these escrow funds and are therefore liable for any economic benefit we received from the use of these funds. Plaintiffs seek a return of any profits, with accrued interest, earned by us related to the escrow accounts at issue, as well as attorneys fees and costs.

The complaint was filed in the U.S. District Court for the Eastern District of Texas (Texarkana Division) on June 2, 2004 and served on us on June 16, 2004. Our motion to dismiss and motion for summary judgment were denied on March 10, 2005. We filed a partial motion for reconsideration of our motion for summary judgment, which was denied on February 24, 2006.

Plaintiffs have filed an amended complaint and a motion for class certification. A hearing on plaintiffs motion for class certification was held on July 19, 2006, and the motion remains pending.

We believe we have defenses to the claims in this lawsuit and intend to defend this lawsuit vigorously.

KPMG Litigation

On December 12, 2006, we filed suit against KPMG LLP, our former outside auditor, in the Superior Court of the District of Columbia. The complaint alleges state law negligence and breach of contract claims related to certain audit and other services provided by KPMG. We are seeking compensatory damages in excess of $2 billion to recover costs related to our restatement and other damages. On December 12, 2006, KPMG removed the case to the U.S. District Court for the District of Columbia. KPMG filed a motion to dismiss on February 16, 2007. Both motions are still pending.

See Restatement Related Matters Securities Class Action Lawsuits In re Fannie Mae Securities Litigation, for a discussion of KPMG s cross claims against us.

Item 4. ***Submission of Matters to a Vote of Security Holders***

None.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is publicly traded on the New York and Chicago stock exchanges and is identified by the ticker symbol FNM. The transfer agent and registrar for our common stock is Computershare, P.O. Box 43081, Providence, Rhode Island 02940.

Common Stock Data

The following table shows, for the periods indicated, the high and low sales prices per share of our common stock in the consolidated transaction reporting system as reported in the Bloomberg Financial Markets service, as well as the dividends per share declared in each period.

Quarter	High	Low	Dividend
2004			
First Quarter	$ 80.82	$ 70.75	$ 0.52
Second Quarter	75.47	65.89	0.52
Third Quarter	77.80	63.05	0.52
Fourth Quarter	73.81	62.95	0.52
2005			
First Quarter	$ 71.70	$ 53.72	$ 0.26
Second Quarter	61.66	49.75	0.26
Third Quarter	60.21	41.34	0.26
Fourth Quarter	50.80	41.41	0.26
2006			
First Quarter	$ 58.60	$ 48.41	$ 0.26
Second Quarter	54.53	46.17	0.26
Third Quarter	56.31	46.30	0.26
Fourth Quarter	62.37	54.40	0.40
2007			
First Quarter	$ 60.44	$ 51.88	$ 0.40

Holders

As of April 2, 2007, we had approximately 19,000 registered holders of record of our common stock.

Dividends

The table set forth under Common Stock Data above presents the dividends we declared on our common stock from the first quarter of 2004 through and including the first quarter of 2007.

In January 2005, our Board of Directors reduced our quarterly common stock dividend rate by 50%, from $0.52 per share to $0.26 per share. We reduced our common stock dividend rate in order to increase our capital surplus, which was a component of our capital restoration plan. See Item 7 MD&A Liquidity and Capital Management Capital Management Capital Adequacy Requirements Capital Restoration Plan and OFHEO-Directed Minimum Capital Requirement for a description of our capital restoration plan. In December 2006, the Board of Directors increased the common stock dividend to $0.40 per share beginning in the fourth quarter of 2006. On May 1, 2007, the Board of Directors again increased the common stock dividend to $0.50 per share. The Board determined that this most recent increased dividend would be effective beginning in the second quarter of 2007, and therefore declared a special common stock dividend of $0.10 per share, payable on May 25, 2007, to stockholders of record on May 18, 2007. This special dividend of $0.10, combined with our previously declared quarterly dividend of $0.40, will result in a total common stock

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dividend of $0.50 per share for the second quarter of 2007. Our Board of Directors will continue to assess dividend payments for each quarter based upon the facts and conditions existing at the time.

Our payment of dividends is subject to certain restrictions, including the submission of prior notification to OFHEO detailing the rationale and process for the proposed dividend and prior approval by the Director of OFHEO of any dividend payment that would cause our capital to fall below specified capital levels. See Item 7 MD&A Liquidity and Capital Management Capital Management Capital Activity OFHEO Oversight of Our Capital Activity for a description of these restrictions. Payment of dividends on our common stock is also subject to the prior payment of dividends on our 11 series of preferred stock, representing an aggregate of 110,175,000 shares outstanding as of April 2, 2007. Quarterly dividends declared on the shares of our preferred stock outstanding totaled $128.4 million for the quarter ended March 31, 2007. See Notes to Consolidated Financial Statements Note 16, Preferred Stock for detailed information on our preferred stock dividends.

Securities Authorized for Issuance under Equity Compensation Plans

The information required by Item 201(d) of Regulation S-K is provided under Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters, which is incorporated herein by reference.

Recent Sales of Unregistered Securities

Information about sales and issuances of our unregistered securities during 2005 and 2006 was provided in Forms 8-K we filed on May 9, 2006, August 9, 2006, November 8, 2006 and February 27, 2007, and in our Annual Report on Form 10-K for the year ended December 31, 2004 filed on December 6, 2006.

The securities we issue are exempted securities under the Securities Act and the Exchange Act to the same extent as obligations of, or guaranteed as to principal and interest by, the United States. As a result, we do not file registration statements with the SEC with respect to offerings of our securities.

Purchases of Equity Securities by the Issuer

The following table shows shares of our common stock we repurchased from January 2005 through December 2006.

	Total Number of Shares Purchased(1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program(2)	Maximum Number of Shares that May Yet be Purchased Under the Program(3)(4)
	(Shares in thousands)			
2005				
January	107	$ 65.60		63,503
February	21	57.86		63,234
March	3	57.17		63,957
April	3	55.02		63,723
May	11	57.24		63,510
June	9	58.79		63,359
July	5	58.86		63,070
August	4	52.44		62,951
September	15	46.70		62,755
October	37	45.42		62,525
November	259	47.35		62,123
December	18	47.67		61,364
Total	492	$ 52.29		61,364
2006				
January	196	$ 53.23		60,596
February	58	58.10		60,112
March	61	54.04		60,269
April	10	52.60		61,267
May	13	50.38	4	61,160
June	13	48.11	4	61,046
July	11	48.55		60,983
August	52	49.29	23	60,900
September	19	53.91	7	60,669
October	210	58.32		60,526
November	231	59.92		60,047
December	26	60.07	9	59,517
Total	900	$ 56.32	47	59,517

(1) In addition to shares repurchased as part of the publicly announced programs described in footnote 2 below, these shares consist of: (a) 513,301 shares of common stock reacquired from employees to pay an aggregate of approximately $29 million in withholding taxes due upon the vesting of restricted stock; (b) 141,239 shares of common stock reacquired from employees to pay an aggregate of approximately $7.5 million in withholding taxes due upon the exercise of stock options; (c) 671,449 shares of common stock repurchased from employees and members of our Board of Directors to pay an aggregate exercise price of approximately $36 million for stock options; and (d) 18,794 shares of common stock repurchased from employees in a limited number of instances relating to employees financial hardship.

(2) Consists of 47,440 shares of common stock repurchased from employees pursuant to our publicly announced employee stock repurchase program. On May 9, 2006, we announced that the Board of Directors had authorized a stock repurchase program (the Employee Stock Repurchase Program) under which we may repurchase up to $100 million of Fannie Mae shares from non-officer employees. On January 21, 2003, we publicly announced that the Board of Directors had approved a share repurchase program (the General Repurchase Authority) under which we could purchase in open market transactions the sum of (a) up to 5% of the shares of common stock outstanding as of December 31,

2002 (49.4 million shares) and (b) additional shares to offset stock issued or expected to be issued under our employee benefit plans. Neither the General Repurchase Authority nor the Employee Stock Repurchase Program has a specified expiration date.

(3) Consists of the total number of shares that may yet be purchased under the General Repurchase Authority as of the end of the month, including the number of shares that may be repurchased to offset stock that may be issued pursuant to the Stock Compensation Plan of 1993 and the Stock Compensation Plan of 2003. Repurchased shares are first offset against any issuances of stock under our employee benefit plans. To the extent that we repurchase more shares than have been issued under our plans in a given month, the excess number of shares is deducted from the 49.4 million shares approved for repurchase under the General Repurchase Authority. Because of new stock issuances and expected issuances pursuant to new grants under our employee benefit plans, the number of shares that may be purchased under the General Repurchase Authority fluctuates from month to month. No shares were repurchased from August 2004 through December 2006 in the open market pursuant to the General Repurchase Authority. See Notes to Consolidated Financial Statements Note 12, Stock-Based Compensation Plans, for information about shares issued, shares expected to be issued, and shares remaining available for grant under our employee benefit plans. Excludes the remaining number of shares authorized to be repurchased under the Employee Stock Repurchase Program. Assuming a price per share of $59.76, the average of the high and low stock prices of Fannie Mae common stock on December 29, 2006, approximately 1.6 million shares may yet be purchased under the Employee Stock Repurchase Program.

(4) Does not reflect the determination by our Board of Directors in February 2007 not to pay out certain shares expected to be issued under our plans. See Notes to Consolidated Financial Statements Note 12, Stock-Based Compensation Plans for a description of these shares.

Item 6. Selected Financial Data

The selected consolidated financial data presented below is summarized from our results of operations for the four-year period ended December 31, 2005, as well as selected consolidated balance sheet data as of December 31, 2005, 2004, 2003, 2002 and 2001. In light of the substantial time, effort and expense incurred since December 2004 to complete the restatement of our consolidated financial statements for 2003 and 2002, we determined that extensive additional efforts would be required to restate all 2001 financial data. In particular, significant complexities of accounting standards, turnover of relevant personnel, and limitations of systems and data all limit our ability to reconstruct additional financial information for 2001. Information published for 2001 prior to the filing of our 2004 Form 10-K should not be relied upon. The data presented below should be read in conjunction with the consolidated financial statements and related notes and with Item 7 MD&A included in this Annual Report on Form 10-K.

	As of December 31,			
	2005	2004	2003	2002
	(Dollars in millions, except per share amounts)			
Income Statement Data:				
Net interest income	$ 11,505	$ 18,081	$ 19,477	$ 18,426
Guaranty fee income	3,779	3,604	3,281	2,516
Derivative fair value losses, net	(4,196)	(12,256)	(6,289)	(12,919)
Other income (loss)(1)	(725)	(812)	(4,220)	(1,735)
Income before extraordinary gains (losses) and cumulative effect of change in accounting principle	$ 6,294	$ 4,975	$ 7,852	$ 3,914
Extraordinary gains (losses), net of tax effect	53	(8)	195	
Cumulative effect of change in accounting principle, net of tax effect			34	
Net income	6,347	4,967	8,081	3,914
Preferred stock dividends and issuance costs at redemption	(486)	(165)	(150)	(111)
Net income available to common stockholders	$ 5,861	$ 4,802	$ 7,931	$ 3,803
Per Common Share Data:				
Earnings per share before extraordinary gains (losses) and cumulative effect of change in accounting principle				
Basic	$ 5.99	$ 4.96	$ 7.88	$ 3.83
Diluted	5.96	4.94	7.85	3.81
Earnings per share after extraordinary gains (losses) and cumulative effect of change in accounting principle				
Basic	$ 6.04	$ 4.95	$ 8.12	$ 3.83
Diluted	6.01	4.94	8.08	3.81
Weighted-average common shares outstanding:				

Basic	970	970	977	992
Diluted	998	973	981	998
Cash dividends declared per share	$ 1.04	$ 2.08	$ 1.68	$ 1.32
New Business Acquisition Data:				
Fannie Mae MBS issues acquired by third parties[(2)]	$ 465,632	$ 462,542	$ 850,204	$ 478,260
Mortgage portfolio purchases[(3)]	146,640	262,647	572,852	370,641
New business acquisitions	$ 612,272	$ 725,189	$ 1,423,056	$ 848,901

	As of December 31,				
	2005	2004	2003	2002	2001
	(Dollars in millions)				
Balance Sheet Data:					
Investments in securities:					
Trading(4)	$ 15,110	$ 35,287	$ 43,798	$ 14,909	$ (45)
Available-for-sale	390,964	532,095	523,272	520,176	503,381
Mortgage loans:					
Loans held for sale	5,064	11,721	13,596	20,192	11,327
Loans held for investment, net of allowance	362,479	389,651	385,465	304,178	267,510
Total assets	834,168	1,020,934	1,022,275	904,739	814,561
Short-term debt	173,186	320,280	343,662	293,538	280,848
Long-term debt	590,824	632,831	617,618	547,755	484,182
Total liabilities	794,745	981,956	990,002	872,840	791,305
Preferred stock	9,108	9,108	4,108	2,678	2,303
Total stockholders equity	39,302	38,902	32,268	31,899	23,256
Regulatory Capital Data:					
Core capital(5)	$ 39,433	$ 34,514	$ 26,953	$ 20,431	$ 18,234
Total capital(6)	40,091	35,196	27,487	20,831	18,500
Mortgage Credit Book of Business Data:					
Mortgage portfolio(7)	$ 737,889	$ 917,209	$ 908,868	$ 799,779	$ 715,953
Fannie Mae MBS held by third parties(8)	1,598,918	1,408,047	1,300,520	1,040,439	878,039
Other guarantees(9)	19,152	14,825	13,168	12,027	16,421
Mortgage credit book of business	$ 2,355,959	$ 2,340,081	$ 2,222,556	$ 1,852,245	$ 1,610,413

	2005	2004	2003	2002
Ratios:				
Return on assets ratio(10)*	0.63%	0.47%	0.82%	0.44%
Return on equity ratio (11)*	19.5	16.6	27.6	15.2
Equity to assets ratio(12)*	4.2	3.5	3.3	3.2
Dividend payout ratio(13)*	17.2	42.1	20.8	34.5
Average effective guaranty fee rate (in basis points)(14)*	21.0bp	20.8bp	21.0bp	19.3bp
Credit loss ratio (in basis points)(15)*	1.9bp	1.0bp	0.9bp	0.8bp
Earnings to combined fixed charges and preferred stock dividends and issuance costs at redemption ratio(16)	1.23:1	1.22:1	1.36:1	1.16:1

(1) Includes investment losses, net; debt extinguishment losses, net; loss from partnership investments; and fee and other income.

(2) Unpaid principal balance of MBS issued and guaranteed by us and acquired by third-party investors during the reporting period. Excludes securitizations of mortgage loans held in our portfolio.

(3) Unpaid principal balance of mortgage loans and mortgage-related securities we purchased for our investment portfolio. Includes advances to lenders and mortgage-related securities acquired through the extinguishment of debt.

(4) Balance as of December 31, 2001 primarily represents the fair value of forward purchases of TBA mortgage securities that were in a loss position.

(5) The sum of (a) the stated value of outstanding common stock (common stock less treasury stock); (b) the stated value of outstanding non-cumulative perpetual preferred stock; (c) paid-in-capital; and (d) retained earnings. Core capital excludes accumulated other comprehensive income.

(6) The sum of (a) core capital and (b) the total allowance for loan losses and reserve for guaranty losses, less (c) the specific loss allowance (that is, the allowance required on individually-impaired loans).

(7) Unpaid principal balance of mortgage loans and mortgage-related securities held in our portfolio.

(8) Unpaid principal balance of Fannie Mae MBS held by third-party investors. The principal balance of resecuritized Fannie Mae MBS is included only once.

(9) Includes additional credit enhancements that we provide not otherwise reflected in the table.

(10) Net income available to common stockholders divided by average total assets.

(11) Net income available to common stockholders divided by average outstanding common equity.

(12) Average stockholders equity divided by average total assets.

(13) Common dividend payments divided by net income available to common stockholders.

(14) Guaranty fee income as a percentage of average outstanding Fannie Mae MBS and other guaranties.

(15) Charge-offs, net of recoveries and foreclosed property expense (income), as a percentage of the average mortgage credit book of business.

(16) Earnings includes reported income before extraordinary gains (losses), net of tax effect and cumulative effect of change in accounting principle, net of tax effect plus (a) provision for federal income taxes, minority interest in earnings of consolidated subsidiaries, loss from partnership investments, capitalized interest and total interest expense. Combined fixed charges and preferred stock dividends and issuance costs at redemption includes (a) fixed charges (b) preferred stock dividends and issuance costs on redemptions of preferred stock, defined as pretax earnings required to pay dividends on outstanding preferred stock using our effective income tax rate for the relevant periods. Fixed charges represent total interest expense and capitalized interest.

Note:

* Average balances for purposes of the ratio calculations are based on beginning and end of year balances.

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

ORGANIZATION OF MD&A

We intend for our MD&A to provide information that will assist the reader in better understanding our consolidated financial statements. Our MD&A explains the changes in certain key items in our consolidated financial statements from year to year, the primary factors driving those changes, our risk management processes and results, any known trends or uncertainties of which we are aware that we believe may have a material effect on our future performance, as well as how certain accounting principles affect our consolidated financial statements. Our MD&A also provides information about our three complementary business segments in order to explain how the activities of each segment impact our results of operations and financial condition. This discussion should be read in conjunction with our consolidated financial statements as of December 31, 2005 and the notes accompanying those consolidated financial statements. Readers should also review carefully Item 1 Business Forward-Looking Statements and Item 1A Risk Factors for a description of the forward-looking statements in this report and a discussion of the factors that might cause our actual results to differ, perhaps materially, from these forward-looking statements. Please refer to Item 1 Business Glossary of Terms Used in this Report for an explanation of key terms used throughout this discussion.

Our MD&A is organized as follows:

- Executive Summary
- Critical Accounting Policies and Estimates
- Consolidated Results of Operations
- Business Segment Results
- Supplemental Non-GAAP Information Fair Value Balance Sheet
- Risk Management
- Liquidity and Capital Management
- Off-Balance Sheet Arrangements and Variable Interest Entities
- Impact of Future Adoption of New Accounting Pronouncements
- 2005 Quarterly Review

EXECUTIVE SUMMARY

Our Mission and Business

Fannie Mae is a mission-driven company, owned by private shareholders (NYSE: FNM) and chartered by Congress to support liquidity and stability in the secondary mortgage market. Our business includes three integrated business segments Single-Family Credit Guaranty, Housing and Community Development and Capital Markets that work together to provide services, products and solutions to our lender customers and a broad range of housing partners.

Together, our business segments contribute to our chartered mission objectives, helping to increase the total amount of funds available to finance housing in the United States and to make homeownership more available and affordable for low-, moderate- and middle-income Americans. We also work with our customers and partners to increase the availability and affordability of rental housing.

We view our mission as a key point of distinction and a fundamental element of our value proposition. By growing our earnings over time and providing investors with attractive returns, we grow capital. Growing our capital enables us to grow our business. As our business grows, so can the benefits that we provide to our customers and housing partners, who in turn can pass those benefits to the American homebuyer in the form of lower mortgage costs and product innovation. Our mission and the interests of our shareholders are aligned and complementary in our business model.

Key 2005 Priorities

We entered 2005 facing some of the most significant challenges in our company s history. In September 2004, OFHEO identified serious deficiencies in our accounting, controls and financial reporting in an interim report of its special examination. In December 2004, the SEC determined that we had misapplied generally accepted accounting principles and directed us to restate previously issued financial statements. Accordingly, in addition to our primary business and mission objectives, in 2005 we focused on a number of key corporate priorities to address identified issues and to build a fundamentally stronger and sounder company going forward. These priorities included the following:

Restoring capital: Rebuilding our capital position, and achieving the 30% surplus over required minimum capital levels in accordance with our agreement with OFHEO, was our most immediate and important corporate objective in 2005. OFHEO determined that we achieved the 30% surplus requirement at September 30, 2005. Since that time, we have increased our capital position, and we were able to begin the process of returning capital to shareholders by increasing our dividend in the fourth quarter of 2006 and again in the second quarter of 2007, and by redeeming expensive series of preferred shares.

Progress on the restatement of our financials: We devoted substantial resources in 2005 and 2006 toward our restatement effort. On December 6, 2006, we filed our 2004 Form 10-K, including restated results for previous periods. We previously announced that we expect to file our 2006 Form 10-K by the end of 2007. We are assessing how the timing of the filing of this 2005 Form 10-K will impact the timing of our 2006 Form 10-K. Becoming a current filer remains a primary corporate priority.

Rebuilding relationships: We have focused on reshaping the culture of Fannie Mae to fully reflect the levels of service, engagement, accountability and effective management that we believe should characterize a company privileged to serve such an important role in a large and vital market. This continues to be a priority of the company.

We maintained our business focus as we addressed and devoted resources to issues outside our normal business operations. We believe that our business results, described below, indicate that we were successful in running our businesses effectively and addressing the key corporate priorities described above.

Market and Economic Factors Affecting Our Business

Our business is significantly affected by the dynamics of the U.S. residential mortgage market, including the total amount of residential mortgage debt outstanding, the volume and composition of mortgage originations and the level of competition for mortgage assets generally among investors.

The Federal Open Market Committee of the Federal Reserve increased the federal funds target rate by 25 basis points at each of its eight meetings in 2005, for a cumulative gain of 200 basis points. The target rate ended the year at 4.25%, its highest level since April 2001. However, the impact on long-term rates was muted, with the ten-year constant maturity Treasury yield closing the year approximately only ten basis points higher than at the start of the year. Mortgage rates in 2005 generally tracked these dynamics. The average rate on short-term Treasury-indexed adjustable-rate mortgages rose significantly over the course of the year, while the yearly average rate for 30-year fixed-rate mortgages increased by considerably less. Relative movements in short- and long-term mortgage rates resulted in a sharp narrowing of the spread between fixed-rate mortgages and ARMs during the course of the year.

For the years 2004 and 2005, home price appreciation and growth in U.S. residential mortgage debt outstanding were particularly strong, as detailed in Item 1 Business Residential Mortgage Market Overview.

Affordability issues were the primary catalyst for a dramatic shift in the composition of mortgage originations between 2003 and 2006. Based on data from LoanPerformance, we estimate that during this period, with regard to prime conventional conforming originations, the ARM share rose from 11% to 23%, the negative-amortizing share rose from 1% to 5%, and the low documentation share rose from 15% to 27%. In

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addition, subprime, Alt-A and investor borrowing grew significantly with the majority of these borrowers selecting ARMs.

In 2006, growth in U.S. residential mortgage debt outstanding and home price appreciation slowed from recent high levels, especially in the second half of the year. However, the volume of non-traditional mortgage products remained high as consumers continued to struggle with affordability issues and the investor share of home purchases remained above historical norms. Additionally, the subprime and Alt-A mortgage originations continued to represent an elevated level of originations by historical standards.

Over the next decade, we expect demographic demand (primarily from stable household formation rates, a positive age structure of the population for homebuying and rising homeownership rates due to the high level of immigration over the past 25 years) to be at a level that should maintain a fundamentally strong mortgage market. We believe that these and other underlying demographic factors will support continued long-term demand for new capital to finance the substantial and sustained housing finance needs of American homebuyers.

In the secondary mortgage market, competition for mortgage assets among a broad range of investors was intense in 2005, resulting in extremely narrow spreads between the cost of our funding and the yields we would expect to generate on many mortgage assets available for purchase. The intensity of competition for mortgage assets remained heightened in 2006 and the first quarter of 2007. Additionally, in our estimation, compensation for credit risk in the marketplace, particularly for higher risk mortgage assets, did not reflect adequate returns in 2005, and remained so through 2006. This dynamic was at least partly attributable to high levels of investment capital among a broad range of global investors seeking higher yields. We believe many investors sought out higher-yielding and higher-risk tranches of mortgage-related securities under the assumption that continued home price appreciation would provide insulation from credit losses.

Summary of Our Financial Results

Net income and diluted earnings per share totaled $6.3 billion and $6.01, respectively, in 2005, compared with $5.0 billion and $4.94 in 2004, and $8.1 billion and $8.08 in 2003.

Total stockholders equity increased to $39.3 billion as of December 31, 2005 from $38.9 billion as of December 31, 2004 and $32.3 billion as of December 31, 2003. The estimated fair value of our net assets (net of tax effect), a non-GAAP measure that we refer to as the fair value of our net assets, increased to $42.2 billion as of December 31, 2005 from $40.1 billion and $28.4 billion as of year-end 2004 and 2003, respectively. Refer to Supplemental Non-GAAP Information Fair Value Balance Sheet for information on the fair value of our net assets.

Below are additional comparative highlights of our performance.

2005 versus 2004

New business acquisitions down 16% from 2004
1% growth in our mortgage credit book of business
36% decrease in net interest income to $11.5 billion
55 basis points decrease in net interest yield to 1.31%
5% increase in guaranty fee income to $3.8 billion
Derivative fair value losses of $4.2 billion, compared with derivative fair value losses of $12.3 billion in 2004

2004 versus 2003

New business acquisitions down 49% from record level of $1.4 trillion in 2003
5% growth in our mortgage credit book of business
7% decrease in net interest income to $18.1 billion
26 basis points decrease in net interest yield to 1.86%
10% increase in guaranty fee income to $3.6 billion
Derivative fair value losses of $12.3 billion, compared

Losses of $68 million on debt extinguishments, compared with losses of $152 million in 2004

with derivative fair value losses of $6.3 billion in 2003

Losses of $152 million on debt extinguishments, compared with losses of $2.7 billion in 2003

A detailed discussion of our results and key drivers of year-over-year changes can be found in Consolidated Results of Operations.

We expect our net income to decline in 2006, primarily due to further reductions in our net interest income and net interest yield in 2006 as a result of the decrease in our interest-earning assets and the decline in the spread between the average yield on these assets and our borrowing costs that we began experiencing at the end of 2004. Our administrative expenses also significantly increased in 2006, to an estimated $3.1 billion, due to costs associated with the restatement process and related regulatory examinations, investigations and litigation defense, the preparation of our consolidated financial statements, control remediation activities and increased headcount to support these efforts. We also expect, however, continued strength in guaranty fee income, moderate increases in our provision for credit losses and somewhat lower derivative fair value losses as interest rates have generally trended up since the end of 2005 and remain at overall higher levels. We do not expect to be able to quantify the financial statement impact of these expected changes to our operating results and financial condition until we complete the preparation of our consolidated financial statements for the year ended December 31, 2006. We meet regularly with OFHEO to discuss our current capital position.

Both GAAP net income and the fair value of net assets are affected by our business activities, as well as changes in market conditions, including changes in the relative spread between our mortgage assets and debt, changes in interest rates and changes in implied interest rate volatility. A detailed discussion of the impact of these market variables on our financial performance can be found in Consolidated Results of Operations and Supplemental Non-GAAP Information-Fair Value Balance Sheet.

Our assets and liabilities consist predominately of financial instruments. We expect significant volatility from period to period in our results of operations and financial condition, due in part to the various ways in which we account for our financial instruments under GAAP. Specifically, under GAAP we measure and record some financial instruments at fair value, while other financial instruments are recorded at historical cost. In addition, as summarized below, changes in the carrying values of financial instruments that we report at fair value in our consolidated balance sheets under GAAP are recognized in our results of operations in a variety of ways depending on the nature of the asset or liability.

We record derivatives, mortgage commitments and trading securities at fair value in our consolidated balance sheets and recognize changes in the fair value of those financial instruments in net income.

We record available-for-sale (AFS) securities, retained interests and guaranty fee buy-ups at fair value in our consolidated balance sheets and recognize changes in the fair value of those financial instruments in accumulated other comprehensive income (AOCI), a component of stockholders equity.

We record held-for-sale (HFS) mortgage loans at the lower of cost or market (LOCOM) in our consolidated balance sheets and recognize changes in the fair value (not to exceed the cost basis of these loans) in net income.

At the inception of a guaranty contract, we estimate the fair value of the guaranty asset and guaranty obligation and record each of those amounts in our consolidated balance sheet. In each subsequent period, we reduce the guaranty asset for guaranty fees received and any impairment. We amortize the guaranty obligation in proportion to the reduction of the guaranty asset and recognize the amortization as guaranty fee income in net income. We do not record subsequent changes in the fair value of the guaranty asset or guaranty obligation in our consolidated financial statements; however, we review guaranty assets for impairment.

We record debt instruments at amortized cost and recognize interest expense in net interest income.

As a result of the variety of ways in which we record financial instruments in our consolidated financial statements, we expect our earnings to vary, perhaps substantially, from period to period and also result in volatility in our stockholders equity and regulatory capital. One of the major drivers of volatility in our financial performance measures, including GAAP net income, is the accounting treatment for derivatives used to manage interest rate risk in our mortgage portfolio. When we purchase mortgage assets, we use a combination of debt and derivatives to fund those assets and manage the interest rate risk inherent in our mortgage investments. Our net income reflects changes in the fair value of the derivatives we use to manage interest rate risk; however, it does not reflect offsetting changes in the fair value of the majority of our mortgage investments or in any of our debt obligations.

We do not evaluate or manage changes in the fair value of our various financial instruments on a stand-alone basis. Rather, we manage the interest rate exposure on our net assets, which includes all of our assets and liabilities, on an aggregate basis regardless of the manner in which changes in the fair value of different types of financial instruments are recorded in our consolidated financial statements. In Supplemental Non-GAAP Information Fair Value Balance Sheet, we provide a fair value balance sheet that presents all of our assets and liabilities on a comparable basis. Management uses the fair value balance sheet, in conjunction with other risk management measures, to assess our risk profile, evaluate the effectiveness of our risk management strategies and adjust our risk management decisions as necessary. Because the fair value of our net assets reflects the full impact of management s actions as well as current market conditions, management uses this information to assess performance and gauge how much management is adding to the long-term value of the company.

Single-Family Credit Guaranty Results

Our Single-Family Credit Guaranty business generated net income of $2.9 billion, $2.5 billion and $2.5 billion in 2005, 2004 and 2003, respectively.

Our total issuance of single-family Fannie Mae MBS declined to $500.7 billion in 2005 compared with $545.4 billion in 2004. Guaranty fee income rose modestly to $4.6 billion in 2005 from $4.5 billion in 2004, as our average single-family mortgage credit book of business increased by 3% during 2005 and the average effective guaranty fees remained stable.

In 2005, we concluded that compensation for credit risk associated with many newly originated loans did not adequately reflect underlying, and often multi-layered, credit risks. Based on this assessment, we made a strategic decision not to pursue the guaranty of a significant subset of mortgage loans because they did not meet our risk and pricing criteria. As a result of this decision, we ceded market share of new single-family mortgage-related securities issuance to private-label issuers. Acquisitions that we did make in 2005 included a heightened proportion of adjustable-rate mortgage loans (ARMs), which peaked in April 2005 at nearly 35% of single-family mortgage applications.

While our market share declined in 2005 relative to private-label issuers, we remained the largest agency issuer of mortgage-related securities. This contributed to our leadership position in the overall market for outstanding mortgage-related securities, which benefited the liquidity and pricing of our MBS relative to securities issued by other market participants.

We believe that our approach to the management of credit risk in 2005 contributed to the maintenance of a credit book with strong credit characteristics, as measured by loan-to-value ratios, credit scores and other loan characteristics that reflect the effectiveness of our credit risk management strategy. A detailed discussion of our credit risk management strategies and results can be found in Risk Management Credit Risk Management.

A detailed discussion of the operations, results and factors impacting our Single-Family business can be found in Business Segment Results Single-Family Credit Guaranty Business.

HCD Results

Our HCD business generated net income of $462 million, $337 million and $286 million in 2005, 2004 and 2003, respectively.

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Our HCD business segment participated in financing $25.6 billion in multifamily rental housing in 2005, which included debt financing through lender partners and investments in low-income housing tax credits (LIHTC). This level of activity was supported by improved multifamily fundamentals, including a decline in overall apartment vacancies and increased rental rates. At the end of 2005, we estimate that we held or guaranteed approximately 18% of multifamily mortgage debt outstanding.

Our tax-advantaged investments, primarily LIHTC, continued to contribute significantly to net income by lowering our effective corporate tax rate. LIHTC investments totaled $7.7 billion in 2005 compared with $6.8 billion in 2004. The tax benefits associated with our LIHTC investments were the primary reasons for our 2005 effective corporate tax-rate being 17% versus the federal statutory rate of 35%.

A detailed discussion of the operations, results and factors impacting our HCD business can be found in Business Segment Results HCD Business.

Capital Markets Results

Our Capital Markets group generated net income of $3.0 billion, $2.1 billion and $5.3 billion in 2005, 2004 and 2003, respectively.

Our Capital Markets group generates income primarily from the difference, or spread, between the yield on the mortgage assets we own and the cost of the debt we issue to fund these assets. Through our investment activities, we seek to maximize long-term total returns, subject to various constraints, while fulfilling our chartered liquidity function. In 2005, the portfolio activities of our Capital Markets group were also conducted within the context of our capital restoration plan, which was finalized with OFHEO in February 2005. The size of our net mortgage portfolio decreased by 20% in 2005 due to a significant increase in portfolio sales, normal liquidations and fewer portfolio purchases. The reduction of our mortgage portfolio helped enable the achievement of the 30% surplus requirement described above.

Because the vast majority of our assets had been reclassified as available-for-sale, we were able to capitalize on the intensity of competition for certain mortgage assets, selling highly valued assets on attractive economic terms. These sales contributed to our objectives of satisfying our capital requirement while supporting our primary liquidity function and, subject to various constraints, maximizing long-term total returns in our Capital Markets group.

The effective management of interest rate risk is fundamental to the overall management of our Capital Markets group. We accept a small amount of interest rate risk that is incidental to our investment activities, but we do not seek to generate significant returns from taking interest rate risk. We believe one measure of the general effectiveness of our interest rate risk management is reflected in our average monthly duration gap, which has not exceeded plus or minus one month in any month since October 2004.

A detailed discussion of the operations, results and factors impacting our Capital Markets group can be found in Business Segment Results Capital Markets Group.

Risk Management

Effectively managing risks credit risk, market risk, operational risk and liquidity risk is a principal focus of our organization, is a key determinant of our success in achieving our mission and business objectives, and is critical to our safety and soundness. Our corporate risk oversight function is led by a Chief Risk Officer who reports directly to our Chief Executive Officer and independently to the Risk Policy and Capital Committee of the Board of Directors.

Our businesses have responsibility for managing the day-to-day risks inherent in our business activities, principally credit risk in our Single-Family and HCD businesses and interest rate risk in our Capital Markets group. A detailed discussion of our risk management strategies, processes and measures is included in Risk Management.

Current Corporate Priorities

We have adopted and are aggressively pursuing the following key corporate objectives in 2007, which we believe will contribute to the achievement of our mission and business objectives:

Grow Revenue: Fannie Mae s Chief Business Officer is leading a company-wide effort to explore additional opportunities to serve mortgage lenders, housing agencies and organizations, investors, shareholders, the housing finance market and the company s affordable housing mission.

Reduce Cost: Management is committed to keeping costs aligned with revenues, and to that end, has undertaken a company-wide effort to reduce its projected 2007 budget by $200 million. For the longer-term, management intends to reduce the overall cost basis of the company through focused efforts to streamline operations and increase productivity.

Exceed Mission: In 2005, we fell short on one of our affordable housing subgoals. We have reported to HUD that we believe we achieved all of our housing goals for 2006, and await their final determination. Our objective is to exceed our housing goals, even as they continue to become more challenging. We intend to provide and expand, as far as possible, liquidity to the overall mortgage market.

Clean Up : This key objective refers to our commitment to complete and file our 2005, 2006 and 2007 financial statements and complete remediation of the company s operational and control weaknesses. Becoming a current and SOX-compliant filer is a top priority.

Operate in Real Time : We have set a longer-term goal of reengineering the company s business operations to make the enterprise more streamlined, efficient, productive and responsive to the market, lender customers and partners, and regulators. We have selected the Lean Six Sigma approach to improving our business operations. Early pilots of this approach have been encouraging, and we will focus on improving the operational platform across our entire organization.

Accelerate Culture Change: The need to strengthen our corporate culture remains a top corporate priority. Fannie Mae s culture change efforts are designed to foster professionalism, competitiveness, and humility through the attributes of service, engagement, accountability, and effective management.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in accordance with GAAP requires management to make a number of judgments, estimates and assumptions that affect the reported amount of assets, liabilities, income and expenses in the consolidated financial statements. Understanding our accounting policies and the extent to which we use management judgment and estimates in applying these policies is integral to understanding our financial statements. We describe our most significant accounting policies in Notes to Consolidated Financial Statements Note 1, Summary of Significant Accounting Policies.

We have identified four of our accounting policies that require significant estimates and judgments and have a significant impact on our financial condition and results of operations. These policies are considered critical because the estimated amounts are likely to fluctuate from period to period due to the significant judgments and assumptions about highly complex and inherently uncertain matters and because the use of different assumptions related to these estimates could have a material impact on our financial condition or results of operations. These four accounting policies are: (i) the fair value of financial instruments; (ii) the amortization of cost basis adjustments using the effective interest method; (iii) the allowance for loan losses and reserve for guaranty losses; and (iv) the assessment of variable interest entities. We evaluate our critical accounting estimates and judgments required by our policies on an ongoing basis and update them as necessary based on changing conditions. Management has discussed each of these significant accounting policies, the related estimates and its judgments with the Audit Committee of the Board of Directors.

Fair Value of Financial Instruments

The use of fair value to measure our financial instruments is fundamental to our financial statements and is our most critical accounting policy because a substantial portion of our assets and liabilities are recorded at estimated fair value. In certain circumstances, our valuation techniques may involve a high degree of management judgment. The principal assets and liabilities that we record at fair value, and the manner in which changes in fair value affect our earnings and stockholders equity, are summarized below.

Derivatives initiated for risk management purposes and mortgage commitments: Recorded in the consolidated balance sheets at fair value with changes in fair value recognized in earnings;

Guaranty assets and guaranty obligations: Recorded in the consolidated balance sheets at fair value at inception of the guaranty obligation. The guaranty obligation affects earnings over time through amortization into income as we collect guaranty fees and reduce the related guaranty asset receivable;

Investments in AFS or trading securities: Recorded in the consolidated balance sheets at fair value. Unrealized gains and losses on trading securities are recognized in earnings. Unrealized gains and losses on AFS securities are deferred and recorded in stockholders equity as a component of AOCI;

HFS loans: Recorded in the consolidated balance sheets at the lower of cost or market with changes in the fair value (not to exceed the cost basis of these loans) recognized in earnings; and

Retained interests in securitizations and guaranty fee buy-ups on Fannie Mae MBS: Recorded in the consolidated balance sheets at fair value with unrealized gains and losses recorded in stockholders equity as a component of AOCI.

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing unrelated parties, other than in a forced or liquidation sale. We determine the fair value of these assets and obligations based on our judgment of appropriate valuation methods and assumptions. The degree of management judgment involved in determining the fair value of a financial instrument depends on the availability and reliability of relevant market data, such as quoted market prices. Financial instruments that are actively traded and have quoted market prices or readily available market data require minimal judgment in determining fair value. When observable market prices and data are not readily available or do not exist, management must make fair value estimates based on assumptions and judgments. In these cases, even minor changes in management s assumptions could result in significant changes in our estimate of fair value. These changes could increase or decrease the value of our assets, liabilities, stockholders equity and net income. We estimate fair values using the following practices:

We use actual, observable market prices or market prices obtained from multiple third parties when available. Pricing information obtained from third parties is internally validated for reasonableness prior to use in the consolidated financial statements.

Where observable market prices are not readily available, we estimate the fair value using market data and model-based interpolations using standard models that are widely accepted within the industry. Market data includes prices of instruments with similar maturities and characteristics, duration, interest rate yield curves, measures of volatility and prepayment rates.

If market data used to estimate fair value as described above is not available, we estimate fair value using internally developed models that employ techniques such as a discounted cash flow approach. These models include market-based assumptions that are also derived from internally developed models for prepayment speeds, default rates and severity.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which establishes a framework for measuring fair value under GAAP. SFAS 157 provides a three-level fair value hierarchy for classifying the source of information used in fair value measures and requires increased disclosures about the sources and measurements of fair value. SFAS 157 is required to be implemented on January 1, 2008. We are currently evaluating whether adoption of this standard will result in any changes to our valuation practices. See Item 7 MD&A Impact of Future Adoption of New Accounting Pronouncements for further discussion of SFAS 157.

Estimating fair value is also a critical part of our impairment evaluation process. When the fair value of an investment declines below the carrying value, we assess whether the impairment is other-than-temporary based on management s judgment. If management concludes that a security is other-than-temporarily impaired, we reduce the carrying value of the security and record a reduction in our net income. Factors that we consider in determining whether a decline in the fair value of an investment is other-than-temporary include the length of time and the extent to which fair value is less than its carrying amount and our intent and ability to hold the investment until its value recovers.

Fair Value of Derivatives

Of the financial instruments that we record at fair value in our consolidated balance sheets, changes in the fair value of our derivatives generally have the most significant impact on the variability of our earnings. The following table summarizes the estimated fair values of derivative assets and liabilities recorded in our consolidated balance sheets as of December 31, 2005 and 2004.

Table 1: Derivative Assets and Liabilities at Estimated Fair Value

	As of December 31,	
	2005	2004
	(Dollars in millions)	
Derivative assets at fair value	$ 5,803	$ 6,589
Derivative liabilities at fair value	(1,429)	(1,145)
Net derivative assets at fair value	$ 4,374	$ 5,444

We present the estimated fair values of our derivatives by the type of derivative instrument in Table 11 of Consolidated Results of Operations Derivatives Fair Value Losses, Net. Our derivatives consist primarily of over-the-counter (OTC) contracts and commitments to purchase and sell mortgage assets. While exchange-traded derivatives can generally be valued using observable market prices or market parameters, OTC derivatives are generally valued using industry-standard models or model-based interpolations that utilize market inputs obtained from widely accepted third-party sources. The valuation models that we use to derive the fair values of our OTC derivatives require inputs such as the contractual terms, market prices, yield curves, and measures of volatility. A substantial majority of our OTC derivatives trade in liquid markets, such as generic forwards, interest rate swaps and options; in those cases, model selection and inputs do not involve significant judgments.

When internal pricing models are used to determine fair value, we use recently executed comparable transactions and other observable market data to validate the results of the model. Consistent with market practice, we have individually negotiated agreements with certain counterparties to exchange collateral based on the level of fair values of the derivative contracts they have executed. Through our derivatives collateral exchange process, one party or both parties to a derivative contract provides the other party with information about the fair value of the derivative contract to calculate the amount of collateral required. This sharing of fair value information provides additional support of the recorded fair value for relevant OTC derivative instruments. For more information regarding our derivative counterparty risk practices, see Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management. In circumstances where we cannot verify the model with market transactions, it is possible that a different valuation model could produce a materially different estimate of fair value. As markets and products develop and the pricing for certain derivative products becomes more transparent, we continue to refine our valuation methodologies. For the year ended December 31, 2005, there were no changes to the quantitative models, or uses of such models, that resulted in a material adjustment to our consolidated statement of income.

See Risk Management for further discussion of the sensitivity of the fair value of our derivative assets and liabilities to changes in interest rates.

Amortization of Cost Basis Adjustments on Mortgage Loans and Mortgage-Related Securities

We amortize cost basis adjustments on mortgage loans and mortgage-related securities recorded in our consolidated balance sheets through earnings using the interest method by applying a constant effective yield. Cost basis adjustments include premiums, discounts and other adjustments to the original value of mortgage loans or mortgage-related securities that are generally incurred at the time of acquisition, which we historically

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referred to as deferred price adjustments. When we buy mortgage loans or mortgage-related securities, we may not pay the seller the exact amount of the unpaid principal balance. If we pay more than the unpaid principal balance, we record a premium that reduces the effective yield below the stated coupon amount. If we pay less than the unpaid principal balance, we record a discount that increases the effective yield above the stated coupon amount.

Pursuant to Statement of Financial Accounting Standards (SFAS) No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (an amendment of FASB Statements No. 13, 60, and 65 and rescission of FASB Statement No. 17)* (SFAS 91), cost basis adjustments are amortized into interest income as an adjustment to the yield of the mortgage loan or mortgage-related security based on the contractual terms of the instrument. SFAS 91, however, permits the anticipation of prepayments of principal to shorten the term of the mortgage loan or mortgage-related security if we (i) hold a large number of similar loans for which prepayments are probable and (ii) the timing and amount of prepayments can be reasonably estimated. We meet both criteria on substantially all of the mortgage loans and mortgage-related securities held in our portfolio. For loans that meet both criteria, we use prepayment estimates to determine periodic amortization of the cost basis adjustments related to these loans. For loans that do not meet the criteria, we do not use prepayment estimates to calculate the rate of amortization. Instead, we assume no prepayment and use the contractual terms of the mortgage loans or mortgage-related securities and factor in actual prepayments that occurred during the relevant period in determining the amortization amount.

For mortgage loans and mortgage-related securities that meet the criteria allowing us to anticipate prepayments, we must make assumptions about borrower prepayment patterns in various interest rate environments that involve a significant degree of judgment. Typically, we use prepayment forecasts from independent third parties in estimating future prepayments. If actual prepayments differ from our estimated prepayments, it could increase or decrease current period interest income as well as future recognition of interest income. Refer to Table 2 below for an analysis of the potential impact of changes in our prepayment assumptions on our net interest income.

We calculate and apply an effective yield to determine the rate of amortization of cost basis adjustments into interest income over the estimated lives of the investments using the retrospective effective interest method to arrive at a constant effective yield. When appropriate, we group loans into pools or cohorts based on similar risk categories including origination year, coupon bands, acquisition period and product type. We update our amortization calculations based on changes in estimated prepayment rates and, if necessary, we record cumulative adjustments to reflect the updated constant effective yield as if it had been in effect since acquisition.

Sensitivity Analysis for Amortizable Cost Basis Adjustments

Interest rates are a key assumption used in our prepayment models. Table 2 shows the estimated effect on our net interest income of the amortization of cost basis adjustments for our investments in loans and securities using the retrospective effective interest method applying a constant effective yield assuming (i) a 100 basis point increase in interest rates and (ii) a 50 basis point decrease in interest rates as of December 31, 2005 and 2004. We based our sensitivity analysis on these hypothetical interest rate changes because we believe they reflect reasonably possible near-term outcomes as of December 31, 2005.

Table 2: Amortization of Cost Basis Adjustments for Investments in Loans and Securities

	For the Year Ended December 31, 2005	2004
	(Dollars in millions)	
Unamortized cost basis adjustments	$ 344	$ 1,820
Reported net interest income	11,505	18,081
Decrease in net interest income from net amortization	(97)	(1,221)
Percentage effect on net interest income of change in interest rates:[1]		
100 basis point increase	1.6%	4.5%
50 basis point decrease	(2.2)	(4.9)

(1) Calculated based on an instantaneous change in interest rates.

As mortgage rates increase, expected prepayment rates generally decrease, which slows the amortization of cost basis adjustments. Conversely, as mortgage rates decrease, expected prepayment rates generally increase, which accelerates the amortization of cost basis adjustments.

Allowance for Loan Losses and Reserve for Guaranty Losses

The allowance for loan losses and the reserve for guaranty losses represent our estimate of probable credit losses arising from loans classified as held for investment in our mortgage portfolio as well as loans that back mortgage-related securities we guarantee. We use the same methodology to determine our allowance for loan losses and our reserve for guaranty losses as the relevant factors affecting credit risk are the same. Credit risk is the risk of loss to future earnings or future cash flows that may result from the failure of a borrower to make the payments required by his or her mortgage loan. We are exposed to credit risk because we own mortgage loans and have guaranteed to MBS trusts that we will supplement amounts received by those MBS trusts as required to permit timely payment of principal and interest on the related Fannie Mae MBS. We strive to mitigate our credit risk by, among other things, working with lender servicers, monitoring loan-to-value ratios and requiring mortgage insurance. See Risk Management Credit Risk Management below for further discussion of how we manage credit risk.

We employ a systematic methodology to determine our best estimate of incurred credit losses. This includes aggregating homogeneous loans into pools based on similar risk characteristics, using models to measure historical default and loss experience on the homogeneous loan populations, evaluating larger multifamily loans individually for impairment, monitoring observable data for key trends, as well as documenting the results of our estimation process.

Determining the adequacy of the allowance for loan losses and the reserve for guaranty losses is complex and requires significant judgment by management about the effect of matters that are inherently uncertain. When appropriate, our methodology involves grouping loans into pools or cohorts based on similar risk characteristics, including origination year, loan-to-value ratio, loan product type and credit rating. We use internally developed models that consider relevant factors historically affecting loan collectibility, such as default rates, severity of loss rates and adverse situations that may have occurred affecting the borrowers ability to repay. Management also applies judgment in considering factors that have occurred but are not yet reflected in the loss factors, such as the estimated value of the underlying collateral, other recoveries and external and economic factors. The methodology and the amount of our allowance for loan losses and reserve for guaranty losses are reviewed and approved on a quarterly basis by our Allowance for Loan Loss Oversight Committee, which is a committee chaired by the Chief Risk Officer or his designee and comprised of senior management from the Single-Family and HCD businesses, the Chief Risk Office and the finance organization.

We adjust our estimate of the allowance for loan losses and reserve for guaranty losses based on period-to-period fluctuations in loss experience, economic conditions in areas of geographic concentration and profile of mortgage characteristics. Using different assumptions about default rates, severity and estimated deterioration in borrowers financial condition than those used in estimating our allowance for loan losses and reserve for guaranty losses could have a material effect on our net income.

Given that a minimal change in any factor listed above that is used for calculation purposes would have a significant impact to the allowance and reserve liability and these factors have significant interdependencies, we do not believe a sensitivity analysis isolating one factor is meaningful. Therefore, the following example illustrates the impact to the allowance and reserve liability given changes to multiple assumptions used for these factors. For example, a natural disaster, such as a hurricane, might have an adverse impact on net income and our allowance for loan losses and reserve for guaranty losses. The damage to the properties that serve as collateral for the mortgages held in our portfolio and the mortgages underlying our mortgage-backed securities could increase our exposure to credit risk if the damage to the properties is not covered by hazard or flood insurance. Our estimate of probable credit losses related to a hurricane would involve considerable judgment and assumptions about the extent of the property damage, the impact on borrower default rates, the value of the collateral underlying the loans and the amount of insurance recoveries. In the case of Hurricane Katrina in 2005, we preliminarily estimated default rates, severity of loss rates, value of the underlying collateral, and other potential recoveries. As more information became available, we determined that the property damage was less extensive than had previously been estimated and the amount of insurance recoveries would be greater than previously expected. Accordingly, we revised our September 30, 2005 estimate of $257 million after-tax, which was disclosed in November of 2005, to an estimate of $106 million pre-tax for 2005.

Consolidation Variable Interest Entities

We are a party to various entities that are considered to be variable interest entities (VIEs) as defined in FASB Interpretation (FIN) No. 46 (revised December 2003), *Consolidation of Variable Interest Entities (an interpretation of ARB No. 51)* (FIN 46R). Generally, a VIE is a corporation, partnership, trust or any other legal structure that either does not have equity investors with substantive voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities. We invest in securities issued by VIEs, including Fannie Mae MBS created as part of our securitization program, certain mortgage- and asset-backed securities that were not issued by us and interests in LIHTC partnerships and other limited partnerships. Our involvement with a VIE may also include providing a guaranty to the entity.

There is a significant amount of judgment required in interpreting the provisions of FIN 46R and applying them to specific transactions. FIN 46R indicates that if an entity is a VIE, either a qualitative or a quantitative assessment may be required to support the conclusion of which party, if any, is the primary beneficiary. The primary beneficiary is the party that will absorb a majority of the expected losses or a majority of the expected returns. If the entity is determined to be a VIE, and we either qualitatively or quantitatively determine that we are the primary beneficiary, we are required to consolidate the assets, liabilities and non-controlling interests of that entity.

To determine whether we are the primary beneficiary of an entity, we first perform a qualitative analysis, which requires certain subjective decisions regarding our assessment, including, but not limited to, the design of the entity, the variability that the entity was designed to create and pass along to its interest holders, the rights of the parties and the purpose of the arrangement. If we cannot conclude after qualitative analysis whether we are the primary beneficiary, we perform a quantitative analysis. Quantifying the variability of a VIE s assets is complex and subjective, requiring analysis of a significant number of possible future outcomes as well as the probability of each outcome occurring. The results of each possible outcome are allocated to the parties holding interests in the VIE and, based on the allocation, a calculation is performed to determine which, if any, is the primary beneficiary. The analysis is required when we first become involved with the VIE and on each subsequent date in which there is a reconsideration event (*e.g.,* a purchase of additional beneficial interests).

We perform qualitative analyses on certain mortgage-backed and asset-backed investment trusts. These qualitative analyses consider whether the nature of our variable interests exposes us to credit or prepayment risk, the two primary drivers of expected losses for these VIEs. For those mortgage-backed investment trusts that we evaluate using quantitative analyses, we use internal models to generate Monte Carlo simulations of cash flows associated with the different credit, interest rate and housing price environments. Material assumptions include our projections of interest rates and housing prices, as well as our expectations of prepayment, default and severity rates. The projection of future cash flows is a subjective process involving significant management judgment, primarily due to inherent uncertainties related to the interest rate and housing price environment, as well as the actual credit performance of the mortgage loans and securities that were held by each investment trust. If we determine that an investment trust meets the criteria of a VIE, we consolidate the investment trust when our models indicate that we are likely to absorb more than 50% of the variability in the expected losses or expected residual returns.

The following demonstrates the sensitivity of our FIN 46R modeling results. We considered the impact of different primary beneficiary conclusions for the trusts in which a change in the variability would have affected our primary beneficiary assessment and our consolidation determination at the time we adopted FIN 46R and at the time we applied FIN 46 to subsequent transactions:

If we changed our assumptions to cause our variability in trusts to increase from an amount between 40% and 50% to greater than 50%, our total assets and liabilities as of December 31, 2005 would increase by approximately $380 million.

If we changed our assumptions to cause our variability in trusts to decrease from an amount between 60% and 50.1% to 50% or less, our total assets and liabilities as of December 31, 2005 would decrease by approximately $400 million.

We also examine our LIHTC partnerships and other limited partnerships to determine if consolidation is required. We use internal cash flow models that are applied to a sample of the partnerships to qualitatively evaluate homogenous populations to determine if these entities are VIEs and, if so, whether we are the primary beneficiary. LIHTC partnerships are created by third parties to finance construction of property, giving rise to tax credits for these partnerships. Material assumptions we make in determining whether the partnerships are VIEs and, if so, whether we are the primary beneficiary, include the degree of development cost overruns related to the construction of the building, the probability of the lender foreclosing on the building, as well as an investor s ability to use the tax credits to offset taxable income. The projection of cash flows and probabilities related to these cash flows requires significant management judgment because of the inherent limitations that relate to the use of historical loss and cost overrun data for the projection of future events. Additionally, we apply similar assumptions and cash flow models to determine the VIE and primary beneficiary status of our other limited partnership investments.

We are exempt from applying FIN 46R to certain investment trusts if the investment trusts meet the criteria of a qualifying special purpose entity (QSPE), and if we do not have the unilateral ability to cause the trust to liquidate or change the trust s QSPE status. The QSPE requirements significantly limit the activities in which a QSPE may engage and the types of assets and liabilities it may hold. Management judgment is required to determine whether a trust s activities meet the QSPE requirements. To the extent any trust fails to meet these criteria, we would be required to consolidate its assets and liabilities if, based on the provisions of FIN 46R, we are determined to be the primary beneficiary of the entity.

The FASB currently is assessing further what activities a QSPE may perform. The outcome of these and future assessments may affect our interpretation of this guidance, and, consequently, the entities we consolidate in future periods.

CONSOLIDATED RESULTS OF OPERATIONS

The following discussion of our consolidated results of operations is based on our results for the years ended December 31, 2005, 2004 and 2003. Table 3 presents a condensed summary of our consolidated results of operations.

Table 3: Condensed Consolidated Results of Operations

	For the Year Ended December 31,			Variance			
				2005 vs. 2004		2004 vs. 2003	
	2005	2004	2003	$	%	$	%
	(Dollars in millions, except per share amounts)						
Net interest income	$ 11,505	$ 18,081	$ 19,477	$ (6,576)	(36)%	$ (1,396)	(7)%
Guaranty fee income	3,779	3,604	3,281	175	5	323	10
Fee and other income	1,526	404	340	1,122	278	64	19
Investment losses, net	(1,334)	(362)	(1,231)	(972)	(269)	869	71
Derivatives fair value losses, net	(4,196)	(12,256)	(6,289)	8,060	66	(5,967)	(95)
Debt extinguishment losses, net	(68)	(152)	(2,692)	84	55	2,540	94
Loss from partnership investments	(849)	(702)	(637)	(147)	(21)	(65)	(10)
Provision for credit losses	(441)	(352)	(365)	(89)	(25)	13	4
Other non-interest expense	(2,351)	(2,266)	(1,598)	(85)	(4)	(668)	(42)
Income before federal income taxes, extraordinary gains (losses), and cumulative effect of change in accounting principle	7,571	5,999	10,286	1,572	26	(4,287)	(42)
Provision for federal income taxes	(1,277)	(1,024)	(2,434)	(253)	(25)	1,410	58
Extraordinary gains (losses), net of tax effect	53	(8)	195	61	763	(203)	(104)
Cumulative effect of change in accounting principle, net of tax effect			34			(34)	(100)
Net income	$ 6,347	$ 4,967	$ 8,081	$ 1,380	28%	$ (3,114)	(39)%
Diluted earnings per common share	$ 6.01	$ 4.94	$ 8.08	$ 1.07	22%	$ (3.14)	(39)%

Net income and diluted earnings per share (EPS) totaled $6.3 billion and $6.01, respectively, in 2005, compared with $5.0 billion and $4.94 in 2004, and $8.1 billion and $8.08 in 2003. We expect high levels of period-to-period volatility in our results of operations and financial condition as part of our normal business activities. This volatility is primarily due to changes in market conditions that result in periodic fluctuations in the estimated fair value of our derivative instruments, which we recognize in our consolidated statements of income as Derivatives fair value losses, net.

Although we use derivatives as economic hedges to help us manage interest rate risk and achieve our targeted interest rate risk profile, we do not meet the criteria for hedge accounting under SFAS No. 133*, Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). Accordingly, we record our derivative instruments at fair value as assets or liabilities in our consolidated balance sheets and recognize the fair value gains and losses in our consolidated statements of income without consideration of offsetting changes in the fair value of the economically hedged exposure. The estimated fair value of our derivatives may fluctuate substantially from period to period because of changes in interest rates, expected interest rate volatility and our derivative activity. Based on the composition of our derivatives, we generally expect to report decreases in the aggregate fair value of our derivatives as interest rates decrease.

Our business segments generate revenues from three principal sources: net interest income, guaranty fee income, and fee and other income. Other significant factors affecting our net income include the timing and size of investment and debt repurchase gains and losses, equity investments, the provision for credit losses, and administrative expenses. We provide a comparative discussion of the impact of these items on our consolidated results of operations for the three-year period ended December 31, 2005 below. We also discuss other significant items presented in our consolidated statements of income.

Net Interest Income

Net interest income, which is the difference between interest income and interest expense, is a primary source of our revenue. Interest income consists of interest on our consolidated interest-earning assets, plus income from the amortization of discounts for assets acquired at prices below the principal value, less expense from

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the amortization of premiums for assets acquired at prices above principal value. Interest expense consists of contractual interest on our interest-bearing liabilities and amortization of any cost basis adjustments, including premiums and discounts, which arise in conjunction with the issuance of our debt. The amount of interest income and interest expense recognized in the consolidated statements of income is affected by our investment activity, debt activity, asset yields and our cost of debt. We expect net interest income to fluctuate based on changes in interest rates and changes in the amount and composition of our interest-earning assets and interest-bearing liabilities. Table 4 presents an analysis of our net interest income and net interest yield for 2005, 2004 and 2003.

As described below in Derivatives Fair Value Losses, Net, we supplement our issuance of debt with interest rate-related derivatives to manage the prepayment and duration risk inherent in our mortgage investments. The effect of these derivatives, in particular the periodic net interest expense accruals on interest rate swaps, is not reflected in net interest income. See Derivatives Fair Value Losses, Net for additional information.

Table 4: Analysis of Net Interest Income and Yield

	For the Year Ended December 31,								
	2005			2004			2003		
	Average[(1)] Balance	Interest	Yield	Average[(1)] Balance	Interest	Yield	Average[(1)] Balance	Interest	Yield
	(Dollars in millions)								
erest-earning assets:									
rtgage loans[(2)]	$ 384,869	$ 20,688	5.38%	$ 400,603	$ 21,390	5.34%	$ 362,002	$ 21,370	5.90
rtgage securities	443,270	22,163	5.00	514,529	25,302	4.92	495,219	26,483	5.35
n-mortgage securities[(3)]	41,369	1,590	3.84	46,440	1,009	2.17	44,375	1,069	2.41
leral funds sold and urities purchased under eements to resell	6,415	299	4.66	8,308	84	1.01	6,509	32	0.49
vances to lenders	4,468	104	2.33	4,773	33	0.69	12,613	110	0.87
al interest-earning assets	$ 880,391	$ 44,844	5.09	$ 974,653	$ 47,818	4.91	$ 920,718	$ 49,064	5.33
erest-bearing liabilities:									
rt-term debt	$ 246,733	$ 6,535	2.65%	$ 331,971	$ 4,380	1.32%	$ 318,600	$ 3,967	1.25
ng-term debt	611,827	26,777	4.38	625,225	25,338	4.05	582,686	25,575	4.39
leral funds purchased securities sold under eements to repurchase	1,552	27	1.74	3,037	19	0.63	6,421	45	0.70
al interest-bearing bilities	$ 860,112	$ 33,339	3.88%	$ 960,233	$ 29,737	3.10%	$ 907,707	$ 29,587	3.26
pact of net non-interest ring funding	$ 20,279		0.10%	$ 14,420		0.05%	$ 13,011		0.05
interest income and net erest yield[(4)]		$ 11,505	1.31%		$ 18,081	1.86%		$ 19,477	2.12

(1) Average balances have been calculated based on beginning and end of year amortized cost.

(2) Includes average balance on nonaccrual loans of $7.4 billion, $7.6 billion and $6.8 billion for the years ended December 31, 2005, 2004 and 2003, respectively.

(3) Includes cash equivalents.

(4) Net interest yield is calculated based on net interest income divided by the average balance of total interest-earning assets.

Table 5 shows the changes in our net interest income between 2005 and 2004 and between 2004 and 2003 that are attributable to changes in the volume of our interest-earning assets and interest-bearing liabilities versus changes in interest rates.

Table 5: Rate/Volume Analysis of Net Interest Income

	2005 vs. 2004			2004 vs. 2003		
	Total Variance	Variance Due to:(1) Volume	Rate	Total Variance	Variance Due to:(1) Volume	Rate
	(Dollars in millions)					
Interest income:						
Mortgage loans	$ (702)	$ (845)	$ 143	$ 20	$ 2,164	$ (2,144)
Mortgage securities	(3,139)	(3,557)	418	(1,181)	1,006	(2,187)
Non-mortgage securities	581	(121)	702	(60)	48	(108)
Federal funds sold and securities purchased under agreements to resell	215	(23)	238	52	11	41
Advances to lenders	71	(2)	73	(77)	(58)	(19)
Total interest income	(2,974)	(4,548)	1,574	(1,246)	3,171	(4,417)
Interest expense:						
Short-term debt	2,155	(1,355)	3,510	413	171	242
Long-term debt	1,439	(552)	1,991	(237)	1,797	(2,034)
Federal funds purchased and securities sold under agreements to repurchase	8	(13)	21	(26)	(22)	(4)
Total interest expense	3,602	(1,920)	5,522	150	1,946	(1,796)
Net interest income	$ (6,576)	$ (2,628)	$ (3,948)	$ (1,396)	$ 1,225	$ (2,621)

(1) Combined rate/volume variances are allocated to the rate and volume variances based on their relative size.

Net interest income of $11.5 billion for 2005 decreased 36% from $18.1 billion in 2004, driven by a 10% decrease in our average interest-earning assets and a 30% (55 basis points) decline in our net interest yield to 1.31%. The decrease in our average interest-earning assets was due to a lower volume of interest-earning assets attributable to liquidations and a significant increase in the sale of fixed-rate mortgage assets from our portfolio, coupled with a reduced level of mortgage purchases. While our overall debt funding needs declined in 2005, our net interest yield was compressed because of an increase in our debt funding costs that primarily resulted from a tightening of short-term interest rates by the Federal Reserve. The increased cost of our debt more than offset an increase in the average yields on our interest-earning assets.

Competition for mortgage assets during 2005 generally increased the number of economically attractive opportunities to sell certain mortgage assets, particularly 15-year and 30-year fixed-rate mortgage-related securities, resulting in a sizeable increase in portfolio sales to $113.6 billion in 2005 compared with $18.4 billion in 2004. These sales were aligned with our need to lower portfolio balances to achieve our capital plan objectives. While portfolio liquidations in 2005 were comparable to 2004, portfolio purchases were substantially lower in 2005 as compared with 2004 due to narrowing spreads on traditional fixed-rate products as the yield curve flattened, as well as our focus on managing the size of our balance sheet to achieve our capital plan objectives. Portfolio purchases totaled $145.4 billion in 2005 compared with $258.5 billion in 2004, and included a much lower proportion of 30-year fixed-rate assets than historical norms. Sales, liquidations, and reduced purchases had the net effect of reducing our average interest-earning assets, as well as decreasing our mortgage portfolio, net balance by 20% to $736.5 billion as of December 31, 2005 from $924.8 billion as of December 31, 2004. Lower portfolio balances have the effect of reducing the net interest income generated by our portfolio.

The average yield on our interest-earning assets increased 18 basis points in 2005 to 5.09%, which was more than offset by an increase of 78 basis points in the average cost of our interest- bearing liabilities to 3.88%. As mortgage originations in our underlying market began to shift during 2004 to a higher share of ARM loans, the composition of our mortgage portfolio began to shift, a trend that continued throughout 2005. As we liquidated higher yielding fixed-rate mortgage assets, we partially replaced these assets in 2005 and 2004 by purchasing a greater proportion of floating-rate and ARM products. Although ARMs tend to earn lower initial yields than fixed-rate mortgage assets, we experienced an increase in our average yield during 2005 as interest rates increased and these floating-rate assets reset to higher interest rates. The flattening of the yield curve during 2005 resulted from a significant increase in short-term interest rates due to actions taken by the Federal Reserve to increase the Federal Funds target interest rate. As of December 31, 2005, the Federal Funds target rate was 4.25%, 200 basis points higher than at the start of the year and the highest level since 2001. The impact on long-term interest rates was much smaller, as the yield on the 10-year Treasury ended the year at 4.39%, 17 basis points higher than the end of 2004. Although we significantly reduced the level of our outstanding short-term debt during 2005, these interest rate changes had the effect of increasing the cost of short-term debt, which further reduced our net interest income and net interest yield. The increase in the cost of our long-term debt reflects the replacement of maturing lower-cost debt that we issued during the past few years to fund our portfolio investments when the yield curve was steep (*i.e.*, short- and medium-term interest rates were low relative to long-term interest rates). As the yield curve flattened during 2005 and we replaced this debt to fund our existing fixed-rate mortgage investments, we experienced an increase in our funding costs. At the same time, we experienced a significant decrease in the periodic net contractual interest expense accrued on our interest rate swaps during 2005, which is reflected in our consolidated statements of income as a component of Derivatives fair value losses, net.

Net interest income of $18.1 billion for 2004 decreased 7% from $19.5 billion in 2003, driven by a 6% increase in our average interest-earning assets that was more than offset by a 12% (26 basis points) decline in our net interest yield to 1.86%. The average yield on our interest-earning assets declined 42 basis points in 2004 to 4.91%, which exceeded the benefit we received from a decrease of 16 basis points in the average cost of our interest-bearing liabilities to 3.10%. During 2004, our mortgage asset purchases consisted of a greater proportion of lower-yielding, floating-rate assets. Partially offsetting this reduction in average yield on our mortgage investments was a slower rate of amortization of premiums in 2004 relative to 2003 due to slower prepayment rates. The yield on our total average debt decreased in 2004 due to the repurchase and call of a significant amount of higher cost long-term debt during 2003 and the issuance of new long-term debt at lower rates. However, as short-term interest rates began to increase in 2004, the cost of our short-term debt began to rise.

We expect the decrease in the volume of our interest-earning assets and the decline in the spread between the average yield on these assets and our borrowing costs that we began experiencing at the end of 2004 and that continued in 2005 to result in further reductions in our net interest income and net interest yield in the near future.

Guaranty Fee Income

Guaranty fee income primarily consists of contractual guaranty fees related to Fannie Mae MBS held in our portfolio and held by third-party investors, adjusted for the amortization of upfront fees and impairment of guaranty assets, net of a proportionate reduction in the related guaranty obligation and deferred profit, and impairment of buy-ups.

Guaranty fee income is primarily affected by the amount of outstanding Fannie Mae MBS and the compensation we receive for providing our guaranty on Fannie Mae MBS. The amount of compensation we receive and the form of payment varies depending on factors such as the risk profile of the securitized loans, the level of credit risk we assume and the negotiated payment arrangement with the lender. Our payment arrangements may be in the form of an upfront exchange of payments, an ongoing payment stream from the cash flows of the MBS trusts, or a combination. We typically negotiate a contractual guaranty fee with the lender and collect the fee on a monthly basis based on the contractual fee rate multiplied by the unpaid principal balance of loans underlying a Fannie Mae MBS issuance. In lieu of charging a higher contractual fee rate for loans with greater credit risk, we may require that the lender pay an upfront fee to compensate us for assuming the additional credit risk. We refer to this payment as a risk-based pricing adjustment. We also may adjust the monthly contractual guaranty fee rate so that the pass-through coupon rates on Fannie Mae MBS are in more easily tradable increments of a whole or half percent by making an upfront payment to the lender (buy-up) or receiving an upfront payment from the lender (buy-down).

As we receive monthly contractual payments for our guaranty obligation, we recognize guaranty fee income. We defer upfront risk-based pricing adjustments and buy-down payments that we receive from lenders and

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recognize these amounts as a component of guaranty fee income over the expected life of the underlying assets of the related MBS trusts. We record buy-up payments we make to lenders as an asset and reduce the recorded asset as cash flows are received over the expected life of the underlying assets of the related MBS trusts. We assess buy-ups for other-than-temporary impairment and include any impairment recognized as a component of guaranty fee income. The extent to which we amortize deferred payments into income depends on the rate of expected prepayments, which is affected by interest rates. In general, as interest rates decrease, expected prepayment rates increase, resulting in accelerated accretion into income of deferred fee amounts, which increases our guaranty fee income. Prepayment rates also affect the estimated fair value of buy-ups. Faster than expected prepayment rates shorten the average expected life of the underlying assets of the related MBS trusts, which reduces the value of our buy-up assets and may trigger the recognition of other-than temporary impairment.

The average effective guaranty fee rate reflects our average contractual guaranty fee rate adjusted for the impact of amortization of deferred amounts and buy-up impairment. Table 6 shows our guaranty fee income, including and excluding buy-up impairments, our average effective guaranty fee rate, and Fannie Mae MBS activity for 2005, 2004 and 2003.

Table 6: Analysis of Guaranty Fee Income and Average Effective Guaranty Fee Rate

	For the Year Ended December 31,						Variance	
	2005		2004		2003		2005 vs. 2004	2004 vs. 2003
	Amount	Rate[(1)]	Amount	Rate[(1)]	Amount	Rate[(1)]		
	(Dollars in millions)							
Guaranty fee income and average effective guaranty fee rate, excluding impairment of buy-ups	$ 3,828	21.3 bp	$ 3,640	21.0 bp	$ 3,474	22.2 bp	5%	5%
Impairment of buy-ups	(49)	(0.3)	(36)	(0.2)	(193)	(1.2)	36	(81)
Guaranty fee income and average effective guaranty fee rate	$ 3,779	21.0 bp	$ 3,604	20.8 bp	$ 3,281	21.0 bp	5%	10%
Average outstanding Fannie Mae MBS and other	$ 1,797,547		$ 1,733,060		$ 1,564,812		4%	11%

guaranties[2]					
Fannie Mae MBS issues[3]	510,138	552,482	1,220,066	(8)	(55)

(1) Presented in basis points and calculated based on guaranty fee income components divided by average outstanding Fannie Mae MBS and other guaranties.

(2) Other guaranties include $19.2 billion, $14.7 billion and $12.8 billion as of December 31, 2005, 2004 and 2003, respectively, related to long-term standby commitments and credit enhancements.

(3) Reflects unpaid principal balance of MBS issued and guaranteed by us, including mortgage loans held in our portfolio that we securitize and MBS issues during the period that we acquire for our portfolio.

Guaranty fee income of $3.8 billion for 2005 was up approximately 5% over 2004, primarily due to a 4% increase in average outstanding Fannie Mae MBS and other guaranties. Guaranty fee income of $3.6 billion for 2004 was up 10% over 2003, primarily due to an 11% increase in average outstanding Fannie Mae MBS and other guaranties. Our average effective guaranty fee rate, which includes the effect of buy-up impairments, remained essentially unchanged during the three-year period at 21.0 basis points in 2005, 20.8 basis points in 2004, and 21.0 basis points in 2003.

Growth in outstanding Fannie Mae MBS depends largely on the volume of mortgage assets made available for securitization and our assessment of the credit risk and pricing dynamics of these mortgage assets. Growth in outstanding Fannie Mae MBS slowed in 2004 and 2005 as compared to 2003, reflecting the impact of a decline in mortgage originations from the record level of $3.9 trillion in 2003 that fueled growth in Fannie Mae MBS issuances to a record level of $1.2 trillion. In addition, the product mix in the primary mortgage market began to shift in 2004 as the share of originations of lower credit quality loans, loans with reduced documentation and loans to fund investor properties increased. At the same time, originations of traditional mortgages, such as conventional fixed-rate loans, which historically have represented the majority of our business volume, decreased. Competition from private-label issuers, which have been a significant source of funding for these mortgage products, reduced our market share and level of MBS issuances. This trend continued in 2006; however, we began to increase our participation in these product types where we concluded that it would be economically advantageous or that it would contribute to our mission objectives.

Our average effective guaranty fee rate, excluding the effect of buy-up impairments, was 21.3 basis points in 2005, 21.0 basis points in 2004 and 22.2 basis points in 2003. Mortgage interest rates were higher in 2005 and 2004 relative to 2003, which reduced the rate of prepayments thereby increasing the average expected life of the underlying assets of outstanding Fannie Mae MBS. As a result, amortization of the deferred guaranty obligations into income slowed during 2005 and 2004, resulting in a reduced average effective guaranty fee rate compared with 2003. The increase in the average expected life of outstanding Fannie Mae MBS also caused the value of our buy-up assets to increase. Consequently, we recognized substantially less buy-up impairment in 2005 and 2004 than in 2003.

Fee and Other Income

Fee and other income includes transaction fees, technology fees, multifamily fees and foreign exchange gains and losses. Transaction and technology fees are largely driven by business volume, while foreign currency exchange gains and losses are driven by fluctuations in exchange rates on our foreign-denominated debt. Fee and other income totaled $1.5 billion, $404 million and $340 million in 2005, 2004 and 2003, respectively. The increase in fee and other income in 2005 from 2004 was primarily due to exchange gains recorded in 2005 on our foreign-denominated debt that stemmed from a strengthening of the U.S. dollar relative to the Japanese yen. We recorded foreign currency exchange gains of $625 million in 2005 versus losses of $304 million in 2004 that were offset by corresponding net losses and gains on foreign currency swaps, which are recognized in our consolidated statements of income as a component of Derivatives fair value gains (losses), net. We eliminate our exposure to fluctuations in foreign exchange rates by entering into foreign currency swaps to convert foreign-denominated debt to U.S. dollars. The increase in fee and other income in 2004 from 2003 was primarily due to a reduction in net foreign currency exchange losses, which more than offset a decline in transaction and technology fees that resulted from reduced business volumes.

Investment Losses, Net

Investment losses, net includes other-than-temporary impairment on AFS securities, lower-of-cost-or-market adjustments on HFS loans, gains and losses recognized on the securitization of loans from our portfolio and the sale of securities, unrealized gains and losses on trading securities and other investment losses. Investment gains and losses may fluctuate significantly from period to period depending upon our portfolio investment and securitization activities, changes in market conditions that may result in fluctuations in the fair value of trading securities, and other-than-temporary impairment. Table 7 summarizes the components of investment gains and losses for 2005, 2004 and 2003.

Table 7: Investment Losses, Net

	For the Year Ended December 31,		
	2005	2004	2003
	(Dollars in millions)		
Other-than-temporary impairment on AFS securities[1]	$ (1,246)	$ (389)	$ (733)
Lower-of-cost-or-market adjustments on HFS loans	(114)	(110)	(370)
Gains (losses) on Fannie Mae portfolio securitizations, net	259	(34)	(13)
Gains on sale of investment securities, net	225	185	87
Unrealized (losses) gains on trading securities, net	(415)	24	(97)

Other investment losses, net	(43)	(38)	(105)
Investment losses, net	$ (1,334)	$ (362)	$ (1,231)

(1) Excludes other-than-temporary impairment on guaranty assets and buy-ups as these amounts are recognized as a component of guaranty fee income.

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Other-than-Temporary Impairment on Available-for-Sale Securities

We periodically evaluate AFS securities for other-than-temporary impairment. Other-than-temporary impairment occurs when we determine that it is probable we will be unable to collect all of the contractual principal and interest payments of a security or if we do not have the ability and intent to hold the security until it recovers to its carrying amount. We consider many factors in assessing other-than-temporary impairment, including the severity and duration of the impairment, recent events specific to the issuer and/or the industry to which the issuer belongs, external credit ratings and recent downgrades, as well as our ability and intent to hold such securities until recovery. When we either decide to sell a security in an unrealized loss position and do not expect the fair value of the security to fully recover prior to the expected time of sale or determine that a security in an unrealized loss position may be sold in future periods prior to recovery of the impairment, we identify the security as other-than-temporarily impaired in the period that the decision to sell or determination that the security may be sold is made. For all other securities in an unrealized loss position resulting primarily from increases in interest rates, we have the positive intent and ability to hold such securities until the earlier of full recovery or maturity. We provide additional detail on our assessment of other-than-temporary impairment in Notes to Consolidated Financial Statements Note 1, Summary of Significant Accounting Policies.

We recognized other-than-temporary impairment on AFS securities totaling $1.2 billion, $389 million and $733 million in 2005, 2004 and 2003, respectively, primarily related to our investments in mortgage-related securities held in our portfolio, interest-only securities, manufactured housing securities, and other non-mortgage investment securities. These impairment amounts are reflected in the results of our Capital Markets group and detailed below.

Other-than-temporary impairment on mortgage-related securities held in our portfolio totaled $1.2 billion, $285 million and $23 million in 2005, 2004 and 2003, respectively. The rising interest rate environment in 2005 caused an overall decline in the fair value of our mortgage-related securities below the carrying value. We generally view changes in the fair value of our mortgage-related securities caused by movements in interest rates to be temporary. The $1.2 billion in other-than-temporary impairment that we recognized in 2005 related to securities totaling approximately $72.7 billion that we wrote down to fair value because we sold these securities before the interest rate impairments recovered. Of the $72.7 billion in securities for which we recorded other-than-temporary impairment in 2005, we sold $46.2 billion in 2005, $12.8 billion in 2006 and $13.7 billion in the first quarter of 2007. We did not recognize other-than-temporary impairment on the remaining mortgage-related securities in our portfolio that were in unrealized loss positions during 2005 because we have the intent and ability to hold these securities until the interest rate impairments recover. The continued upward trend in interest rates during 2006 caused a further decline in the fair value of our mortgage-related securities, which is likely to result in our recognition of material other-than-temporary impairment charges in 2006 for impaired securities that we sold prior to recovery of the impairment.

The other-than-temporary impairment on mortgage-related securities recognized in 2004 primarily related to certain securities with unrealized losses as of December 31, 2004 that we identified for possible sale in 2005 to comply with OFHEO s directive that we achieve a 30% surplus over our statutory minimum capital requirement by September 30, 2005.

We are required to write down the cost basis of our investments in interest-only securities to fair value when there is both a decline in fair value below the carrying amount and an adverse change in expected cash flows. We then recognize the write-down in earnings and establish a new cost basis for the security. Decreases in mortgage interest rates cause the expected lives of these securities to shorten, which decreases the expected cash flows and fair value of the securities. Mortgage interest rates reached historic lows in mid-2003 before beginning to increase during the second half of 2003 and 2004. While mortgage interest rates generally trended up in 2004 and 2005, they were somewhat volatile with periodic declines over the course of each year. We recognized other-than-temporary impairment of $19 million, $49 million and $78 million on mortgage-related interest-only securities in 2005, 2004 and 2003, respectively. The upward trend in interest rates in 2005 and 2004 resulted in lower impairment amounts during those years relative to 2003 when interest rates fell to historic lows. Periodic declines in interest rates could result in additional future impairments on our interest-only securities.

Beginning in 2002 and continuing in 2003, there was a significant weakening in the manufactured housing sector. As a result, certain manufactured housing servicers began to experience financial difficulties, triggering deterioration in the credit quality of certain securities as evidenced by credit downgrades and a considerable decline in fair value. Other-than-temporary impairment on our investments in manufactured housing securities totaled \$15 million, \$55 million and \$511 million in 2005, 2004 and 2003, respectively.

We recognized other-than-temporary impairment on non-mortgage investment securities totaling \$21 million, \$2 million and \$139 million in 2005, 2004 and 2003, respectively. The other-than-temporary impairment charge in 2005 related to corporate debt obligations. The other-than-temporary impairment charge in 2003 was largely attributable to our investments in certain aircraft lease securities, which suffered a decline in value due to the downturn in the airline industry. We completed the sale of all of our aircraft lease securities in 2005 and did not record any other-than-temporary impairment on these securities in 2005 or 2004.

We may subsequently recover other-than-temporary impairment amounts we record on securities if we collect all of the contractual principal and interest payments due or if we sell the security at an amount greater than the adjusted cost basis of the security.

Lower-of-Cost-or-Market Adjustments on Held-for-Sale Loans

We record loans classified as held for sale at the lower of cost or market, with any excess of cost over fair value reflected as a valuation allowance and changes in the valuation allowance recognized in income. The fair value of held for sale mortgage loans will fluctuate from period to period based primarily on changes in mortgage interest rates. As interest rates decline, the fair value of fixed-rate mortgage loans will generally increase, and as interest rates rise, the fair value of fixed-rate mortgage loans will generally decrease. In an environment of increasing interest rates or significant interest rate volatility, the LOCOM adjustment will typically increase.

We recorded losses related to LOCOM adjustments totaling \$114 million, \$110 million and \$370 million in 2005, 2004 and 2003, respectively. The slight increase in 2005 as compared to 2004 relates to higher interest rates during the period, which reduced the value of our HFS loans and resulted in higher LOCOM adjustments. In 2003, we purchased a significant volume of mortgage loans in response to the record level of mortgage originations in the primary market as mortgage interest rates reached record lows in the first half of 2003. An increase in interest rates in the second half of 2003 reduced the value of our HFS loans, resulting in a significantly higher amount of LOCOM adjustments in 2003 as compared with 2004.

Gains (Losses) on Fannie Mae Portfolio Securitizations, Net

Portfolio securitizations involve the transfer of mortgage loans or mortgage-related securities from our balance sheet to a trust to create Fannie Mae MBS (whether in the form of single-class Fannie Mae MBS, REMICs or other types of beneficial interests). We may retain an interest in the assets transferred to a trust in a portfolio securitization by receiving a portion of the resulting issued securities. If the transfer qualifies as a sale under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB Statement No. 125)* (SFAS 140), we determine the gain (loss) on sale by allocating the carrying value of the financial assets sold and the interests retained based on their relative estimated fair values. The gain (loss) we recognize is the difference between the cash proceeds from the sale, net of any liabilities assumed, and the cost allocated to the financial assets sold. The timing of the recognition of the gain (loss) is dependent upon meeting specific accounting criteria. As a result, the gain (loss) on sale may be recorded in a different accounting period than the period in which the securitization is completed. In addition, we may securitize financial assets in a different accounting period than the period in which the financial assets were purchased. See Notes to Consolidated Financial Statements Note 1, Summary of Significant Accounting Policies and Notes to Consolidated Financial Statements Note 6, Portfolio Securitizations for additional information on our accounting for Fannie Mae portfolio securitizations.

Gains or losses on Fannie Mae portfolio securitizations in any given period are primarily affected by the level of securitization activity, the carrying amount of the financial assets sold, and changes in interest rates and prices from the time the financial assets are purchased until the completion of the securitization. We may record losses on portfolio securitizations because we are required to recognize a liability for the fair value of our guaranty obligation in determining the gain or loss on the sale. Cash proceeds from portfolio securitizations totaled $55.0 billion, $12.3 billion and $7.2 billion in 2005, 2004 and 2003, respectively, and we recognized net gains on these transactions of $259 million in 2005 and net losses of $34 million and $13 million in 2004 and 2003, respectively.

Gains on Sale of Investment Securities, Net

Gains and losses on the sale of investment securities in any given period are primarily affected by the volume of sales and changes in interest rates and prices from the time the securities are purchased until the time they are sold. We recorded net gains of $225 million, $185 million and $87 million in 2005, 2004 and 2003, respectively, primarily related to the sale of securities totaling $113.6 billion, $18.4 billion and $24.7 billion, respectively.

We began to increase the level of sales from our mortgage portfolio beginning in the latter part of 2004. Competition for mortgage assets during 2005 generally increased the number of economically attractive opportunities to sell certain mortgage assets, resulting in a sizeable increase in portfolio sales during 2005. These sales were aligned with our need to lower portfolio balances to achieve our capital plan objectives.

Unrealized Gains (Losses) on Trading Securities, Net

Trading securities are carried at fair value with unrealized gains and losses recorded in earnings. We expect unrealized gains and losses on trading securities to fluctuate each period with changes in volumes, interest rates and market prices. Generally, increases in medium- and long-term interest rates result in losses on mortgage-related securities classified as trading and decreases in interest rates result in gains. We recorded net unrealized losses on trading securities of $415 million in 2005, net unrealized gains of $24 million in 2004 and net unrealized losses of $97 million in 2003. The increase in medium- and long-term interest rates during 2005 caused the fair value of our trading securities to decline, resulting in significant unrealized losses for the year. We experienced unrealized gains on trading securities during 2004 due to the modest decrease in long-term interest rates from the end of 2003 to the end of 2004. In 2003, an increase in interest rates in the second half of the year resulted in unrealized losses for the year.

Derivatives Fair Value Losses, Net

We record all derivatives as either assets or liabilities in the consolidated balance sheets at estimated fair value and recognize changes in fair value in our consolidated statements of income. Changes in the fair value of our derivatives, including mortgage commitments, resulted in losses of $4.2 billion, $12.3 billion and $6.3 billion in 2005, 2004 and 2003, respectively. Included in these derivatives fair value loss amounts are net contractual interest expense accruals on interest rate swaps totaling $1.3 billion, $5.0 billion and $6.4 billion in 2005, 2004 and 2003, respectively, which we consider to be part of the cost of funding our mortgage investments. Had we elected to fund our mortgage investments with long-term fixed-rate debt instead of a combination of short-term variable-rate debt and interest rate swaps, the expense related to our interest rate swap accruals would have been reflected as interest expense instead of as a component of our derivatives fair value losses.

To fully understand the derivatives fair value gains and losses recognized in our consolidated statements of income, it is important to examine the gains and losses in the context of our overall interest rate risk management objectives and strategy, including the economic objective in our use of various types of derivative instruments, the factors that drive changes in the fair value of our derivatives, how these factors affect changes in the fair value of other assets and liabilities, and the differences in accounting for our derivatives and other financial instruments.

While we use debt instruments as the primary means to fund our mortgage investments and manage our interest rate risk exposure, we supplement our issuance of debt with interest rate-related derivatives to manage the prepayment and duration risk inherent in our mortgage investments. As an example, by combining a pay-fixed swap with short-term variable-rate debt, we can achieve the economic effect of converting short-term variable-rate debt into long-term fixed-rate debt. By combining a pay-fixed swaption with short-term variable-rate debt, we can achieve the economic effect of converting short-term variable-rate debt into long-term callable debt. The cost of derivatives used in our management of interest rate risk is an inherent part of the cost of funding and hedging our mortgage investments and is economically similar to the interest expense that we recognize on the debt we issue to fund our mortgage investments. However, because we do not apply hedge accounting to our derivatives, the fair value gains or losses on our derivatives, including the periodic net contractual interest expense accruals on our swaps, are reported as Derivatives fair value losses, net in our consolidated statements of income rather than as interest expense.

Our derivatives consist primarily of over-the-counter (OTC) contracts and commitments to purchase and sell mortgage assets that are valued using a variety of valuation models. The valuation model that we select to estimate the fair value of our derivatives requires assumptions and inputs, such as market prices, yield curves and measures of interest rate volatility, which may require judgment. Accordingly, we have identified the estimation of the fair value of our derivatives as a critical accounting policy, which we discuss further in Critical Accounting Policies and Estimates Fair Value of Financial Instruments Sensitivity Analysis for Risk Management Derivatives and Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments. The primary factors affecting changes in the fair value of our derivatives include the following:

Changes in the level of interest rates: Because our derivatives portfolio as of December 31, 2005, 2004 and 2003 predominately consisted of pay-fixed swaps, we typically reported declines in fair value as interest rates decreased and increases in fair value as interest rates increased. As part of our economic hedging strategy, these derivatives, in combination with our debt issuances, are intended to offset changes in the fair value of our mortgage assets, which tend to increase in value when interest rates decrease and, conversely, decrease in value when interest rates rise.

Implied interest rate volatility: We purchase option-based derivatives to economically hedge the embedded prepayment option in our mortgage investments. A key variable in estimating the fair value of option-based derivatives is implied volatility, which reflects the market s expectation about the future volatility of interest rates. Assuming all other factors are held equal, including interest rates, a decrease in implied volatility would reduce the fair value of our derivatives and an increase in implied volatility would increase the fair value. The time remaining until our option-based derivatives expire is another important factor that affects the fair value. As the remaining life of an option shortens, the time value decreases and becomes less sensitive to changes in implied interest rate volatility. Time value is the amount by which the price of the option exceeds its intrinsic value.

Changes in our derivative activity: As interest rates change, we are likely to take actions to rebalance our portfolio to manage our interest rate exposure. As interest rates decrease, expected mortgage prepayments are likely to increase, which reduces the duration of our mortgage investments. In this scenario, we generally will rebalance our existing portfolio to manage this risk by terminating pay-fixed swaps or adding receive-fixed swaps, which shortens the duration of our liabilities. Conversely, when interest rates increase and the duration of our mortgage assets increases, we are likely to rebalance our existing portfolio by adding pay-fixed swaps that have the effect of extending the duration of our liabilities. We also add derivatives in various interest rate environments to hedge the risk of incremental mortgage purchases that we are not able to accomplish solely through our issuance of debt securities.

The following tables show the impact of derivatives on our consolidated statements of income and consolidated balance sheets. Table 8 provides an analysis of changes in the estimated fair value of the net derivative asset (liability), excluding mortgage commitments, recorded in our consolidated balance sheets during the periods December 31, 2005, 2004 and 2003, including the components of the derivatives fair value gains (losses) recorded in our consolidated statements of income. As indicated in Table 8, we recorded a net derivative asset, excluding mortgage commitments, of $4.4 billion and $5.4 billion in our consolidated balance sheets as of December 31, 2005 and 2004, respectively. The general effect on our consolidated financial

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statements of the changes in the estimated fair value of our derivatives shown in this table is described following the table.

Table 8: Changes in Risk Management Derivative Assets (Liabilities) at Fair Value, Net[(1)]

	As of December 31,		
	2005	2004	2003
	(Dollars in millions)		
Beginning net derivative asset (liability)[(2)]	$ 5,432	$ 3,988	$ (3,365)
Effect of cash payments:			
Fair value at inception of contracts entered into during the period[(3)]	846	2,998	5,221
Fair value at date of termination of contracts settled during the period[(4)]	879	4,129	1,520
Periodic net cash contractual interest payments	1,632	6,526	5,365
Total cash payments	3,357	13,653	12,106
Income statement impact of recognized amounts:			
Periodic net contractual interest expense accruals on interest rate swaps	(1,325)	(4,981)	(6,363)
Net change in fair value during the period	(3,092)	(7,228)	1,610
Derivatives fair value losses, net[(5)]	(4,417)	(12,209)	(4,753)
Ending derivative asset[(2)]	$ 4,372	$ 5,432	$ 3,988
Derivatives fair value gains (losses) attributable to:			
Periodic net contractual interest expense accruals on interest rate swaps	$ (1,325)	$ (4,981)	$ (6,363)
Net change in fair value of terminated derivative contracts from end of prior year to date of termination	(1,434)	(4,096)	(1,103)
Net change in fair value of outstanding derivative contracts, including derivative contracts entered into during the period	(1,658)	(3,132)	2,713
Derivatives fair value losses, net[(5)]	$ (4,417)	$ (12,209)	$ (4,753)

(1) Excludes mortgage commitments.

(2) Represents the net of Derivative assets at fair value and Derivative liabilities at fair value recorded in our consolidated balance sheets, excluding mortgage commitments.

(3) Primarily includes upfront premiums paid on option contracts, which totaled $853 million, $3.0 billion and $5.1 billion in 2005, 2004 and 2003, respectively. Also includes upfront cash paid or received on other derivative contracts. Additional detail on option premium payments provided in Table 9.

(4) Primarily represents cash paid upon termination of derivative contracts. The weighted average life in years at termination was approximately 15.5 years, 8.1 years and 6.7 years for contracts terminated in 2005, 2004 and 2003, respectively. The fair value at date of termination of contracts settled during 2002 totaled $7.6 billion and

had a weighted average life at termination of approximately 5.2 years.

(5) Reflects net derivatives fair value losses recognized in the consolidated statements of income, excluding mortgage commitments.

Amounts presented in Table 8 have the following effect on our consolidated financial statements:

Cash payments made to purchase options (purchased options premiums) increase the derivative asset recorded in the consolidated balance sheets.

Cash payments to terminate and/or sell derivative contracts reduce the derivative liability recorded in the consolidated balance sheets.

Periodic interest payments on our interest rate swap contracts also reduce the derivative liability as we accrue these amounts based on the contractual terms and recognize the accrual as an increase to the net derivative liability recorded in the consolidated balance sheets. The corresponding offsetting amount is recorded as expense and included as a component of derivatives fair value losses in the consolidated statements of income.

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Changes in the estimated fair value of our derivatives that result in a loss are recorded as an increase to the derivative liability or as a decrease to the derivative asset recorded in the consolidated balance sheets. The corresponding offsetting amount is recorded as a component of derivatives fair value losses in the consolidated statements of income.

Changes in the estimated fair value of our derivatives that result in a gain are recorded as a decrease to the derivative liability or as an increase to the derivative asset recorded in the consolidated balance sheets. The corresponding offsetting amount is recorded as a component of derivatives fair value gains in the consolidated statements of income.

The upfront premiums we pay to enter into option contracts primarily relate to swaption agreements, which give us the right to enter into a specific swap for a defined period of time at a specified rate. We can exercise the option up to the designated date. Table 9 below provides information on our option activity during 2005 and the amount of outstanding options as of December 31, 2005 based on the original premiums paid.

Table 9: Purchased Options Premiums[1]

	Original Premium Payments	Original Weighted Average Life to Expiration	Remaining Weighted Average Life
	(Dollars in millions)		
Outstanding options as of December 31, 2004	$ 13,230	5.6 years	4.0 years
Purchases[2]	853		
Exercises	(1,027)		
Expirations	(1,398)		
Outstanding options as of December 31, 2005	$ 11,658	6.5 years	4.3 years

(1) As of December 31, 2003, the estimated amount of outstanding options based on the original premiums paid, the original weighted average life to expiration and the remaining weighted average life were $12.5 billion, 4.8 years and 3.7 years, respectively. As of December 31, 2002, the estimated amount of outstanding options based on the original premiums paid, the original weighted average life to expiration and the remaining weighted average life were $9.4 billion, 3.3 years and 2.8 years, respectively.

(2) Amount of purchases is included in Table 8 as a component of the line item Fair value at inception of contracts entered into during the period. Purchases for 2004 and 2003 are included in Footnote 3 of Table 8.

Table 10 provides additional detail on the derivatives fair value gains and losses recognized in our consolidated statements of income for 2005, 2004 and 2003 by type of derivative instrument. The 5-year interest rate swap rate, which is shown below in Table 10 as of the end of each quarter for the respective years, is a key reference interest rate affecting the estimated fair value of these derivatives.

Table 10: Derivatives Fair Value Gains (Losses), Net

	For the Year Ended December 31,		
	2005	**2004**	**2003**
	(Dollars in millions)		
Risk management derivatives:			
Swaps:			
Pay-fixed	$ 549	$ (10,640)	$ (4,269)
Receive-fixed	(1,118)	3,917	1,849
Basis swaps	(2)	51	(1)
Foreign currency swaps	(673)	379	695
Swaptions:			
Pay-fixed	(1,393)	(3,841)	387
Receive-fixed	(2,071)	(1,913)	(3,047)
Interest rate caps	283	(140)	(339)
Other[1]	8	(22)	(28)
Risk management derivatives fair value losses, net	(4,417)	(12,209)	(4,753)
Mortgage commitment derivatives fair value gains (losses), net[2]	221	(47)	(1,536)
Total derivatives fair value losses, net	$ (4,196)	$ (12,256)	$ (6,289)

	2005	**2004**	**2003**
5-year swap rate:			
Quarter ended March 31	4.63%	3.17%	3.18%
Quarter ended June 30	4.15	4.30	2.76
Quarter ended September 30	4.66	3.81	3.24
Quarter ended December 31	4.88	4.02	3.64

(1) Includes MBS options, forward starting debt, forward purchase and sale agreements, swap credit enhancements, mortgage insurance contracts and exchange-traded futures.

(2) The subsequent recognition in our consolidated statements of income associated with cost basis adjustments that we record upon the settlement of mortgage commitments accounted for as derivatives resulted in expense of approximately $870 million, $541 million and $883 million in 2005, 2004 and 2003, respectively. These amounts are reflected in our consolidated statements of income as a component of either Net interest income or Investment losses, net.

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Table 11 provides additional detail on the estimated fair value of derivatives recorded in our consolidated balance sheets and the related outstanding notional amount by derivative instrument type as of December 31, 2005 and 2004. We describe our risk management derivative activity in Risk Management Interest Rate Risk Management and Other Market Risks. We describe our credit exposure on our risk management derivatives in Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management.

Table 11: Notional and Fair Value of Derivatives

	As of December 31,			
	2005		2004	
	Notional Amount	Estimated Fair Value(1)	Notional Amount	Estimated Fair Value(1)
	(Dollars in millions)			
Risk management derivatives:				
Swaps:				
Pay-fixed	$ 188,787	$ (2,954)	$ 142,017	$ (6,687)
Receive-fixed	123,907	(1,301)	81,193	479
Basis swaps	4,000	(2)	32,273	7
Foreign currency swaps	5,645	200	11,453	686
Swaptions:				
Pay-fixed	149,405	2,270	170,705	3,370
Receive-fixed	138,595	6,202	147,570	7,711
Interest rate caps	33,000	436	104,150	638
Other(2)	776	69	733	84
Risk management derivatives excluding accrued interest	644,115	4,920	690,094	6,288
Accrued interest		(548)		(856)
Total risk management derivatives	$ 644,115	$ 4,372	$ 690,094	$ 5,432
Mortgage commitment derivatives:				
Mortgage commitments to purchase whole loans	$ 2,081	$ 6	$ 2,118	$ 4
Forward contracts to purchase mortgage-related securities	17,993	62	20,059	43
Forward contracts to sell mortgage-related securities	19,120	(66)	18,423	(35)
Total mortgage commitment derivatives	$ 39,194	$ 2	$ 40,600	$ 12

(1) Represents the net amount of Derivative assets at fair value and Derivative liabilities at fair value in the consolidated balance sheets.

(2) Includes MBS options, swap credit enhancements, forward starting debt and the fair value of mortgage insurance contracts that are accounted for as derivatives. These mortgage insurance contracts have payment

provisions that are not based on a notional amount.

As discussed above, because a significant portion of our derivatives consists of pay-fixed swaps, we expect the aggregate estimated fair value of our derivatives to decline and result in derivatives losses when interest rates decline because we are paying a higher fixed rate of interest relative to the current interest rate environment. The $8.1 billion decrease in derivative losses in 2005 from 2004 was largely attributable to the increase in interest rates during 2005, which increased the aggregate fair value of interest rate swaps and resulted in a significant reduction in the net contractual interest expense recognized on our interest rate swaps. During 2005, we experienced a decrease in the fair value of our option-based derivatives primarily due to time decay of these options and a decrease in implied volatility during 2005. Interest rates have generally trended up since the end of 2005 and remained at overall higher levels through March 2007. As a result, we expect our derivative losses in 2006 to be lower than 2005.

During 2004, there was a decrease in implied volatility that resulted in a decline in the estimated fair value of our option-based derivatives, including both our pay-fixed and receive-fixed swaptions. Although we recorded derivatives fair value losses of $12.3 billion in our consolidated statements of income due to the decrease in the estimated fair value of our derivatives, as discussed in Supplemental Non-GAAP Information Fair Value Balance Sheet, the estimated fair value of our net assets (net of tax effect), excluding net capital transactions that included proceeds from the issuance of preferred stock and payment of dividends, increased by $8.9 billion in 2004. This increase was driven in part by an increase in the estimated fair value of our mortgage assets that resulted from the decrease in implied volatility.

While changes in the estimated fair value of our derivatives resulted in net expense in each reported period, we incurred this expense as part of our overall interest rate risk management strategy to economically hedge the prepayment and duration risk of our mortgage investments. As more fully described in Risk Management Interest Rate Risk Management and Other Market Risks, we believe our duration gap, which is a measure of the difference between the estimated durations of our interest rate sensitive assets and liabilities, is a useful tool in assessing our interest rate exposure and our management thereof as it shows the extent to which changes in the fair value of our mortgage investments are offset by changes in the fair value of our debt and derivatives.

In 2003, we announced the implementation of new corporate financial disciplines that resulted in our taking less interest rate exposure, which had the effect of reducing the potential for economic losses resulting from changes in interest rates but also reducing the potential for economic gains. As part of these disciplines, we committed to managing the portfolio s duration gap within a target range of plus or minus six months substantially all of the time. Our duration gap has not exceeded plus or minus one month for any month since October 2004. We present our monthly duration gap for the period January 1, 2003 to December 31, 2005 in Risk Management Interest Rate Risk Management and Other Market Risks Measuring Interest Rate Risk. To maintain our duration gap within the tighter tolerances, we issue more callable debt, purchase more options and take rebalancing actions earlier and with greater frequency than we did prior to adopting this policy. However, the increased level of optionality provided by our callable debt and option-based derivatives generally reduces the magnitude of rebalancing actions needed for a given change in interest rates. The effects of our investment strategy, including our interest rate risk management, are reflected in changes in the estimated fair value of our net assets over time.

Debt Extinguishment Losses, Net

We call debt securities in order to reduce future debt costs as a part of our integrated interest rate risk management strategy. We also repurchase debt in order to enhance the liquidity of our debt. Debt extinguishment losses (and gains) are affected by the level of debt extinguishment activity and the price performance of our debt securities. Typically, the amount of debt repurchased has a greater impact on gains and losses recognized on debt extinguishments than the amount of debt called. Debt repurchases, unlike debt calls, may require the payment of a premium and therefore result in higher extinguishment costs. As a result, we historically have generally repurchased high interest rate debt at times (and in amounts) when we believed we had sufficient income available to absorb or offset those higher costs.

We recognized a pre-tax loss of $68 million in 2005 from the repurchase of $22.9 billion and call of $28 billion of debt. In comparison, we recognized a pre-tax loss of $152 million in 2004 from the repurchase of $4.3 billion and call of $155.6 billion of debt, and a pre-tax loss of $2.7 billion in 2003 from the repurchase of $19.8 billion and call of $188.7 billion of debt. As interest rates began to rise in 2004, we began to curb our debt repurchase activity.

Loss from Partnership Investments

We make numerous investments in limited partnerships, which primarily include investments in LIHTC partnerships that sponsor affordable housing projects. These investments assist us in achieving our affordable housing mission and also provide a return on capital by generating tax credits and net operating losses that reduce our federal income tax liability. Our partnership investments totaled approximately $9.3 billion and $8.1 billion as of December 31, 2005 and 2004, respectively. In some cases, we consolidate these entities in

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our financial statements. In other cases, we account for these investments using the equity method and record our share of operating losses in the consolidated statements of income as Loss from partnership investments. Investments we accounted for under the equity method totaled $4.5 billion and $4.2 billion as of December 31, 2005 and 2004, respectively. We provide additional information about these investments and applicable accounting in Off-Balance Sheet Arrangements and Variable Interest Entities LIHTC Partnership Interests.

Loss from partnership investments, net, accounted for under the equity method totaled $849 million, $702 million and $637 million in 2005, 2004 and 2003, respectively. The increase in losses in each year was primarily due to our increased level of LIHTC partnership investments. In March 2007, we sold a portfolio of investments in LIHTC partnerships totaling approximately $676 million in LIHTC credits. These equity interests represented less than 10% of our overall LIHTC portfolio. We may sell LIHTC investments in the future if we believe that the economic return from the sale will be greater than the benefit we would receive from continuing to hold these investments. However, we view these investments as a significant channel for advancing our affordable housing mission and expect to continue to invest in LIHTC partnerships, which we expect will generate additional net operating losses and tax credits in the future. For more information on tax credits associated with our LIHTC investments, refer to Provision for Federal Income Taxes below.

Provision for Credit Losses

The provision for credit losses results from a detailed analysis estimating an appropriate allowance for loan losses for single-family and multifamily loans classified as held for investment in our mortgage portfolio and reserve for guaranty losses for credit-related losses associated with certain mortgage loans that back Fannie Mae MBS held in our portfolio and held by other investors. The provision for credit losses may reflect an increase or decrease, depending on whether we need to increase or decrease the allowance for loan losses and reserve for guaranty losses based on our estimate of incurred losses in our portfolio as of each balance sheet date.

The provision for credit losses increased to $441 million in 2005, an increase of $89 million, or 25%, from the provision in 2004. We recorded a provision for credit losses of $106 million in 2005 for single-family and multifamily properties affected by Hurricane Katrina. We initially estimated for the Gulf Coast Hurricanes Katrina and Rita a range of after-tax losses of $250 million to $550 million (pre-tax range of $385 million to $846 million). However, as more information became available, we determined that property damage was less extensive than had been previously estimated, the amount of insurance recoveries were greater than previously expected, and Hurricane Rita did not have a significant impact on our credit losses. Because we had information regarding the probable amount of this existing loss contingency available to us prior to issuing our 2005 consolidated financial statements, we were required to record the most recent estimated loss amount of $106 million in the period it arose based on information available at the time of the issuance of the consolidated financial statements. We also increased our provision for credit losses as a result of our adoption of Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3). Under SOP 03-3, we are required to record loans we purchase from Fannie Mae MBS trusts due to default at fair value because these loans have deteriorated in credit quality since origination. The excess of the purchase price over the fair value, if any, is recorded as a charge to Reserve for guarantee losses in the consolidated balance sheet.

The provision for credit losses decreased slightly to $352 million in 2004, down $13 million, or 4%, from 2003. An observed trend of reduced levels of recourse proceeds from lenders on charged-off loans had the effect of increasing the provision for credit losses in 2004; however, lower than anticipated charge-offs more than offset this increase, leading to a slight reduction in the provision compared to 2003.

We provide additional detail on credit losses and factors affecting our allowance for loan losses and reserve for guaranty losses in Risk Management Credit Risk Management Mortgage Credit Risk Management and Critical

Accounting Policies and Estimates Allowance for Loan Losses and Reserve for Guaranty Losses.

Other Non-Interest Expense

Foreclosed Property Expense (Income)

Foreclosed property expense (income) includes gains and losses on the sale of acquired properties and valuation losses on REO properties held for sale. Foreclosed property expense (income) is affected by the level of foreclosures and the loss severity rate (average loss per case). Home price appreciation and credit enhancements generally reduce the severity of our losses.

We recorded foreclosed property income of $13 million in 2005, expense of $11 million in 2004 and income of $12 million in 2003. The acceleration of home prices during this period helped to mitigate our foreclosure losses and resulted in gains on the sale of certain REO properties. The slowdown in the housing market during 2006 and the first quarter of 2007 has resulted in substantially lower home price appreciation and home price declines in some regions, which is likely to increase the level of foreclosures as well as our loss severity rates. As a result, we expect our credit losses to increase for 2006 and 2007. We provide additional detail on our management of credit losses, including foreclosed property expense, in Risk Management Credit Risk Management Mortgage Credit Risk Management.

Administrative Expenses

Administrative expenses include costs incurred to run our daily operations, such as salaries and employee benefits, professional services, occupancy expense and technology expenses. Administrative expenses totaled $2.1 billion in 2005, up $459 million, or 28%, over 2004, primarily related to costs associated with our restatement and related regulatory examinations, investigations and litigation defense, which totaled approximately $570 million in 2005. Administrative expenses totaled $1.7 billion in 2004, up $202 million, or 14%, over 2003, primarily due to the write off of $159 million of software that had been previously capitalized in conjunction with the reengineering of our core technology infrastructure.

Costs associated with the restatement process and related regulatory examinations, investigations and litigation defense also significantly increased our administrative expenses in 2006. Further increasing our administrative expenses in 2006 were costs attributable to or associated with the preparation of our consolidated financial statements and periodic SEC financial reports for periods through 2004, as well as control remediation activities and increased headcount to support these efforts. Administrative expenses totaled an estimated $3.1 billion in 2006, of which approximately $850 million was attributable to the restatement process and related regulatory examinations, investigations and litigation defense and approximately $200 million was attributable to or associated with the preparation of our financial statements for periods subsequent to 2004. We anticipate that the costs associated with the preparation of our post-2004 consolidated financial statements and periodic SEC reports will continue to have a substantial impact on administrative expenses at least until we are current in filing our periodic financial reports with the SEC.

We have recently implemented cost-cutting measures in an effort to reduce our administrative expenses for future periods, which we expect will reduce our administrative expenses by approximately $200 million for 2007 as compared with 2006. We also expect to reduce our administrative expenses, excluding costs associated with returning to timely financial reporting, to approximately $2 billion per year in 2008. This amount is significantly higher than our historical level of administrative expenses because of the significant investment we have made to remediate material weaknesses in our internal controls by enhancing our organizational structure and systems.

Other Expenses

Other expenses include credit enhancement expenses that relate to costs associated with the purchase of additional mortgage insurance to protect against credit losses, regulatory penalties and other miscellaneous expenses. Other expenses totaled $251 million, $607 million and $156 million in 2005, 2004 and 2003, respectively. The decrease in 2005 as well as the increase in 2004 over 2003 primarily stems from the recognition in 2004 of the $400 million civil penalty that we paid to the U.S. Treasury in 2006 pursuant to our settlements with OFHEO and the SEC.

Provision for Federal Income Taxes

The provision for federal income taxes includes deferred tax expense plus current tax expense. Deferred tax expense represents the net change in the deferred tax asset or liability balance during the year plus any change in a valuation allowance. The current tax expense represents the amount of tax currently payable to or receivable from tax authorities. The provision for income taxes does not include the tax effect related to adjustments recorded in AOCI.

Our effective income tax rate, excluding the provision for taxes related to extraordinary amounts and the cumulative effect of change in accounting principle, was reduced below the 35% statutory rate to 17%, 17% and 24% in 2005, 2004 and 2003, respectively. The difference between the statutory rate and our effective tax rate is primarily due to the tax benefits we receive from our investments in LIHTC partnerships that help in supporting our affordable housing mission. As disclosed in Notes to Consolidated Financial Statements Note 10, Income Taxes, our effective tax rate would have been 30%, 32% and 31% in 2005, 2004 and 2003, respectively, had we not received the tax benefits from our investments in LIHTC partnerships.

The variance in our effective income tax rate over the past three years is primarily due to the combined effect of fluctuations in our pre-tax income, which affects the relative tax benefit of tax-exempt income and tax credits, and an increase in the actual dollar amount of tax credits. Our effective income tax rate may vary from period to period, depending on, among other factors, our earnings and the level of tax credits. We expect tax credits resulting from our investments in LIHTC partnerships to grow in the future, which is likely to reduce our effective tax rate assuming we are able to use all of the tax credits generated. The extent to which we are able to use all of the tax credits generated by existing or future investments in housing tax credit partnerships to reduce our federal income tax liability will depend on the amount of our future federal income tax liability, which we cannot predict with certainty. In addition, our ability to use tax credits in any given year may be limited by the corporate alternative minimum tax rules, which ensure that corporations pay at least a minimum amount of federal income tax annually. For 2005, we were not able to use all the tax credits we received because our income tax liability, after applying all such credits, would have been reduced below the minimum tax amount. We were able to apply a portion of these unused credits to reduce our income tax liability for 2004. We expect to use the remainder in future years, to the extent permissible, and may evaluate selling any potential unusable tax credits if we determine that we can generate a greater economic return from selling versus holding certain LIHTC investments.

We recorded a net deferred tax asset of $7.7 billion and $6.1 billion as of December 31, 2005 and 2004, respectively. We have not recorded a valuation allowance against our net deferred tax asset as we anticipate it is more likely than not that the results of future operations will generate sufficient taxable income to realize the entire tax benefit.

Extraordinary Gains (Losses), Net of Tax Effect

When we determine that we are the primary beneficiary of a VIE under FIN 46R, we are required to consolidate the assets and liabilities of the VIE in our consolidated financial statements at fair value. Effective with the adoption of FIN 46R, any difference between the then fair value and the previous carrying amount of our interests in the VIE is recorded as an extraordinary gain (loss), net of tax effect, in our consolidated statements of income. As a result of our adoption of FIN 46R in 2003, we recorded an extraordinary gain, net of tax effect, of $195 million due to the consolidation of VIEs.

BUSINESS SEGMENT RESULTS

Table 12 provides a summary of the financial results for each of our business segments for the years ended December 31, 2005, 2004 and 2003.

Table 12: Business Segment Results Summary

	For the Year Ended December 31,			Increase (Decrease)			
				2005 vs. 2004		2004 vs. 2003	
	2005	2004	2003	$	%	$	%
	(Dollars in millions)						
Revenues:[1]							
Single-Family Credit Guaranty	$ 5,805	$ 5,153	$ 4,994	$ 652	13%	$ 159	3%
Housing and Community Development	743	538	398	205	38	140	35
Capital Markets	43,601	46,135	47,293	(2,534)	(5)	(1,158)	(2)
Total	$ 50,149	$ 51,826	$ 52,685	$ (1,677)	(3)%	$ (859)	(2)%
Net income:							
Single-Family Credit Guaranty	$ 2,889	$ 2,514	$ 2,481	$ 375	15%	$ 33	1%
Housing and Community Development	462	337	286	125	37	51	18
Capital Markets	2,996	2,116	5,314	880	42	(3,198)	(60)
Total	$ 6,347	$ 4,967	$ 8,081	$ 1,380	28%	$ (3,114)	(39)%

	As of December 31,			
	2005	2004		
Total assets:				
Single-Family Credit Guaranty	$ 12,871	$ 11,543	$ 1,328	12%
Housing and Community Development	11,829	10,166	1,663	16
Capital Markets Group	809,468	999,225	(189,757)	(19)
Total	$ 834,168	$ 1,020,934	$ (186,766)	(18)%

[1] Includes interest income, guaranty fee income, and fee and other income.

We use various methodologies to allocate certain balance sheet and income statement amounts between operating segments. For a description of our allocation methodologies and more financial detail on our business segments, see Notes to Consolidated Financial Statements Note 14, Segment Reporting. Following is an analysis and discussion of the performance of our business segments.

Single-Family Credit Guaranty Business

Our Single-Family Credit Guaranty business generated net income of $2.9 billion, $2.5 billion and $2.5 billion in 2005, 2004 and 2003, respectively. The primary source of revenue for our Single-Family business is guaranty fee income. Other sources of revenue include technology and other fees and interest income. Expenses primarily include administrative expenses and credit-related expenses, including the provision for credit losses.

Net income for the Single-Family business segment increased by $375 million or 15% in 2005 from 2004, primarily due to higher interest income and guaranty fee income offset by an increase in our provision for credit losses and administrative expenses. Interest income earned on cash flows from the date of the remittance by servicers to us until the date of distribution by us to MBS certificate holders, commonly referred to as float income, increased by $282 million as a result of higher short-term interest rates throughout 2005. Guaranty fee income for 2005 increased slightly from 2004 as the average single-family mortgage credit book of business increased 3%. The average effective guaranty fee rate remained essentially unchanged from year to year.

Expenses increased 13% in 2005 due in part to the segment s allocation of a portion of the costs associated with our restatement and related matters.

The provision for credit losses increased by 46% to $454 million in 2005, primarily attributable to our provision for credit losses related to Hurricane Katrina and our implementation of SOP 03-3. The provision for credit losses includes $105 million associated with Hurricane Katrina. As discussed further in Risk Management Mortgage Credit Risk Management Credit Losses , we have reduced and refined the initial estimate of the potential impact of Hurricane Katrina that we disclosed in 2005. This reduction results from several factors, including the liquidation of a number of the loans relating to flooded properties from our mortgage portfolio that resulted in no losses, the amount of insurance recoveries being greater than previously expected on the flooded properties and reduced delinquencies for affected loans within the flood-damaged areas.

Net income for the Single-Family business segment remained essentially unchanged in 2004 from 2003, with an increase in guaranty fee income offset by lower fee and other income, and higher expenses. Guaranty fee income increased by 6% in 2004 from 2003, primarily due to growth in average single-family mortgage credit book of business in 2004. The average effective guaranty fee rate on single-family Fannie Mae MBS remained essentially unchanged in 2004 as compared to 2003. This increase in guaranty fee income was offset primarily by an increase in other expenses in 2004 due to the allocation of a portion of the $400 million civil penalty paid to the U.S. Treasury in connection with our settlements with the SEC and OFHEO; and a decline in fee and other income due to reduced fees from technology-related transactions resulting from reduced transaction volume.

Our credit losses remained low in 2005 and 2004. The rapid acceleration in home prices during the period from 1999 to 2005, combined with our use of credit enhancements, helped to mitigate our credit losses. Our conventional single-family serious delinquency rate increased to 0.79% in December 2005, compared with 0.63% in December 2004, as a result of Hurricane Katrina in 2005. Our conventional single-family serious delinquency rate subsequently improved as a result of the factors described above, dropping to 0.65% in December 2006. As a result of the significant slowdown in home price appreciation during 2006 and our belief that home prices could decline modestly in 2007, we expect credit losses will increase in future periods.

During 2005 and 2004, there was intense competition for the purchase of mortgage assets by a growing number of mortgage investors through a variety of investment vehicles and structures. During these years, in a steeper interest rate curve environment and with a variety of new mortgage products being introduced and accepted by investors, consumers took advantage of adjustable-rate mortgages, including non-traditional products such as interest-only ARMs, negative-amortizing ARMs and a variety of other product and risk combinations. The increased demand for floating-rate and subprime mortgage loans accelerated the growth of competing securitization options in the form of private-label mortgage-related securities. The demand for these products continued throughout 2006 and slowed in 2007.

Single-family mortgage originations posted the second strongest year in history at $3.0 trillion ($1.5 trillion for home purchase and $1.5 trillion for refinancing) in 2005, up approximately 9% from 2004. However, based on our assessment of the underlying risk, we made a strategic decision to not pursue the guaranty of a significant portion of mortgage loan originations during 2004 and 2005. In doing so, we ceded market share of new single-family mortgage-related securities issuances to private-label issuers. Our estimated overall market share of new mortgage-related securities issuance declined to 23.5% in 2005, compared with 29.2% in 2004 and 45.0% in 2003. These estimates of market share are based on publicly available data and exclude previously securitized mortgages. In 2006, single-family mortgage originations fell to $2.8 trillion and our market share remained essentially unchanged from 2005.

Our conventional single-family mortgage credit book of business remained relatively stable from 2004 to 2005. We believe that our assessment and approach to the management of credit risk during these years allowed us to maintain a conventional single-family mortgage credit book of business with strong credit risk characteristics. The weighted average original loan-to-value ratio and weighted average mark-to-market loan-to-value ratio for our conventional single-family mortgage credit book of business were 70% and 53%, respectively, as of December 31, 2005. The weighted average credit score for our conventional single-family mortgage credit book of business was 721 as of December 31, 2005. These credit risk characteristics were substantially the same as of December 31, 2006. We discuss the characteristics of our conventional single-family mortgage credit book of business in greater detail in Risk Management Mortgage Credit Risk Management Single-Family.

As discussed above, the demand for ARM products, including non-traditional products such as interest-only ARMs and negative-amortizing ARMs, remained higher than historical norms in 2004 and 2005, making up 33% and 32%, respectively, of conventional single-family mortgage originations. The popularity of ARMs declined in 2006, making up 29% of conventional single-family mortgage originations, and has continued to decline in 2007 as a result of the decline in interest rates on fixed-rate mortgages; the decrease in the spread, or difference, between interest rates on fixed-rate mortgages and ARMs; and improvements in housing affordability from the 20-year low recorded in July 2006. Additional factors that we believe may be contributing to the continued decline in the popularity of ARMs include heightened consumer awareness of the risks of certain non-traditional ARM product features, and lender approaches that may be evolving as a result of the interagency guidance on non-traditional mortgages. We believe that these factors may result in many homeowners choosing to refinance into fixed-rate mortgages in anticipation of future interest rate resets on ARMs. We estimate that approximately $1.1 trillion in ARMs are scheduled to reset at least once during 2007, with approximately an additional $300 billion scheduled to reset in 2008.

We are focused on understanding and serving our customers needs, strengthening our relationships with key partners, and helping lenders reach and serve new, emerging and non-traditional markets by providing more flexible, low-cost mortgage options. We also continue to expand our mortgage options for borrowers with weaker credit histories.

HCD Business

Our Housing and Community Development business generated net income of $462 million, $337 million and $286 million in 2005, 2004 and 2003, respectively. The primary sources of revenues for our HCD business are guaranty fee income and fee and other income. Expenses primarily include administrative expenses, credit-related expenses and losses associated with LIHTC and other partnership investments that are offset by the related tax benefits from these investments.

Net income for the HCD business segment increased by $125 million, or 37%, in 2005 from 2004 as a result of increased tax benefits from tax-advantaged investments and higher fee and other income. HCD makes a variety of partnership investments in affordable housing. These investments include tax-advantaged investments (primarily LIHTC investments) where the economic benefits are primarily derived from tax credits, as well as other affordable housing investments that generate cash flow and equity appreciation. LIHTC investments, which totaled $7.7 billion in 2005, compared to $6.8 billion in 2004, comprised the largest proportion of investment activity in 2005. Losses from partnership investments increased by $147 million as HCD increased its investment activity; however, these losses were more than offset by increased LIHTC tax benefits which were the primary reason for the reduction in our 2005 effective corporate tax rate to 17%. Guaranty fee income was down slightly as the 5% increase in the average multifamily mortgage credit book of business was offset by lower effective guaranty fee rates in 2005. Fee and other income doubled in 2005 to $628 million primarily due to an increase in multifamily transaction fees caused by higher borrower refinancing activity in 2005 as compared to 2004. Expenses increased 28% in 2005 due to the segments allocation of a portion of the costs associated with our restatement and related matters.

Net income for the HCD business segment increased by 18% in 2004 from 2003, primarily due to an increase in tax benefits from tax-advantaged investments, guaranty fee income and fee and other income. These increases in revenues are partially offset by higher expenses. The increase in income tax benefits was largely attributable to growth in LIHTC and other partnership investment balances, reduced by a 10% increase in pre-tax losses from these partnership investments. Guaranty fee income increased by 25% in 2004, as a result of growth in the average multifamily mortgage credit book of business in 2004 at stable effective guaranty fee rates. Growth in fee and other income was fueled by increases in multifamily transaction fees that resulted from substantially higher borrower refinancing activity in 2004 compared to 2003. Other expenses increased due to the allocation of a portion of the $400 million civil penalty paid to the U.S. Treasury in connection with our settlements with the SEC and OFHEO, as well as increased direct and allocated costs. Net interest expense increased, reflecting higher internal funding costs due to our increased investment in LIHTC and other equity investments.

We expect tax credits resulting from our investments in LIHTC partnerships to grow in the future, which is likely to reduce our effective tax rate. The extent to which we are able to use all of the tax credits generated by existing or future investments in housing tax credit partnerships to reduce our federal income tax liability will depend on the amount of our future federal income tax liability, which we cannot predict with certainty. However, we may make a strategic decision to sell certain investments in the future as another means of realizing the benefits. In March 2007, we sold a portfolio of investments in LIHTC partnerships totaling approximately $676 million in LIHTC credits. These equity interests represented less than 10% of our overall LIHTC portfolio. We may sell LIHTC investments in the future if we believe that the economic return from the sale will be greater than the benefit we would receive from continuing to hold these investments. However, we view these investments as a significant vehicle for advancing our affordable housing mission and expect to continue to invest in LIHTC partnerships.

HCD s Multifamily Group benefited from the improvement in multifamily real estate fundamentals during 2005. The two key drivers were an increase in the population of prime apartment renters and solid job growth throughout 2005. These factors contributed to a decline in overall apartment vacancies and an increase in monthly rental rates in 2005. These multifamily real estate fundamentals continued to improve during 2006.

Our multifamily serious delinquency rate increased to 0.32% in December 2005, compared with 0.11% in December 2004, as a result of Hurricane Katrina in 2005. Our multifamily serious delinquency rate subsequently improved, declining to 0.08% in December 2006. As discussed further in Risk Management Mortgage Credit Risk Management Credit Losses , we have reduced and refined our estimate of the potential impact of Hurricane Katrina due to our ongoing loss mitigation activities. We currently do not believe that we have credit concerns on multifamily properties related to the hurricanes.

We are one of the largest participants in the multifamily secondary market. HCD s multifamily business has been challenged in recent years. Competition has been fueled by private-label issuers of CMBS and aggressive bidding for multifamily debt among institutional investors, which reflects the high level of funds available for investment in the secondary mortgage market. We have responded to market challenges with an increased emphasis on serving partner needs with customized lending options and advanced a number of efficiency initiatives that will help make it quicker and easier to do business with us and at a lower cost. HCD continues to grow and diversify its business into new areas that expand the supply of affordable housing, such as increased investment in rental and for-sale housing projects, including LIHTC investments. HCD further enables the expansion of affordable housing stock by participating in specialized debt financing, acquiring mortgage loans from a variety of new public and private partners, and increasing other community lending activities.

Capital Markets Group

Our Capital Markets group generated net income of $3.0 billion, $2.1 billion and $5.3 billion in 2005, 2004 and 2003, respectively. The primary sources of revenues for our Capital Markets group include net interest income and fee and other income. Derivatives fair value losses, investment gains and losses, and debt extinguishment gains and losses also have a significant impact on the financial performance of our Capital Markets group.

Net income for the Capital Markets group increased by $880 million, or 42%, in 2005 from 2004. The reduction in net interest income and an increase in investment losses were almost completely offset by lower derivatives fair value losses. Net interest income decreased $6.9 billion, or 39%, in 2005 from 2004 largely due to a 10% decline in the average mortgage portfolio balance resulting from a decrease in securities purchases and an increase in sales activity throughout 2005. The majority of the portfolio sales and a large portion of portfolio liquidations were comprised of fixed-rate Fannie Mae MBS, which caused the product mix of the portfolio to shift slightly as floating-rate securities and adjustable-rate mortgage products increased as a percentage of our total mortgage portfolio. In addition, significant increases in short-term interest rates had the effect of increasing the cost of our short-term debt, which further reduced net interest income.

Investment losses increased from $446 million in 2004 to $1.5 billion in 2005 due to higher other-than-temporary impairment on AFS securities and unrealized losses on trading securities as the fair value of our mortgage assets declined due to rising interest rates. The $1.2 billion in other-than-temporary impairment that we recognized in 2005 related to securities that were written down to fair value because we sold these securities before the interest rate impairment recovered. We did not recognize other-than-temporary impairment on the remaining mortgage-related securities in our portfolio that were in unrealized loss positions during 2005 because we have the intent and ability to hold these securities until full recovery.

Derivatives fair value losses dropped 66% to $4.2 billion in 2005, reflecting a rise in interest rates that resulted in (i) the fair value of our interest rate derivatives to increase relative to 2004 and (ii) the spread between our pay-fixed and receive-variable swap positions to narrow causing our interest accruals on our interest rate swaps to decrease by $3.7 billion. The significant increase in fee and other income was primarily attributable to foreign currency exchange gains on our foreign-denominated debt as the dollar strengthened against the Japanese yen in 2005 as compared to 2004. As discussed in Risk Management Interest Rate Risk Management and Other Market Risks , when we issue foreign-denominated debt, we swap out of the foreign currency completely at the time of the debt issue in order to minimize our exposure to currency risk. As such, the aforementioned gains are offset by losses on fair value of the related derivatives.

The $3.2 billion, or 60%, decrease in the net income of our Capital Markets group in 2004 from 2003 was due to an increase in derivatives fair value losses and a decline in net interest income, partially offset by decreases in debt extinguishment losses, the provision for federal income taxes and investment losses. The $6.0 billion increase in derivatives fair value losses recorded in 2004 primarily resulted from a decrease in implied volatility that reduced the fair value of our option-based derivatives. Net interest income declined by $1.3 billion, or 7%, in 2004 from 2003, largely due to a decline in our net interest yield resulting from an increase in short-term interest rates and a shift in portfolio purchases to a greater percentage of adjustable-rate assets with lower initial spreads. Our Capital Markets group undertook a significantly lower level of debt repurchase activity during 2004 compared to 2003, resulting in a $2.5 billion decrease in debt extinguishment losses. The provision for federal income taxes decreased 70% from 2003 due to significantly lower taxable income. Investment losses declined by $861 million in 2004 due to a reduction in other-than-temporary impairments on certain assets as compared to 2003.

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Table 13: Mortgage Portfolio Activity[1]

	Purchases[2]			Sales			Liquidations[3]		
	2005	2004	2003	2005	2004	2003	2005	2004	200
				(Dollars in millions)					
ge loans:									
ate:									
erm	$ 60,267	$ 53,305	$ 98,474	$ 1	$	$ 8	$ 55,427	$ 69,182	$ 135
ediate-term[4]	18,824	23,470	56,591	9			38,603	31,446	37
xed-rate loans	79,091	76,775	155,065	10		8	94,030	100,628	172
able-rate	5,515	9,118	8,800	41	66		11,392	7,640	6
mortgage loans	84,606	85,893	163,865	51	66	8	105,422	108,268	179
ge securities:									
ate:									
erm	13,630	58,412	292,675	93,910	14,691	18,079	83,861	107,309	257
ediate-term[5]	832	4,834	37,499	12,117	3,460	5,350	6,670	8,097	12
xed-rate es	14,462	63,246	330,174	106,027	18,151	23,429	90,531	115,406	270
able-rate	46,359	109,339	31,720	7,562	161	1,283	51,165	24,785	6
mortgage es	60,821	172,585	361,894	113,589	18,312	24,712	141,696	140,191	277
mortgage o	$ 145,427	$ 258,478	$ 525,759	$ 113,640	$ 18,378	$ 24,720	$ 247,118	$ 248,459	$ 456
liquidation							30.7%	27.9%	

(1) Excludes premiums, discounts and other cost basis adjustments.

(2) Excludes advances to lenders and mortgage-related securities acquired through the extinguishment of debt.

(3) Includes scheduled repayments, prepayments and foreclosures.

(4) Consists of mortgage loans with contractual maturities at purchase equal to or less than 15 years.

(5) Consists of mortgage securities with maturities of 15 years or less at issue date.

Mortgage Investment Activity

Our mortgage investment activities during 2005 were conducted within the context of our capital restoration plan, which was finalized with OFHEO in February 2005. The size of our net mortgage portfolio declined 20% during 2005 to $736.5 billion as of December 31, 2005, due to a significant increase in portfolio sales, normal liquidations and fewer portfolio purchases. Lowering our net mortgage portfolio enabled us to achieve our capital objective. On November 1, 2005, OFHEO announced that we had achieved a 30% surplus over our statutory minimum capital requirement at September 30, 2005. OFHEO s requirement that we maintain a 30% capital surplus remains in effect at OFHEO s discretion.

Competition for mortgage assets during 2005 generally increased the number of economically attractive opportunities to sell certain mortgage assets, particularly 15-year and 30-year fixed-rate mortgage-related securities, resulting in a sizeable increase in portfolio sales to $113.6 billion in 2005 compared with $18.4 billion in 2004. These sales were aligned with our need to lower portfolio balances to achieve our capital plan objectives. While portfolio liquidations in 2005 were comparable to 2004, portfolio purchases were substantially lower in 2005 as compared with 2004 due to narrowing spreads on traditional fixed-rate products as the yield curve flattened, as well as our focus on managing the size of our balance sheet to achieve our capital plan objectives. Portfolio purchases totaled $145.4 billion in 2005 compared with $258.5 billion in 2004, and included a much lower proportion of 30-year fixed-rate assets than historical norms.

Our mortgage purchases in 2004 decreased by $267.3 billion, or 51%, from our purchases in 2003. In 2004, spreads between our debt and mortgage assets were very narrow throughout the year, reflecting both strong investor demand for mortgage assets from banks, funds and other investors. Accordingly, because fewer available mortgage assets met our risk/return objectives in 2004 as compared to 2003, we purchased fewer mortgage assets in 2004. In addition, mortgage liquidations in 2004 decreased by $207.7 billion, or 46%, from liquidations in 2003, due to higher prevailing mortgage rates in 2004, which reduced refinancing activity in 2004 as compared to 2003. Because liquidations of the mortgage assets in our portfolio in 2004 were roughly equal to our purchases of mortgage assets in 2004, our mortgage portfolio balance increased only slightly from 2003 to 2004.

We routinely enter into forward purchase commitments that lock in the future delivery of mortgage loans and mortgage-related securities at a fixed price or yield. Retained commitments are a leading indicator of future acquisition volume and a key driver of earnings growth in our Capital Markets group. Net retained commitments to purchase mortgage assets were $35.5 billion and $132.5 billion for year ended December 31, 2005 and December 31, 2006, respectively.

Recent Trends in Mortgage Investment Activity

During 2006 and through the first quarter of 2007, we continued to manage the size of our balance sheet to maintain a 30% capital surplus. Portfolio purchases and sales during 2006 were consistent with the primary objectives of our business model supporting liquidity in the secondary mortgage market and, subject to various constraints, maximizing long-term total returns from our investment activities. Portfolio purchases were higher in 2006 than in 2005. Portfolio sales and liquidations declined significantly in 2006 from 2005. The net impact of purchases, sales and liquidations in 2006 on our net mortgage portfolio balance as of December 31, 2006 was nominal, resulting in our 2006 balance staying essentially unchanged from the balance as of December 31, 2005.

Under our May 23, 2006 consent order with OFHEO, we agreed to continue to maintain a 30% capital surplus over our statutory minimum capital requirement until the Director of OFHEO, in his discretion, determines the requirement should be modified or allowed to expire, taking into account factors such as resolution of accounting and internal control issues. We also agreed not to increase the size of our net mortgage portfolio assets above the amount shown in the minimum capital report to OFHEO as of December 31, 2005 ($727.75 billion), except in limited circumstances at OFHEO s discretion.

If market conditions change significantly, the limit on the size of our net mortgage portfolio assets could constrain our ability to capitalize fully on economically attractive opportunities to add mortgage portfolio assets to our portfolio. In addition to the portfolio limit, our ability to purchase and sell mortgage assets is also constrained by our risk parameters, operational limitations, regulatory limitations, and limitations related to our analysis of whether we will hold assets until a temporary impairment recovers.

We regularly meet with OFHEO to discuss current market conditions and our mortgage and capital markets activities. In addition, we will contact OFHEO if the market environment changes markedly and we determine that such changes could limit our ability to provide liquidity, meet our housing goals, or compete effectively in the secondary mortgage market while remaining within the portfolio limit prescribed by OFHEO.

On February 28, 2007, we submitted an updated business plan to OFHEO that included a report on our progress in remediating our internal control deficiencies, completing the requirements of the consent order and other matters. OFHEO reviewed our business plan and has directed us to maintain compliance with the $727.75 billion portfolio cap. Until the Director of OFHEO has determined that modification or expiration of the limitation is appropriate, we will remain subject to this limitation on portfolio growth.

Table 14 shows the balance of our mortgage portfolio, which reflects the net impact of our purchases, sales and liquidations, and the composition of our mortgage portfolio by product type as of December 31, 2005, 2004, 2003, 2002 and 2001.

Table 14: Mortgage Portfolio Composition[1]

	As of December 31,				
	2005	2004	2003	2002	2001
	(Dollars in millions)				
Mortgage loans:					
Single-family:[2]					
Government insured or guaranteed	$ 15,036	$ 10,112	$ 7,284	$ 6,404	$ 6,381
Conventional:					
Long-term, fixed-rate	199,917	230,585	250,915	223,794	198,468
Intermediate-term, fixed-rate[3]	61,517	76,640	85,130	59,521	45,018
Adjustable-rate	38,331	38,350	19,155	12,142	12,791
Total conventional single-family	299,765	345,575	355,200	295,457	256,277
Total single-family	314,801	355,687	362,484	301,861	262,658
Multifamily:[2]					
Government insured or guaranteed	1,148	1,074	1,204	1,898	2,116
Conventional:					
Long-term, fixed-rate	3,619	3,133	3,010	3,165	2,991
Intermediate-term, fixed-rate[3]	45,961	39,009	29,717	15,213	10,807
Adjustable-rate	1,151	1,254	1,218	1,107	962
Total conventional multifamily	50,731	43,396	33,945	19,485	14,760
Total multifamily	51,879	44,470	35,149	21,383	16,876
Total mortgage loans	366,680	400,157	397,633	323,244	279,534
Unamortized premiums (discounts) and cost basis adjustments, net	1,254	1,647	1,768	1,358	(493)
Lower of cost or market adjustments on loans held for sale	(89)	(83)	(50)	(16)	(36)
Allowance for loan losses for loans held for investment	(302)	(349)	(290)	(216)	(168)
Total mortgage loans, net	367,543	401,372	399,061	324,370	278,837
Mortgage-related securities:					
Fannie Mae single-class MBS	160,322	272,665	337,463	292,611	237,051
Non-Fannie Mae single-class mortgage securities	27,162	35,656	33,367	38,731	50,982
Fannie Mae structured MBS	74,129	71,739	68,459	87,772	90,147
	86,129	109,455	45,065	28,188	29,137

Non-Fannie Mae structured mortgage securities					
Mortgage revenue bonds	18,802	22,076	20,359	19,650	18,391
Other mortgage-related securities	4,665	5,461	6,522	9,583	10,711
Total mortgage-related securities	371,209	517,052	511,235	476,535	436,419
Market value adjustments[4]	(789)	6,680	7,973	17,868	7,205
Other-than-temporary impairments	(553)	(432)	(412)	(204)	(22)
Unamortized premiums (discounts) and cost basis adjustments, net[5]	(909)	173	1,442	1,842	(1,060)
Total mortgage-related securities, net	368,958	523,473	520,238	496,041	442,542
Mortgage portfolio, net	$ 736,501	$ 924,845	$ 919,299	$ 820,411	$ 721,379

(1) Mortgage loans and mortgage-related securities are reported at unpaid principal balance.

(2) Mortgage loans include $113.3 billion, $152.7 billion, $162.5 billion, $135.8 billion and $113.4 billion of mortgage-related securities that were consolidated in the consolidated balance sheets as loans as of December 31, 2005, 2004, 2003, 2002 and 2001, respectively.

(3) Intermediate-term, fixed-rate consists of mortgage loans with contractual maturities at purchase equal to or less than 15 years.

(4) Includes unrealized gains and losses on mortgage-related securities and securities commitments classified as trading and available-for-sale.

(5) Includes the impact of other-than-temporary impairments of cost basis adjustments.

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The changing product mix of originations in our underlying market had a pronounced effect on the composition of mortgage assets purchased for our portfolio during 2005 and 2004. Due to a higher percentage of adjustable-rate mortgage originations in 2005 and 2004, a substantially larger proportion of our purchases in 2005 and 2004 consisted of ARMs and floating-rate mortgage-related securities than in previous years. In addition, higher sales of fixed-rate securities in 2005 contributed to the shift in the product mix of our portfolio.

Debt Funding and Derivatives

Total debt outstanding was $764.7 billion as of December 31, 2005, compared with $955.5 billion as of December 31, 2004. The 20% decline in our debt outstanding was directly correlated to the decline in our portfolio balances. During 2005, we reduced our total short-term debt by 46%, from $322.7 billion as of December 31, 2004 to $173.9 billion as of December 31, 2005, compared to a decrease of 7% our total long-term debt outstanding, from $632.8 billion as of December 31, 2004 to $590.8 billion as of December 31, 2005. Our total debt outstanding declined slightly during 2006 to approximately $774.4 billion as of December 31, 2006.

The notional value of outstanding derivative instruments used to hedge interest rate risk in our portfolio declined to $644.1 billion as of December 31, 2005 compared with $690.1 billion as of December 31, 2004. We periodically terminate offsetting receive-fixed and pay-fixed swaps that result from our ongoing interest rate risk management process. The notional amount of derivatives also declines with maturing derivatives.

The total notional amount of our outstanding derivative instruments used to hedge interest rate risk in our portfolio increased in 2006 from 2005 by approximately 16%. The increase in the notional amount of our derivatives book at the end of 2006 reflects higher balances of both pay-fixed and receive-fixed swaps, partially offset by a reduction in interest rate swaptions. As interest rates during the first half of the year generally increased and the durations of our mortgage assets lengthened, we generally added to our net pay-fixed swap position. During the second half of 2006, when interest rates generally declined and the durations of our mortgage assets shortened, we added to our net receive-fixed swap position. These actions are consistent with our approach to interest rate risk management.

Non-Mortgage Investments

As discussed further in Liquidity and Capital Management , our Capital Markets group also purchases non-mortgage investments. Our non-mortgage investments consist primarily of high-quality securities that are readily marketable or have short-term maturities, such as commercial paper. As of December 31, 2005 and 2004, we had approximately $52.2 billion and $55.1 billion, respectively, in liquid assets, net of any cash and cash equivalents pledged as collateral. Our investments in non-mortgage securities, which account for the majority of our liquid assets, totaled $37.1 billion and $43.9 billion as of December 31, 2005 and 2004, respectively.

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Table 15 shows our investments in non-mortgage securities, which are presented at fair value as of December 31, 2005, 2004 and 2003.

Table 15: Non-Mortgage Investments

	As of December 31, 2005	2004 (Dollars in millions)	2003
Non-mortgage-related securities:			
Asset-backed securities	$ 19,190	$ 25,645	$ 26,862
Corporate debt securities	11,840	15,098	16,432
Municipal bonds		863	1,203
Other non-mortgage-related securities[1]	6,086	2,303	2,335
Total non-mortgage-related securities	$ 37,116	$ 43,909	$ 46,832

[1] Includes investments in commercial paper of $5.1 billion, $1.3 billion and $1.3 billion as of December 31, 2005, 2004 and 2003, respectively.

Table 16 shows the amortized cost, maturity and weighted average yield of our investments in mortgage and non-mortgage securities as of December 31, 2005.

Table 16: Amortized Cost, Maturity and Average Yield of Investments in Available-for-Sale Securities

	Total Amortized Cost[1]	Total Fair Value	One Year or Less Amortized Cost[1]	One Year or Less Fair Value	After One Year Through Five Years Amortized Cost[1]	After One Year Through Five Years Fair Value	After Five Years Through Ten Years Amortized Cost[1]	After Five Years Through Ten Years Fair Value	After Te Amortized Cost[1]
	As of December 31, 2005 (Dollars in millions)								
BS[2]	$ 144,193	$ 143,742	$ 1	$ 1	$ 651	$ 666	$ 2,148	$ 2,206	$ 141,393
ae ortgage	26,372	26,356			100	98	283	288	25,989
uctured	74,452	74,102			54	55	384	388	74,014
ae tgage	86,273	86,006					37	37	86,236
nue bonds	18,836	19,178	98	97	319	317	695	702	17,724
	4,227	4,464		(2)					4,227

e-related									
ecurities[2]	19,197	19,190	4,725	4,724	12,089	12,083	1,218	1,217	1,165
securities	11,843	11,840	3,018	3,017	8,725	8,723	100	100	
related									
	6,032	6,086	5,679	5,733	353	353			
	$ 391,425	$ 390,964	$ 13,521	$ 13,570	$ 22,291	$ 22,295	$ 4,865	$ 4,938	$ 350,748
	5.76%		4.23%		3.19%		5.56%		5.98%

(1) Amortized cost includes unamortized premiums, discounts and other cost basis adjustments, as well as other-than-temporary impairment write downs.

(2) Asset-backed securities, including mortgage-backed securities, are reported based on contractual maturities assuming no prepayments.

(3) Includes commitments related to mortgage securities that are accounted for as securities.

(4) Yields are determined by dividing interest income (including the amortization and accretion of premiums, discounts and other cost basis adjustments) by amortized cost balances as of year-end.

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SUPPLEMENTAL NON-GAAP INFORMATION FAIR VALUE BALANCE SHEET

Because our assets and liabilities consist predominately of financial instruments, we routinely use fair value measures to make investment decisions and to measure, monitor and manage our risk. The balance sheets presented in our consolidated financial statements reflect some financial assets measured and reported at fair value while other financial assets, along with most of our financial liabilities, are measured and reported at historical cost.

Each of the non-GAAP supplemental consolidated fair value balance sheets presented below in Table 17 reflects all of our assets and liabilities at estimated fair value. Estimated fair value is the amount at which an asset or liability could be exchanged between willing parties, other than in a forced or liquidation sale. We believe that the non-GAAP supplemental consolidated fair value balance sheets are useful to investors because they provide consistency in the measurement and reporting of all of our assets and liabilities. Management principally uses this information to gain a clearer picture of changes in our assets and liabilities from period to period and to understand how the overall value of the company is changing from period to period.

Our consolidated fair value balance sheets include the following non-GAAP financial measures:

- the estimated fair value of our other assets and our total assets;
- the estimated fair value of our other liabilities and our total liabilities; and
- the estimated fair value of our net assets (net of tax effect).

These measures are not defined terms within GAAP and may not be comparable to similarly titled measures reported by other companies. The estimated fair value of our net assets (net of tax effect) presented in the non-GAAP supplemental consolidated fair value balance sheets is not intended as a substitute for amounts reported in our consolidated financial statements prepared in accordance with GAAP. We believe, however, that the non-GAAP supplemental consolidated fair value balance sheets and the fair value of our net assets, when used in conjunction with our consolidated financial statements prepared in accordance with GAAP, can serve as valuable incremental tools for investors to assess changes in our overall value over time relative to changes in market conditions.

Cautionary Language Relating to Supplemental Non-GAAP Financial Measures

In reviewing our non-GAAP supplemental consolidated fair value balance sheets, there are a number of important factors and limitations to consider. The estimated fair value of our net assets is calculated as of a particular point in time based on our existing assets and liabilities and does not incorporate other factors that may have a significant impact on that value, most notably any value from future business activities in which we expect to engage. As a result, the estimated fair value of our net assets presented in our non-GAAP supplemental consolidated fair value balance sheets does not represent an estimate of our net realizable value, liquidation value or our market value as a whole. Amounts we ultimately realize from the disposition of assets or settlement of liabilities may vary significantly from the estimated fair values presented in our non-GAAP supplemental consolidated fair value balance sheets. Because temporary changes in market conditions can substantially affect the fair value of our net assets, we do not believe that short-term fluctuations in the fair value of our net assets attributable to mortgage-to-debt OAS or changes in the fair value of our net guaranty assets are necessarily representative of the effectiveness of our investment strategy or the long-term underlying value of our business. We believe the long-term value of our business depends primarily on our ability to acquire new assets and funding at attractive prices and to effectively manage the risks of these assets and liabilities over time. However, we believe that focusing on the factors that affect near-term changes in the estimated fair value of our net assets helps us evaluate our long-term value and assess whether temporary market factors have caused our net assets to become overvalued or undervalued relative to the level of risk and expected long-term fundamentals of our business.

In addition, as discussed in Critical Accounting Policies and Estimates Fair Value of Financial Instruments, when quoted market prices or observable market data are not available, we rely on internally developed

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models that may require management judgment and assumptions to estimate fair value. Differences in assumptions used in our models could result in significant changes in our estimates of fair value.

Table 17: Non-GAAP Supplemental Consolidated Fair Value Balance Sheets

	As of December 31, 2005			As of December 31, 2004		
	Carrying Value	Fair Value Adjustment[1]	Estimated Fair Value	Carrying Value	Fair Value Adjustment[1]	Estimated Fair Value
	(Dollars in millions)					
Assets:						
Cash and cash equivalents	$ 3,575	$	$ 3,575(2)	$ 3,701	$	$ 3,701(2)
Federal funds sold and securities purchased under agreements to resell	8,900		8,900(2)	3,930		3,930(2)
Trading securities	15,110		15,110(2)	35,287		35,287(2)
Available-for-sale securities	390,964		390,964(2)	532,095		532,095(2)
Mortgage loans held for sale	5,064	36	5,100(2)	11,721	131	11,852(2)
Mortgage loans held for investment, net of allowance for loan losses	362,479	(350)	362,129(2)	389,651	7,952	397,603(2)
Derivative assets at fair value	5,803		5,803(2)	6,589		6,589(2)
Guaranty assets and buy-ups	7,629	3,077	10,706(2)(3)	6,616	2,647	9,263(2)(3)
Total financial assets	799,524	2,763	802,287	989,590	10,730	1,000,320
Other assets	34,644	(861)	33,783(4)(5)	31,344	(23)	31,321(4)(5)
Total assets	$ 834,168	$ 1,902	$ 836,070(6)	$ 1,020,934	$ 10,707	$ 1,031,641(6)
Liabilities:						
Federal funds purchased and securities sold under agreements to repurchase	$ 705	$	$ 705(2)	$ 2,400	$ (1)	$ 2,399(2)
Short-term debt	173,186	(209)	172,977(2)	320,280	(567)	319,713(2)
Long-term debt	590,824	5,978	596,802(2)	632,831	15,445	648,276(2)
Derivative liabilities at fair value	1,429		1,429(2)	1,145		1,145(2)
Guaranty obligations	10,016	(4,848)	5,168(2)	8,784	(3,512)	5,272(2)
Total financial liabilities	776,160	921	777,081	965,440	11,365	976,805
Other liabilities	18,585	(1,916)	16,669(5)(7)	16,516	(1,850)	14,666(5)(7)
Total liabilities	794,745	(995)	793,750(8)	981,956	9,515	991,471(8)
	121		121	76		76

Minority interests in consolidated subsidiaries												
Net assets, net of tax effect (non-GAAP)	$	39,302	$	2,897	$	42,199(9)	$	38,902	$	1,192	$	40,094(9)
Fair value adjustments						(2,897)						(1,192)
Total stockholders equity (GAAP)					$	39,302					$	38,902

Explanation and Reconciliation of Non-GAAP Measures to GAAP Measures

(1) Each of the amounts listed as a fair value adjustment represents the difference between the carrying value reported in our GAAP consolidated balance sheets and our best judgment of the estimated fair value of the listed asset or liability.

(2) The estimated fair value of each of these financial instruments has been computed in accordance with the GAAP fair value guidelines prescribed by SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (SFAS 107), as described in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments. In Note 18, we also discuss the methodologies and assumptions we use in estimating the fair value of our financial instruments.

(3) Represents the estimated fair value produced by combining the estimated fair value of our guaranty assets as of December 31, 2005 and 2004, respectively, with the estimated fair value of buy-ups. In our GAAP consolidated balance sheets, we report our guaranty assets as a separate line item and include all buy-ups associated with our guaranty assets in Other assets. As a result, the GAAP carrying value of our guaranty assets reflects only those arrangements entered into subsequent to our adoption of FIN 45 on January 1, 2003. On a GAAP basis, our guaranty assets totaled $6.8 billion and $5.9 billion as of December 31, 2005 and 2004, respectively, and the associated buy-ups totaled $781 million and $692 million as of December 31, 2005 and 2004, respectively.

(4) In addition to the $9.1 billion and $7.1 billion of assets included in Other assets in the GAAP consolidated balance sheets as of December 31, 2005 and 2004, respectively, the assets included in the estimated fair value of our non-

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GAAP other assets consist primarily of the assets presented on five line items in our GAAP consolidated balance sheets, consisting of advances to lenders, accrued interest receivable, partnership investments, acquired property, net, and deferred tax assets, which together totaled $26.4 billion and $24.9 billion as of December 31, 2005 and 2004, respectively, in both the GAAP consolidated balance sheets and the non-GAAP supplemental consolidated balance sheets. In addition, we deduct the carrying value of the buy-ups associated with our guaranty obligation from our GAAP other assets because we combine the guaranty asset with the associated buy-ups when we determine the fair value of the asset.

(5) Other assets and Other liabilities are reflected in each of the non-GAAP fair value balance sheets at their GAAP carrying values. With the exception of partnership investments and partnership liabilities, the GAAP carrying values of these other assets and other liabilities generally approximate fair value. The fair values of partnership investments and partnership liabilities are generally different from their GAAP carrying values, potentially materially. We have included partnership investments and partnership liabilities at their carrying value in each of the non-GAAP fair value balance sheets. We assume that other deferred assets and liabilities, consisting of prepaid expenses and deferred charges such as deferred debt issuance costs, have no fair value. We adjust the GAAP-basis deferred income taxes for purposes of each of our non-GAAP supplemental consolidated fair value balance sheets to include estimated income taxes on the difference between our non-GAAP supplemental consolidated fair value balance sheets net assets, including deferred taxes from the GAAP consolidated balance sheets, and our GAAP consolidated balance sheets stockholders equity. Because our adjusted deferred income taxes are a net asset in each year, the amounts are included in our non-GAAP fair value balance sheets as a component of other assets.

(6) Non-GAAP total assets represent the sum of the estimated fair value of (i) all financial instruments carried at fair value in our GAAP balance sheets, including all financial instruments that are not carried at fair value in our GAAP balance sheets but that are reported at fair value in accordance with SFAS 107 in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments, (ii) non-GAAP other assets, which include all items listed in footnote 4 that are presented as separate line items in our GAAP consolidated balance sheets rather than being included in our GAAP other assets and (iii) the estimated fair value of credit enhancements, which are not included in Other assets in the consolidated balance sheets.

(7) In addition to the $8.1 billion and $7.2 billion of liabilities included in Other liabilities in the GAAP consolidated balance sheets as of December 31, 2005 and 2004, respectively, the liabilities included in the estimated fair value of our non-GAAP other liabilities consist primarily of the liabilities presented on three line items on our GAAP consolidated balance sheets, consisting of accrued interest payable, reserve for guaranty losses and partnership liabilities, which together totaled $10.5 billion and $9.3 billion as of December 31, 2005 and 2004. As indicated above in footnote 5, these items are reported in our non-GAAP fair value balance sheets at their GAAP carrying values.

(8) Non-GAAP total liabilities represent the sum of the estimated fair value of (i) all financial instruments that are carried at fair value in our GAAP balance sheets, including those financial instruments that are not carried at fair value in our GAAP balance sheets but that are reported at fair value in accordance with SFAS 107 in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments, and (ii) non-GAAP other liabilities, which include all items listed in footnote 7 that are presented as separate line items in our GAAP consolidated balance sheets rather than being included in our GAAP other liabilities.

(9) Represents the estimated fair value of total assets less the estimated fair value of total liabilities, which reconciles to total stockholders equity (GAAP).

Key Drivers of Changes in the Estimated Fair Value of Net Assets (Non-GAAP)

We expect periodic fluctuations in the estimated fair value of our net assets due to our business activities, as well as due to changes in market conditions, including changes in interest rates, changes in relative spreads between our mortgage assets and debt, and changes in implied volatility. Following is a discussion of the effects these market conditions generally have on the fair value of our net assets and the factors we consider to be the principal drivers of changes in the estimated fair value of our net assets. We also disclose the sensitivity of the estimated fair value of our net assets to changes in interest rates in Risk Management Interest Rate Risk Management and Other Market Risks.

Capital Transactions, Net. Capital transactions include our issuances of common and preferred stock, our repurchases of stock and our payment of dividends. Cash we receive from the issuance of preferred and common stock results in an increase in the fair value of our net assets, while repurchases of stock and dividends we pay on our stock reduce the fair value of our net assets.

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Estimated Net Interest Income from OAS. OAS income represents the estimated net interest income generated during the current period that is attributable to the market spread between the yields on our mortgage-related assets and the yields on our debt during the period, calculated on an option-adjusted basis.

Guaranty Fees, Net. Guaranty fees, net, represent the net cash receipts during the reported period related to our guaranty business, and are generally calculated as the difference between the contractual guaranty fees we receive during the period and the expenses we incur during the period that are associated with our guaranty business. Changes in guaranty fees, net, result from changes in portfolio size and composition, changes in the credit quality of the underlying assets and changes in the market spreads for similar instruments.

Fee and Other Income and Other Expenses, Net. Fee and other income includes miscellaneous fees, such as resecuritization transaction fees and technology-related fees. Other expenses primarily include costs incurred during the period that are associated with the Capital Markets group.

Return on Risk Positions. Our investment activities expose us to market risks, including duration and convexity risks, yield curve risk, OAS risk and volatility risk. The return on risk positions represents the estimated net increase or decrease in the fair value of our net assets resulting from net exposures related to the market risks we actively manage. We actively manage, or hedge, interest rate risk related to our mortgage investments in order to maintain our interest rate risk exposure within prescribed limits. However, we do not actively manage certain other market risks. Specifically, we do not actively manage the mortgage-to-debt OAS or interest rate risk related to our guaranty business, as discussed below. Additional information about credit, market and operational risks and our strategies for managing these types of risks is included in Risk Management.

Mortgage-to-debt OAS. Funding mortgage investments with debt exposes us to mortgage-to-debt OAS risk, which represents basis risk. Basis risk is the risk that interest rates in different market sectors will not move in the same direction or amount at the same time. We generally hold our mortgage investments to generate a spread over our debt on a long-term basis. The fair value of our assets and liabilities can be significantly affected by periodic changes in the net OAS between the mortgage and agency debt sectors. The fair value impact of changes in mortgage-to-debt OAS for a given period represents an estimate of the net unrealized increase or decrease in the fair value of our net assets resulting from fluctuations during the reported period in the net OAS between our mortgage assets and our outstanding debt securities. When the mortgage-to-debt OAS on a given mortgage asset increases, or widens, the fair value of the asset will typically decline relative to the debt. The level of OAS and changes in OAS are model-dependent and differ among market participants depending on the prepayment and interest rate models used to measure OAS.

We work to manage the OAS risk that exists at the time we purchase mortgage assets through our asset selection process. We use our proprietary models to evaluate mortgage assets on the basis of yield-to-maturity, option-adjusted yield spread, historical valuations and embedded options. Our models also take into account risk factors such as credit quality, price volatility and prepayment experience. We purchase mortgage assets that appear economically attractive to us in the context of current market conditions and that fall within our OAS targets. Although a widening of mortgage-to-debt OAS during a period generally results in lower fair values of the mortgage assets relative to the debt during that period, it can provide us with better investment opportunities to purchase mortgage assets because a wider OAS is indicative of higher expected returns. We generally purchase mortgage assets when mortgage-to-debt OAS is relatively wide and restrict our purchase activity or sell mortgage assets when mortgage-to-debt OAS is relatively narrow. We do not, however, attempt to actively manage or hedge the impact of changes in mortgage-to-debt OAS after we purchase mortgage assets, other than through asset monitoring and disposition.

Change in the Fair Value of our Net Guaranty Assets. As described more fully in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments, we calculate the estimated fair value of our existing guaranty business based on the difference between the estimated fair value of the guaranty fees we expect to receive and the estimated fair value of the guaranty obligations we assume. The fair value of both our guaranty assets and our guaranty obligations is highly sensitive to changes in interest rates and credit quality. Changes in interest rates can result in significant periodic fluctuations in the fair value of our net assets. For example, as interest rates decline, the expected prepayment rate on fixed-rate mortgages increases, which lowers the fair value of our existing guaranty business. We do not believe, however, that periodic changes in fair value are the best indication of the long-term value of our guaranty business because they do not take into account future guaranty business activity. Based on our historical experience, we expect that the guaranty fee income generated from future business activity will largely replace any guaranty fee income lost as a result of mortgage prepayments. Accordingly, we do not actively manage or hedge expected changes in the fair value of our net guaranty assets related to changes in interest rates. To assess the value of our underlying guaranty business, we focus primarily on changes in the fair value of our net guaranty assets resulting from business growth, changes in the credit quality of existing guaranty arrangements and changes in anticipated future credit performance.

Market Drivers of Changes in Fair Value

Selected relevant market information is shown below in Table 18. Our goal is to minimize the risk associated with changes in interest rates for our investments in mortgage assets. Accordingly, we do not expect changes in interest rates to have a significant impact on the fair value of our net mortgage assets. The market conditions that we expect to have the most significant impact on the fair value of our net assets include changes in implied volatility and relative changes between mortgage OAS and debt OAS. A decrease in implied volatility generally increases the estimated fair value of our mortgage assets and decreases the estimated fair value of our debt and derivatives, while an increase in implied volatility generally has the opposite effect. A tighter, or lower, mortgage OAS generally increases the estimated fair value of our mortgage assets, and a tighter debt OAS generally increases the fair value of our liabilities. Changes in interest rates, however, may have a significant impact on our guaranty business because we do not actively manage or hedge expected changes in the fair value of our net guaranty assets related to changes in interest rates. We have included the Lehman U.S. MBS Index OAS over the U.S. Treasury yield curve and over the LIBOR yield curve for each of 2004 and 2005. Mortgage market participants have generally moved from a Treasury basis to a LIBOR basis as the preferred way for measuring mortgage OAS. We use OAS to LIBOR as our primary basis for measuring both mortgage OAS and debt OAS.

Table 18: Selected Market Information[1]

	As of December 31,			Change	
	2005	2004	2003	2005 vs. 2004	2004 vs. 2003
10-year U.S. Treasury note yield	4.39%	4.22%	4.25%	0.17%	(0.03)%
Implied volatility[2]	19.5%	20.1%	22.9%	(0.6)%	(2.8)%
30-year Fannie Mae MBS par coupon rate	5.75%	5.21%	5.28%	0.54%	(0.07)%
Lehman U.S. MBS Index OAS (in basis points) over LIBOR yield curve	4.2bp	(11.5)bp	(3)	15.7bp	(3)
Lehman U.S. MBS Index OAS (in basis points) over U.S. Treasury yield curve	54.5bp	22.5bp	27.6bp	32.0bp	(5.1)bp
Lehman U.S. Agency Debt Index OAS (in basis points) over LIBOR yield curve	(11.0)bp	(6.3)bp	(3)	(4.7)bp	(3)
	35.5bp	32.2bp	36.9bp	3.3bp	(4.7)bp

Lehman U.S. Agency Debt Index OAS (in basis points) over U.S. Treasury yield curve

(1) Information obtained from Lehman Live and Bloomberg.

(2) Implied volatility for an interest rate swaption with a 3-year option on a 10-year final maturity.

(3) Not available.

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Changes in Non-GAAP Estimated Fair Value of Net Assets

The following table summarizes the change in the fair value of our net assets, as adjusted for capital transactions, for each of 2005 and 2004.

Table 19: Non-GAAP Estimated Fair Value of Net Assets (Net of Tax Effect)

	2005	2004
Balance as of January 1	$ 40,094	$ 28,393
Capital transactions:[1]		
Common dividends, share repurchases and issuances, net	(943)	(2,165)
Preferred dividends and share issuances, net	(486)	4,760
Capital transactions, net	(1,429)	2,595
Change in estimated fair value of net assets, net of capital transactions	3,534	9,106
Total change in estimated fair value of net assets	2,105	11,701
Balance as of December 31[2]	$ 42,199	$ 40,094

(1) Represents net capital transactions, which are reflected in the Consolidated Statements of Changes in Stockholders Equity.

(2) Represents estimated fair value of net assets (net of tax effect) presented in Table 17: Non-GAAP Supplemental Consolidated Fair Value Balance Sheets.

Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

As indicated above in Table 19, the estimated fair value of our net assets (net of tax effect) as of December 31, 2005 was $42.2 billion, an increase of $2.1 billion, or 5%, from December 31, 2004. The $2.1 billion increase in 2005 included the effect of the payment of $1.4 billion of dividends to holders of our common and preferred stock. The estimated fair value of our net guaranty assets increased by approximately $1.5 billion. This increase in fair value is primarily due to higher interest rates and improvements in the credit quality of our book of business in 2005, which was driven primarily by the increase in home prices during the year. As displayed in Table 18 above, the 30-year Fannie Mae MBS par coupon rate and the 10-year U.S. Treasury note yield increased in 2005, which slowed the rate of expected prepayments and increased the fair value of our net guaranty assets.

As also indicated in Table 18, mortgage OAS based on the Lehman U.S. MBS Index to LIBOR increased by 15.7 basis points from minus 11.5 basis points as of year-end 2004, to 4.2 basis points as of year-end 2005. Debt OAS based on the Lehman U.S. Agency Debt Index to LIBOR decreased by 4.7 basis points from minus 6.3 basis points as of year-end 2004, to minus 11.0 basis points as of year-end 2005. This net increase in mortgage to debt OAS, a slight decline in interest rates and the flattening of the yield curve resulted in a decline in the fair value of our net mortgage assets. More than offsetting this decline were the cash inflows from our net mortgage assets and a slight decrease in implied volatility.

Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

The estimated fair value of our net assets (net of tax effect) increased by $11.7 billion, or 41%, to $40.1 billion as of December 31, 2004 from the prior year end. Of the total $11.7 billion increase in 2004, approximately $2.8 billion was attributable to capital transactions, consisting primarily of $5.0 billion of gross proceeds we received from a preferred stock offering in 2004, partially offset by the payment of $2.2 billion of dividends to holders of our common and preferred stock. Net cash inflows generated by our Single-Family, HCD and Capital Markets businesses also contributed to the increase in fair value of our net assets (non-GAAP) in 2004. The remainder of the increase of $9.1 billion in 2004 was largely attributable to changes in market conditions, primarily related to an increase in implied volatility, as explained below.

Also as indicated in Table 18, implied volatility decreased considerably during 2004 compared to 2003. For example, the implied volatility of 3-year swaptions on 10-year underlying instruments declined by 280 basis points, to 20.1% as of December 31, 2004 from 22.9% as of December 31, 2003. As shown in Table 17, this decrease in implied volatility had the effect of increasing the estimated fair value of our mortgage assets more than it increased the estimated fair value of our debt and derivatives funding of those assets as shown above in Table 17. Changes in OAS had less of an impact on the fair value of our net assets over this period. According to the Lehman U.S. MBS Index, the OAS of mortgages to the U.S. Treasury yield curve decreased by 5.1 basis points to 22.5 basis points as of December 31, 2004, which contributed to an increase in the fair value of our mortgage assets. The OAS on debt securities included in the Lehman U.S. Agency Debt Index decreased by 4.7 basis points to 32.2 basis points as of December 31, 2004, which contributed to an increase in the fair value of our debt.

RISK MANAGEMENT

Overview

Our businesses expose us to the following four major categories of risk:

Credit Risk. Credit risk is the risk of financial loss resulting from the failure of a borrower or institutional counterparty to honor its contractual obligations to us and exists primarily in our mortgage credit book of business and derivatives portfolio.

Market Risk. Market risk represents the exposure to potential changes in the market value of our net assets from changes in prevailing market conditions. A significant market risk we face and actively manage is interest rate risk the risk of changes in our long-term earnings or in the value of our net assets due to changes in interest rates.

Operational Risk. Operational risk relates to the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events.

Liquidity Risk. Liquidity risk is the risk to our earnings and capital arising from an inability to meet our cash obligations in a timely manner.

We also are subject to a number of other risks that could adversely impact our business, financial condition, results of operations and cash flows, including legal and reputational risks that may arise due to a failure to comply with laws, regulations or ethical standards and codes of conduct applicable to our business activities and functions.

Effective management of risks is an integral part of our business and critical to our safety and soundness. In the following sections, we provide an overview of our corporate risk governance structure and risk management processes, which are intended to identify, measure, monitor and control the principal risks we assume in conducting our business activities in accordance with defined policies and procedures. Following the overview, we provide additional information on how we manage each of our four major categories of risk. In Item 1A Risk Factors, we identify other risk factors that may adversely affect our business.

Risk Governance Structure

We made significant organizational changes in 2005 and 2006 to enhance our risk governance structure and strengthen our internal controls due to identified material weaknesses. During 2005, we adopted an enhanced corporate risk framework to address weaknesses in our risk governance structure. This new framework is intended to ensure that people and processes are organized in a way that promotes a cross-functional approach to risk management and controls are in place to better manage our risks. Basic tenets of our corporate risk framework include establishing corporate-wide policies for risk management, delegating to business units primary responsibility for the management of the day-to-day risks inherent in the activities of the business unit, and monitoring aggregate risks and compliance with risk policies at a corporate level.

Our corporate risk framework is supported by a governance structure encompassing the Board of Directors, an independent corporate risk oversight organization, business units, management-level risk committees and

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Internal Audit. As we continue in our efforts to build out our risk oversight organization, we are establishing clear lines of authority, clarifying roles and responsibilities, and enacting policies and procedures designed to ensure that we have an independent risk oversight function with appropriate checks and balances throughout our company.

Risk Policy and Capital Committee of the Board of Directors

The Board of Directors is responsible for approving our risk governance framework and providing capital and risk management oversight. The Board exercises its oversight of credit risk, market risk, operational risk and liquidity risk primarily through the Board s Risk Policy and Capital Committee. The responsibilities of the Risk Policy and Capital Committee include:

- recommending for Board approval enterprise risk governance policy and limits consistent with our mission, safety and soundness;
- overseeing the development of policies and procedures designed to: (i) define, measure, identify and report on credit, market, liquidity and operational risk; and (ii) establish and communicate risk management controls throughout the company;
- overseeing compliance with all enterprise-wide risk management policies;
- overseeing the Chief Risk Office; and
- reviewing the sufficiency of personnel, systems and other risk management capabilities.

In 2006, the Board of Directors adopted corporate risk principles that are being implemented to govern our risk activities. These principles include taking risks in an informed and disciplined manner and ensuring that we are adequately compensated for the risks we take, consistent with our mission goals.

Chief Risk Office

The Chief Risk Office is an independent risk oversight organization with responsibility for oversight of credit risk, market risk and operational risk. The Chief Risk Office is headed by a Chief Risk Officer who reports directly to the Chief Executive Officer and independently to the Risk Policy and Capital Committee of the Board of Directors. The Chief Risk Office and the position of Chief Risk Officer were established in 2005. The Chief Risk Office is responsible for formulating corporate risk policies and monitoring the company s aggregate risk profile. The Chief Risk Office works closely with our business units to ensure they have in place the structure and information systems necessary to adequately identify, measure, report, monitor and control their key business risks, consistent with corporate standards. The Chief Risk Office also is responsible for validation of risk models and for developing and implementing an economic risk capital framework.

The Chief Risk Officer is responsible for establishing our overall risk governance structure and providing independent evaluation and oversight of our risk management activities. In addition to directing the Chief Risk Office, the Chief Risk Officer oversees our management-level corporate risk committees. The Chief Risk Officer reports on a regular basis to our Board of Directors regarding our corporate risk profile, including our aggregate risk exposure, the level of risk by type of risk, performance relative to risk limits and any significant risk management issues. The Chief Risk Officer also reports to the Board of Directors annually on management s adherence to our corporate risk principles.

Risk Management Committees

At the end of 2006, we restructured our risk management committees to enhance our risk governance framework. We dissolved the Corporate Risk Management Committee, which had previously focused on both credit and market risk oversight, and formed two separate committees, the Credit Risk Committee and the Market Risk Committee. We now have three management-level risk committees that focus on our major categories of risk: (i) the Credit Risk Committee, which focuses on credit risk; (ii) the Market Risk

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Committee, which focuses on market, liquidity and model risk; and (iii) the Operational Risk Committee, which focuses on operational risk. Each committee is responsible for, among other things:

- monitoring aggregated risk exposure;
- discussing emerging risk issues;
- reviewing key corporate risk limits and exposures;
- reviewing the risk aspects of significant new business initiatives; and
- reviewing and recommending risk policies with corporate-wide or significant business unit implications.

We also established two additional management-level risk committees that focus on other significant business risks: (i) the Capital Structure Committee, which focuses on capital management activities; and (ii) the Compliance Coordination Committee, which focuses on compliance with legal and regulatory requirements. Our Compliance Coordination Committee also is responsible for coordinating the legal and regulatory compliance risk governance functions with other control functions, such as Legal, Internal Audit and the Chief Risk Office.

The Management Executive Committee, which is chaired by the Chief Executive Officer and composed of principal executive officers of the company, has responsibility for reviewing and approving our enterprise-wide risk tolerance policy and our enterprise-wide risk framework, addressing issues referred to it by our risk committees, addressing matters that involve multiple types of risks and addressing other significant business and reputational risks. Where appropriate, the Management Executive Committee brings transactions of an extraordinary nature and significant potential new business activities to the Risk Policy and Capital Committee of the Board of Directors, as well as other relevant committees if necessary, for review and approval.

Business Units

Business unit managers execute company-wide risk policies set by the Chief Risk Officer, develop risk management strategies for their specific businesses, and establish and implement risk management policies and practices within their businesses. Each business unit is responsible for identifying, measuring and managing key credit risks within its business. In addition, each business unit has business unit risk managers who are responsible for ensuring that there are clear delineations of responsibility for managing credit risk, adequate systems for measuring credit risk, appropriately structured limits on risk taking, effective internal controls and a comprehensive risk reporting process. As part of our risk governance structure, we have established within each business unit risk committees that are responsible for decisions relating to risk strategy, policies and controls.

Internal Audit

Our Internal Audit group, under the direction of the Chief Audit Executive, provides an objective assessment of the design and execution of our internal control system, including our management systems, risk governance, and policies and procedures. The Chief Audit Executive reports directly and independently to the Audit Committee of the Board of Directors, and audit personnel are compensated on objectives set for the group by the Audit Committee rather than corporate financial results or goals. The Chief Audit Executive operates independently of management and may be removed only upon Board approval. Internal Audit activities are designed to provide reasonable assurance that resources are safeguarded; that significant financial, managerial and operating information is complete, accurate and reliable; and that employee actions comply with our policies and applicable laws and regulations.

Office of Compliance and Ethics

Our Office of Compliance and Ethics, under the direction of the Chief Compliance Officer, is responsible for developing and carrying out corporate policies related to compliance, ethics and investigations. The Office of Compliance and Ethics and the position of Chief Compliance Officer were established in 2005. The Chief Compliance Officer reports directly to the Chief Executive Officer and independently to the Compliance

Committee of the Board of Directors. Office of Compliance and Ethics personnel are compensated on objectives set for the group by the Compliance Committee of the Board of Directors rather than corporate financial results or goals. The Chief Compliance Officer operates independently of management and may be removed only upon Board approval. The Chief Compliance Officer is responsible for overseeing our compliance activities; developing and promoting a code of ethical conduct; evaluating and investigating any allegations of misconduct; and overseeing and coordinating our OFHEO and HUD regulatory reporting and examinations.

Credit Risk Management

We assess, price and assume mortgage credit risk as a basic component of our business. We assume institutional counterparty credit risk in a variety of our business transactions, including transactions designed to mitigate mortgage credit risk and interest rate risk. The degree of credit risk to which we are exposed will vary based on many factors, including the risk profile of the borrower or counterparty, the contractual terms of the agreement, the amount of the transaction, repayment sources, the availability and quality of collateral and other factors relevant to current events, conditions and expectations. We evaluate these factors and actively manage, on an aggregate basis, the extent and nature of the credit risk we bear, with the objective of ensuring that we are adequately compensated for the credit risk we take, consistent with our mission goals.

Our Single-Family Credit Guaranty and HCD businesses are responsible for identifying, measuring, monitoring and managing credit risk subject to corporate risk policies and limits approved by the Chief Risk Office, which provides corporate oversight of the credit risk management process. The Credit Risk Committee, which focuses on credit risk, meets at least monthly to review our aggregate credit risk profile and monitor our exposure relative to credit risk limits.

Our credit-related losses during the period 2003 to 2005 reflect the high credit quality of our mortgage credit book of business, resulting from the effect of a combination of several factors, including strong home price appreciation during the period, the benefits we receive from credit enhancements and other risk-sharing strategies, and our loss mitigation efforts. Our credit-related losses during this period remained at what we consider to be low levels, not exceeding 0.02% of our mortgage credit book of business during any given year. Because the rapid acceleration of home prices during the period from 1999 to 2005 was a significant factor in helping to mitigate our credit losses over the past several years, we expect our credit losses to increase as a result of the significant slowdown in home price appreciation during 2006 and our belief that home prices could decline modestly in 2007.

Mortgage Credit Risk Management

Mortgage credit risk is the risk that a borrower will fail to make required mortgage payments. We are exposed to credit risk on our mortgage credit book of business because we either hold the mortgage assets or have issued a guaranty in connection with the creation of Fannie Mae MBS backed by mortgage assets. Our mortgage credit book of business consists of both on- and off-balance sheet arrangements, including single-family and multifamily mortgage loans held in our portfolio; Fannie Mae MBS and non-Fannie Mae mortgage-related securities held in our portfolio; Fannie Mae MBS held by third- party investors; and credit enhancements that we provide on mortgage assets. We provide additional information regarding our off-balance sheet arrangements in Off-Balance Sheet Arrangements and Variable Interest Entities below.

Factors affecting credit risk on loans in our single-family mortgage credit book of business include the borrower s financial strength and credit profile; the type of mortgage; the characteristics of the property and the value of the property securing the mortgage; and economic conditions, such as changes in home prices. Factors that affect credit risk on a multifamily loan include the structure of the financing; the type and location of the property; the condition and value of the property; the financial strength of the borrower and lender; market and sub-market trends and growth;

and the current and anticipated cash flows from the property. These and other factors affect both the amount of expected credit loss on a given loan and the sensitivity of that loss to changes in the economic environment.

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Table 20 displays the composition of our mortgage credit book of business as of December 31, 2005, 2004 and 2003. Our single-family mortgage credit book of business accounted for approximately 94% of our entire mortgage credit book of business as of December 31, 2005 and approximately 95% as of December 31, 2004 and 2003.

Table 20: Composition of Mortgage Credit Book of Business

	As of December 31, 2005					
	Single-Family		Multifamily		Total	
	Conventional(1)	Government(2)	Conventional(1)	Government(2)	Conventional(1)	Government(2)
	(Dollars in millions)					
Mortgage portfolio:(3)						
Mortgage loans(4)	$ 299,765	$ 15,036	$ 50,731	$ 1,148	$ 350,496	$ 16,184
Fannie Mae MBS(4)	232,574	1,001	404	472	232,978	1,473
Agency mortgage-related securities(4)(5)	28,604	2,380		57	28,604	2,437
Mortgage revenue bonds	4,000	3,965	8,375	2,462	12,375	6,427
Other mortgage-related securities(6)	85,698	1,174		43	85,698	1,217
Total mortgage portfolio	650,641	23,556	59,510	4,182	710,151	27,738
Fannie Mae MBS held by third parties(7)	1,523,043	23,734	50,345	1,796	1,573,388	25,530
Other(8)	3,291		15,718	143	19,009	143
Mortgage credit book of business	$ 2,176,975	$ 47,290	$ 125,573	$ 6,121	$ 2,302,548	$ 53,411

	As of December 31, 2004					
	Single-Family		Multifamily		Total	
	Conventional(1)	Government(2)	Conventional(1)	Government(2)	Conventional(1)	Government(2)
	(Dollars in millions)					
Mortgage portfolio:(3)						
Mortgage loans(4)	$ 345,575	$ 10,112	$ 43,396	$ 1,074	$ 388,971	$ 11,186
Fannie Mae MBS(4)	341,768	1,239	505	892	342,273	2,131
Agency mortgage-related securities(4)(5)	37,422	4,273		68	37,422	4,341
Mortgage revenue bonds	6,344	4,951	8,037	2,744	14,381	7,695
Other mortgage-related securities(6)	108,082	669	12	46	108,094	715
Total mortgage portfolio	839,191	21,244	51,950	4,824	891,141	26,068
Fannie Mae MBS held by third parties(7)	1,319,066	32,337	54,639	2,005	1,373,705	34,342

Other[8]	346		14,111	368	14,457	368
Mortgage credit book of business	$ 2,158,603	$ 53,581	$ 120,700	$ 7,197	$ 2,279,303	$ 60,778

	As of December 31, 2003					
	Single-Family		Multifamily		Total	
	Conventional[1]	Government[2]	Conventional[1]	Government[2]	Conventional[1]	Government[2]
	(Dollars in millions)					
Mortgage portfolio:[3]						
Mortgage loans[4]	$ 355,200	$ 7,284	$ 33,945	$ 1,204	$ 389,145	$ 8,488
Fannie Mae MBS[4]	402,079	1,933	412	1,498	402,491	3,431
Agency mortgage-related securities[4][5]	30,672	7,235		68	30,672	7,303
Mortgage revenue bonds	6,242	5,983	5,828	2,306	12,070	8,289
Other mortgage-related securities[6]	46,714	169	42	54	46,756	223
Total mortgage portfolio	840,907	22,604	40,227	5,130	881,134	27,734
Fannie Mae MBS held by third parties[7]	1,200,222	38,487	59,403	2,408	1,259,625	40,895
Other[8]	330		12,346	492	12,676	492
Total mortgage credit book of business	$ 2,041,459	$ 61,091	$ 111,976	$ 8,030	$ 2,153,435	$ 69,121

(1) Refers to mortgage loans and mortgage-related securities that are not guaranteed or insured by the U.S. government or any of its agencies.

(2) Refers to mortgage loans and mortgage-related securities guaranteed or insured by the U.S. government or one of its agencies.

(3) Mortgage portfolio data is reported based on unpaid principal balance.

(4) Mortgage loan data includes mortgage-related securities that were consolidated and reported in our consolidated balance sheets as loans of $113.3 billion, $152.7 billion and $162.5 billion as of December 31, 2005, 2004 and 2003, respectively.

(5) Includes mortgage-related securities issued by Freddie Mac and Ginnie Mae. We held mortgage-related securities issued by Freddie Mac totaling $28.7 billion as of December 31, 2005, which exceeded 10% of our stockholders equity as of that date.

(6) Includes mortgage-related securities issued by entities other than Fannie Mae, Freddie Mac or Ginnie Mae.

(7) Includes Fannie Mae MBS held by third-party investors. The principal balance of resecuritized Fannie Mae MBS is included only once.

(8) Includes additional single-family and multifamily credit enhancements that we provide not otherwise reflected in the table.

Our strategy in managing mortgage credit risk consists of three primary components: (1) acquisition policy and standards; (2) portfolio diversification and monitoring; and (3) credit loss management. We use various metrics to evaluate credit performance in our mortgage credit book of business. We estimate incurred credit losses inherent in our mortgage credit book of business as of each balance sheet date and maintain a combined balance of allowance for loan losses and reserve for guaranty losses at a level we believe reflects these losses.

Acquisition Policy and Standards

Single-Family

Our Single-Family business is responsible for pricing and managing credit risk relating to the portion of our single-family mortgage credit book of business consisting of single-family mortgage loans and Fannie Mae MBS backed by single-family mortgage loans (whether held in our portfolio or held by third parties). This portion of our business, for which we have access to more detailed loan-level information, represented approximately 94%, 92% and 95% of our total conventional single-family mortgage credit book of business as of December 31, 2005, 2004 and 2003, respectively. Unless otherwise noted, the credit statistics we provide relate only to this specific portion of our conventional single-family mortgage credit book.

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We have established underwriting guidelines for these loans that are intended to provide a comprehensive analysis of borrowers and mortgage loans based upon known risk characteristics. We also have policies and various quality assurance efforts to review a sample of loans to measure compliance with our underwriting and eligibility criteria. We assess the characteristics and quality of a lender s loans and processes through a post-purchase loan review program, on-site reviews of lender operations and regular comparisons of actual loan performance to expected performance.

Lenders generally represent and warrant compliance with our asset acquisition requirements when they sell mortgage loans to us or deliver mortgage loans in exchange for Fannie Mae MBS. We may require the lender to repurchase a loan or we may seek another remedy if we identify any underwriting or eligibility deficiencies. We have developed a proprietary automated underwriting system, Desktop Underwriter®, which measures default risk by assessing the primary risk factors of a mortgage, including the loan-to-value ratio, the borrower s credit profile, the type of mortgage, the loan purpose, and other mortgage and borrower characteristics. Subject to our review and approval, we also purchase and securitize mortgage loans that have been underwritten using other automated underwriting systems, as well as mortgage loans underwritten to agreed-upon standards that differ from our standard underwriting criteria.

The use of credit enhancements is an important part of our single-family acquisition policy and standards, although it also exposes us to institutional counterparty risk. Based on our current acquisition policy and standards, we may accept loans originated with loan-to-value ratios of up to 100%; however, from time to time, we may make an exception to these guidelines and acquire loans with a loan-to-value ratio greater than 100%. Our charter requires that conventional single-family mortgage loans that we purchase or that back Fannie Mae MBS with loan-to-value ratios above 80% at acquisition be covered by one or more of the following:

- primary mortgage insurance;
- a seller s agreement to repurchase or replace any mortgage loan in default (for such period and under such circumstances as we may require); or
- retention by the seller of at least a 10% participation interest in the mortgage loans.

Primary mortgage insurance is the most common type of credit enhancement in our mortgage credit book of business and is typically provided on a loan-level basis. Primary mortgage insurance, which is typically provided by one of eight mortgage insurance companies, transfers varying portions of the credit risk associated with a mortgage loan to a third-party insurer. As discussed below in Institutional Counterparty Credit Risk Management Mortgage Insurers , these insurers are subject to our eligibility requirements. The amount of insurance we obtain on any mortgage loan depends on our requirements, which depend on our assessment of risk. In addition to the credit enhancement required by our charter, we may require or obtain supplemental credit enhancement for some mortgage loans, typically those with higher credit risk. Our use of discretionary credit enhancements depends on our view of the inherent credit risk, the price of the credit enhancement, and our risk versus return objective. The percentage of our conventional single-family mortgage credit book of business with credit enhancement, including primary mortgage, pool mortgage insurance, lender recourse and shared risk, was 18%, 19% and 21% as of December 31, 2005, 2004 and 2003, respectively. The percentage of our conventional single-family mortgage credit book of business with credit enhancement has not changed significantly since the end of 2005.

The remaining portion of our conventional single-family mortgage credit book of business consists of non-Fannie Mae mortgage-related securities backed by single-family mortgage loans and credit enhancements that we provide on single-family mortgage assets. Non-Fannie Mae mortgage-related securities held in our portfolio include Freddie Mac securities, Ginnie Mae securities, private-label mortgage-related securities, Fannie Mae MBS backed by private-label mortgage-related securities, and housing-related municipal revenue bonds. Our Capital Markets group prices and manages credit risk related to this specific portion of our conventional single-family mortgage credit book. We may not have access to detailed loan-level data on these particular mortgage-related assets and therefore may not manage the credit performance of individual loans. However, a substantial majority of these securities benefit from significant forms of credit enhancement, including guarantees from Ginnie Mae or Freddie Mac, insurance policies, structured subordination and similar sources of credit protection. All non-Fannie Mae agency securities held in our portfolio as of December 31, 2006 were rated AAA/Aaa by Standard & Poor s and Moody s. Over 90% of non-agency mortgage-related securities held in our portfolio as of December 31, 2006 were rated AAA/Aaa by Standard & Poor s and Moody s.

Housing and Community Development

Our HCD business is responsible for managing the credit risk on multifamily mortgage loans we purchase and on Fannie Mae MBS backed by multifamily loans (whether held in our portfolio or held by third parties). HCD also makes equity investments in LIHTC limited partnerships that own an interest in rental housing that the partnerships have developed or rehabilitated. On a much smaller scale, our HCD business also makes investments in other rental or for-sale housing developments and provides loans and credit support to public entities and local banks to support affordable housing and community development. We have established credit and underwriting guidelines for these transactions. While the underwriting of single-family loans primarily focuses on an evaluation of the borrower s ability to repay the loan, the underwriting of multifamily loans focuses primarily on an evaluation of expected cash flows from the property for repayment. Our multifamily guidelines require a comprehensive analysis of the property value, the LTV ratio, the local market, the borrower and its investment in the property, the property s historical and projected financial performance, the property s physical condition and third-party reports, including appraisals and engineering and environmental reports. For multifamily equity investments, we also evaluate the strength of our investment sponsors and third-party asset managers.

Multifamily loans we purchase or that back Fannie Mae MBS are either underwritten by a Fannie Mae-approved lender or subject to our underwriting review prior to closing. Many of our agreements delegate the underwriting decisions to the lender, principally through our Delegated Underwriting and Servicing, or DUS™, program. Loans delivered to us by DUS lenders represented approximately 87% and 89% of our multifamily mortgage credit book of business as of December 31, 2005 and 2004, respectively. Lenders represent and warrant compliance with our underwriting requirements when they sell us mortgage loans, when they request securitization of their loans into Fannie Mae MBS or when they request that we provide credit enhancement in connection with an affordable housing bond transaction. In addition, we use proprietary models and analytical tools to price and measure credit risk at acquisition. After closing, we conduct a post-purchase review of certain loans based on the product type or risk profile of the loan, the lender s historical underwriting practices, the market and submarket conditions. If non-compliance issues are revealed during the review process, we may take a variety of actions, including increasing the lender credit loss sharing or requiring a lender to repurchase a loan, depending on the severity of the issues identified.

The use of credit enhancements is also an important part of our multifamily acquisition policy and standards. We use a variety of credit enhancement vehicles including lender risk sharing, lender repurchase agreements, pool insurance, subordinated participations in mortgage loans or structured pools, cash and letter of credit collateral agreements, and cross-collateralization/cross-default provisions. The most prevalent form of credit enhancement is lender risk sharing. Lenders in the DUS program typically share in loan-level credit losses in one of two ways. Generally, they either bear losses up to the first 5% of unpaid principal balance of the loan and share in remaining losses up to a prescribed limit, or they agree to share with us up to one-third of the credit losses on an equal basis. The percentage of our multifamily credit book of business with credit enhancement was 95% as of December 31, 2005, 2004 and 2003.

Portfolio Diversification and Monitoring

Single-Family

Our single-family mortgage credit book of business is diversified based on several factors that influence credit quality. We continually review the credit quality of our single-family mortgage credit book of business with a focus on a variety of mortgage loan risk factors, including loan-to-value ratios, loan product type, property type, occupancy type, credit score, loan purpose, property location and age of loan. Table 21 presents our conventional single-family mortgage credit book of business as of December 31, 2005, 2004 and 2003, based on the key risk characteristics that we monitor closely to assess the sensitivity of our credit losses to economic changes. Table 22 presents our conventional single-family business volumes for 2005, 2004 and 2003 based on these risk characteristics. We typically obtain the data for these statistics from the sellers or servicers of the mortgage loans and receive representations and warranties as to the accuracy of the information. While we perform various quality assurance checks by sampling loans to assess compliance with our underwriting and eligibility criteria, we do not independently verify all reported information. As noted above, we generally have access to detailed loan-level statistics only on conventional single-family mortgage loans held in our portfolio and backing Fannie MBS (whether held in our portfolio or held by third parties).

Table 21: Risk Characteristics of Conventional Single-Family Mortgage Credit Book

	Percent of Book of Business[1] As of December 31,		
	2005	**2004**	**2003**
Original loan-to-value ratio:[2]			
<= 60.00	26%	26%	26%
60.01% to 70.00%	17	17	17
70.01% to 80.00%	41	40	39
80.01% to 90.00%	8	9	10
90.01% to 100.0%	8	8	8
Greater than 100%			
Total	100%	100%	100%
Weighted average	70%	70%	70%
Estimated mark-to-market loan-to-value ratio:[2]			
<= 60.00	60%	53%	43%
60.01% to 70.00%	17	20	22
70.01% to 80.00%	16	18	24
80.01% to 90.00%	5	6	8
90.01% to 100.0%	2	3	3
Greater than 100%			
Total	100%	100%	100%
Weighted average	53%	57%	60%
Average loan amount	$ 129,657	$ 125,812	$ 122,901
Product type:[3]			
Fixed-rate:			
Long-term	65%	64%	64%
Intermediate-term	21	24	27
Interest-only			
Total fixed-rate	86	88	91
Adjustable-rate:			
Interest-only	4	2	1
Negative-amortizing	2	1	1

Other ARMs	8	9	7
Total adjustable-rate	14	12	9
Total	100%	100%	100%
Number of property units:			
1 unit	96%	96%	96%
2-4 units	4	4	4
Total	100%	100%	100%
Property type:			
Single-family homes	92%	93%	93%
Condo/Co-op	8	7	7
Total	100%	100%	100%

	Percent of Book of Business[1] As of December 31,		
	2005	2004	2003
Occupancy type:			
Primary residence	91%	92%	92%
Second/vacation home	4	3	3
Investor	5	5	5
Total	100%	100%	100%
Credit score:			
< 620	5%	5%	5%
620 to < 660	10	11	11
660 to < 700	18	18	18
700 to < 740	23	23	23
>= 740	43	41	40
Not available	1	2	3
Total	100%	100%	100%
Weighted average	721	719	717
Loan purpose:			
Purchase	34%	31%	28%
Cash-out refinance	31	30	30
Other refinance	35	39	42
Total	100%	100%	100%
Geographic concentration:[4]			
Midwest	17%	17%	17%
Northeast	19	19	18
Southeast	23	22	22
Southwest	16	16	16
West	25	26	27
Total	100%	100%	100%
Origination year:			
<= 1995	2%	2%	5%
1996			1
1997		1	1
1998	2	2	3
1999	1	2	2
2000	1	1	1
2001	4	6	9
2002	12	17	25
2003	36	46	53

2004	21	23	
2005	21		
Total	100%	100%	100%

(1) Percentages calculated based on unpaid principal balance of loans as of the end of each period.
(2) Excludes loans for which this information is not readily available. The methodology used to estimate the mark-to-market loan-to-value ratio was implemented in 2004.
(3) Long-term fixed-rate consists of mortgage loans with contractual maturities greater than 15 years. Intermediate-term fixed-rate consists of mortgage loans with contractual maturities equal to or less than 15 years.
(4) Midwest includes IL, IN, IA, MI, MN, NE, ND, OH, SD and WI. Northeast includes CT, DE, ME, MA, NH, NJ, NY, PA, PR, RI, VT and VI. Southeast includes AL, DC, FL, GA, KY, MD, MS, NC, SC, TN, VA and WV. Southwest includes AZ, AR, CO, KS, LA, MO, NM, OK, TX and UT. West includes AK, CA, GU, HI, ID, MT, NV, OR, WA and WY.

Table 22: Risk Characteristics of Conventional Single-Family Mortgage Business Volume

	Percent of Business Volume[1] For the Year Ended December 31, 2005	2004	2003
Original loan-to-value ratio:			
<= 60.00	22%	23%	29%
60.01% to 70.00%	16	16	18
70.01% to 80.00%	46	43	38
80.01% to 90.00%	7	8	8
90.01% to 100.0%	9	10	7
Greater than 100%			
Total	100%	100%	100%
Weighted average	72%	71%	68%
Average loan amount	$ 171,761	$ 158,759	$ 153,461
Product type:[2]			
Fixed-rate:			
Long-term	69%	62%	63%
Intermediate-term	9	16	27
Interest-only	1		
Total fixed-rate	79	78	90
Adjustable-rate:			
Interest-only	9	5	1
Negative-amortizing	3	2	1
Other ARMs	9	15	8
Total adjustable-rate	21	22	10
Total	100%	100%	100%
Number of property units:			
1 unit	96%	96%	96%
2-4 units	4	4	4
Total	100%	100%	100%
Property type:			
Single-family detached	90%	91%	93%
Condo/Co-op	10	9	7
Total	100%	100%	100%

Occupancy type:			
Primary residence	89%	91%	93%
Second/vacation home	5	4	3
Investor	6	5	4
Total	100%	100%	100%

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	Percent of Business Volume[1] For the Year Ended December 31,		
	2005	2004	2003
Credit score:			
< 620	5%	6%	4%
620 to < 660	11	12	10
660 to < 700	19	19	18
700 to < 740	23	24	24
>= 740	42	39	44
Not available			
Total	100%	100%	100%
Weighted average	719	715	721
Loan purpose:			
Purchase	47%	43%	22%
Cash-out refinance	35	29	32
Other refinance	18	28	46
Total	100%	100%	100%
Geographic concentration:[3]			
Midwest	16%	17%	18%
Northeast	18	19	18
Southeast	25	22	20
Southwest	16	14	14
West	25	28	30
Total	100%	100%	100%

(1) Percentages calculated based on unpaid principal balance of loans at time of acquisition.

(2) Long-term fixed-rate consists of mortgage loans with contractual maturities greater than 15 years. Intermediate-term fixed-rate consists of mortgage loans with contractual maturities equal to or less than 15 years.

(3) See footnote 4 to Table 21 for states included in each geographic region.

The key elements of the above risk characteristics are as follows:

Loan-to-value (LTV) ratio. The LTV ratio is the ratio, at a given point in time, of the unpaid principal balance of a mortgage loan to the value of the property that serves as collateral for the loan (expressed as a percentage). LTV ratio is a strong predictor of credit performance. In most cases, the original LTV is based on the appraised property value reported to us at the time of acquisition of the loan and the original unpaid principal balance of the loan. The aggregate current or estimated mark-to-market LTV is based on the estimated current value of the property, calculated using an internal valuation model that estimates periodic changes in home value, and the unpaid principal balance of the loan as of the date of each reported period. Assuming all other factors are equal, the likelihood of default and the gross severity of a loss in the event of default are typically lower as the LTV ratio decreases.

Product type. Product type is defined by the nature of the interest rate applicable to the mortgage (fixed for the duration of the loan or adjustable subject to contractual terms) and by the maturity of the loan. We generally divide our Single-Family business into three primary product types: long-term, fixed-rate mortgages with original terms of greater than 15 years; intermediate-term, fixed-rate mortgages with original terms of 15 years or less; and ARMs of any term. During 2004, 2005 and 2006, there was a proliferation of alternative product types, including negative-amortizing loans and interest-only loans. Negative-amortizing loans allow the borrower to make monthly payments that are less than the interest actually accrued for the period. The unpaid interest is added to the principal balance of the loan, which increases the outstanding loan balance. Negative-amortizing loans are typically adjustable-rate mortgage loans. Interest-only loans allow the borrower to pay only the monthly interest due, and none of the principal, for a fixed term. After the end of that term, usually five to ten years, the borrower can choose to refinance, pay the principal balance in a lump sum, or begin paying the monthly scheduled principal due on the loan, which results in a higher monthly payment at that time. Interest-only loans can be adjustable-rate or fixed-rate mortgage loans. While negative-amortizing and interest-only loans have been offered by lenders for some time, we began separately reporting and more closely monitoring them as their prevalence increased during 2004 to 2006.

Certain residential loan product types have features that may result in increased credit risk when compared to residential loans without those features. In general, 15-year fixed-rate mortgages exhibit the lowest default rate among the types of mortgage loans we securitize and purchase, due to the accelerated rate of principal amortization on these mortgages and the credit profiles of borrowers who use them. The next lowest rate of default is associated with 30-year fixed-rate mortgages. Balloon/reset mortgages and ARMs typically default at a higher rate than fixed-rate mortgages, although default rates for different types of ARMs may vary. While ARMs are typically originated with interest rates that are initially lower than those available for fixed-rate mortgages, the interest rates on ARMs change over time based on changes in an index or reference interest rate. As a result, the borrower s payments may rise or fall, within limits, as interest rates change. As payment amounts increase, the risk of default also increases. In the low interest rate environment experienced during 2006, 2005, 2004 and 2003, this industry trend was reversed with ARMs exhibiting lower default rates than fixed-rate mortgages. We expect loans that permit a borrower to defer the payment of principal or interest, such as negative-amortizing and interest-only loans, to default more often than traditional mortgage loans. We consider the risk of default in determining our guaranty fee and purchase price.

Number of units. We classify mortgages secured by housing with four or fewer living units as single- family. Mortgages on one-unit properties tend to have lower credit risk than mortgages on multiple-unit properties, such as duplexes, all other factors held equal. Over 95% of our conventional single-family mortgage credit book of business consists of loans secured by one-unit properties.

Property type. We evaluate the underlying type of property that secures a mortgage loan. Condominiums are generally considered to have higher credit risk than single-family detached properties. Condominiums are often more difficult to resell than single-family detached properties, and they historically have exhibited greater volatility in home price trends.

Occupancy type. Borrowers may purchase a home as a primary residence, a second or vacation home, or an investment property. Assuming all other factors are equal, mortgages on properties occupied by the borrower as a primary or secondary residence tend to have lower credit risk than mortgages on investment properties.

Credit score. Credit score is a measure often used by the financial services industry, including our company, to assess borrower credit quality. Credit scores are generated by credit repositories and calculated based on proprietary statistical models that evaluate many types of information on a borrower s credit report and predict the likelihood that a borrower will repay future obligations as expected. FICO® scores, developed by Fair Isaac Corporation, are commonly used credit scores. FICO scores, as reported by the credit repositories, may range from a low of 300 to a high of 850. Based on Fair Isaac Corporation statistical information, a higher FICO score typically indicates a lesser degree of credit risk.

We obtain borrower credit scores on the majority of single-family mortgage loans that we purchase or that back Fannie Mae MBS. We believe the average credit score within our single-family mortgage credit book of business is a strong indicator of default risk.

Loan purpose. Loan purpose indicates how the borrower intends to use the funds from a mortgage loan. We designate the loan purpose as purchase, cash-out refinance or other refinance. The funds in a purchase transaction are used to acquire a property. In addition to paying off an existing first mortgage lien, the funds in a cash-out refinance transaction also may be used for other purposes, including paying off subordinate mortgage liens and providing unrestricted cash proceeds to the borrower. Cash-out refinancings have a higher risk of default. All other refinance transactions are defined as other re-financings. We also may disclose certain loans that were modified prior to our acquisition as refinanced loans.

Geographic concentration. Local economic conditions affect borrowers ability to repay loans and the value of the collateral underlying a loan, if all other factors are equal. We analyze geographic exposure at a variety of levels of geographic aggregation, including at the regional level. Geographic diversification reduces mortgage credit risk.

Loan age. We monitor year of origination and loan age, which is defined as the number of years since origination. Statistically, the peak ages for default are currently from two to six years after origination.

The credit quality of the mortgage loans in our conventional single-family mortgage credit book of business remained high as of December 31, 2005 and 2004, as evidenced by weighted average loan-to-value ratios and weighted average credit scores. The weighted average original loan-to-value ratio was an estimated 70% as of both December 31, 2005 and 2004. The weighted average estimated mark-to-market loan-to-value ratio for our conventional single-family mortgage credit book of business decreased to 53% as of December 31, 2005, from 57% as of December 31, 2004. The weighted average credit score was 721 and 719 as of December 31, 2005 and 2004, respectively. As of December 31, 2006, the weighted average original loan-to-value ratio was an estimated 70% and the weighted average estimated mark-to-market loan-to-value ratio was an estimated 55%. The weighted average credit score remained at 721 as of December 31, 2006.

The most notable change in the overall risk profile of our single-family mortgage credit book of business in recent years has been in product types. As a result of the rise in home prices over the past several years, there has been a shift in the primary mortgage market to mortgage loans with features that make it easier for borrowers to qualify for a mortgage loan and that offer lower initial monthly payments by allowing the borrower to defer repayment of principal or interest. These products include interest-only mortgage loans that are available with both fixed-rate and adjustable-rate terms and ARMs that have the potential for negative amortization. In addition, there has been an increasing industry trend towards streamlining the mortgage loan underwriting process by reducing the documentation requirements for borrowers and accepting alternative or non-traditional documentation. Reduced documentation loans in some cases present higher credit risk than loans underwritten with full standard documentation. We have worked with our lender customers to support a broad range of mortgage products, including Alt-A and subprime products and other products with a higher level of credit risk, which have represented an increased proportion of mortgage originations in recent years. Although there is no uniform definition for Alt-A and subprime loans across the mortgage industry, Alt-A loans are generally defined as loans with lower or alternative documentation requirements, while subprime loans are generally defined as loans made to borrowers with weaker credit profiles. We have increased our participation in these types of products where we have concluded that it would be economically advantageous or that it would contribute to our mission objectives. We have worked to enhance our credit analytics and data to better understand, assess and price for the risks associated with these products to allow us to closely monitor credit risk and pricing dynamics across the full spectrum of mortgage product types.

The percentage of our single-family mortgage credit book of business consisting of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans was not material as of December 31, 2005. We estimate these loans represented approximately 0.2% of our single-family mortgage credit book of business as of December 31, 2006. To date, our purchases of subprime mortgage loans generally have been accompanied by the purchase of credit enhancements that materially reduce our exposure to credit losses on these mortgages. We estimate that approximately 2% of our single-family mortgage credit book of business as of December 31, 2006 consisted of private-label mortgage-related securities backed by subprime mortgage loans and, to a lesser extent, resecuritizations of private-label mortgage-related securities backed by subprime mortgage loans. We believe our credit exposure to the subprime mortgage loans underlying the private-label mortgage-related securities in our portfolio is limited because we have focused our purchases to date on the highest-rated tranches of these securities.

Interest-only ARMs, which represented approximately 5% of our conventional single-family business volume in 2004, increased to approximately 9% of our conventional single-family business volume in both 2005 and

2006. Most of the interest-only products we acquired during 2004 to 2006 had adjustable-rate terms. Approximately 43% of the interest-only products we acquired in 2006 had fixed-rate terms. Negative-amortizing ARMs represented approximately 2% of our conventional single-family business volume in 2004, compared with approximately 3% of our conventional single-family business volume in both 2005 and 2006. As a result of the shift in the product profile of new business in recent years, interest-only ARMs and negative-amortizing ARMs together represented approximately 6% of our conventional single-family mortgage credit book of business as of December 31, 2005 and 2006.

In September 2006, the federal financial regulatory agencies (The Board of Governors of the Federal Reserve System, the Office of Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, and the Federal Deposit Insurance Corporation) jointly issued Interagency Guidance on Nontraditional Mortgage Product Risks to address risks posed by interest-only loans and other mortgage products that allow borrowers to defer repayment of principal or interest. The guidance also addresses the layering of risks that results from combining these product types with other features that may compound risk, such as relying on reduced documentation to evaluate a borrower s creditworthiness. The guidance directs federally regulated financial institutions (which includes the bulk of our lender customers) originating these loans to maintain underwriting standards that are consistent with prudent lending practices, including analysis of a borrower s capacity to repay the full amount of credit that may be extended and to provide borrowers with clear and balanced information about the relative benefits and risks of these products sufficiently early in the process to enable them to make informed decisions.

In December 2006, OFHEO directed us to take immediate action to apply the risk management, underwriting and consumer disclosure principles of this guidance to mortgages we purchase or guarantee. In response to the guidance, we are implementing changes to our Desktop Underwriter® automated underwriting system relating to the calculation of qualifying ratios for certain non-traditional mortgage products. We are also making adjustments to our underwriting and eligibility standards to ensure our guidelines conform to the interagency guidance. We submitted a report to OFHEO in February 2007 on our progress in developing policies, credit quality standards and capital provisions in line with the guidance. OFHEO may require additional changes to our underwriting system and guidelines in connection with the interagency guidance, and we are currently discussing with OFHEO the actions we should take to implement the principles of this guidance, consistent with our role as a secondary mortgage market participant.

In addition to the shift in the product profile of new business described above, we have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet HUD s increased housing goals and new subgoals. These strategies include entering into some purchase and securitization transactions with lower expected economic returns than our typical transactions. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD s goals and subgoals, which could increase our credit losses. See Item 1 Business Our Charter and Regulation of Our Activities Regulation and Oversight of Our Activities HUD Regulation Housing Goals for a description of our housing goals.

We use analytical tools to measure credit risk exposures, assess performance of our mortgage credit book of business, and evaluate risk management alternatives. We continually refine our methods of measuring credit risk, setting risk and return targets, and transferring risk to third parties. We use our analytical models to establish forecasts and expectations for the credit performance of loans in our mortgage credit book and compare actual performance to those expectations. Comparison of actual versus projected performance and changes in other key trends are monitored to identify changes in risk or return profiles and to provide the basis for revising policies, standards, guidelines, credit enhancements or guaranty fees for future business.

<u>Housing and Community Development</u>

Diversification within our multifamily mortgage credit book of business and LIHTC equity investments business by geographic concentration, term-to-maturity, interest rate structure, borrower concentration and credit enhancement arrangements is an important factor that influences credit quality and performance and helps reduce our credit risk.

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We monitor the performance and risk concentrations of multifamily loans and properties on an ongoing basis throughout the life cycle of the investment at the loan, property and portfolio level. We closely track the physical condition and financial performance of the property, the historical performance of the loan or property, the relevant local market economic conditions that may signal changing risk or return profiles and other risk factors. For example, we closely monitor rental payment trends and vacancy levels in local markets to identify loans meriting closer attention or loss mitigation actions. We also evaluate the servicers submissions and may require the servicer to take certain actions to mitigate the likelihood of delinquency or default. For our investments in multifamily loans and properties, the primary asset management responsibilities are performed by our DUS lenders. For our LIHTC investments, the primary asset management responsibilities are performed by our LIHTC syndicator partners or third parties. These partners provide us with periodic construction status updates and property operating information. We compare the information received to our construction schedules, tax delivery schedules and industry standards to measure and grade project performance.

We use proprietary models and analytical tools to periodically re-evaluate our multifamily mortgage credit book of business, establish forecasts of credit performance and estimate future potential credit losses. Information derived from our analyses is used to identify changes in risks and provide the basis for revising policies, standards, pricing and credit enhancements.

We also have data on and manage multifamily mortgage credit risk at the loan level. We had loan-level data on approximately 90% of our total multifamily mortgage credit book as of December 31, 2005, 2004 and 2003. Unless otherwise noted, the credit statistics provided for our multifamily mortgage credit book generally include only mortgage loans in our portfolio, outstanding Fannie Mae MBS (excluding Fannie Mae MBS backed by non-Fannie Mae mortgage-related securities) and credit enhancements that we provide, where we have more detailed loan-level information.

Credit Loss Management

Single-Family

We manage problem loans to mitigate credit losses. If a mortgage loan does not perform, we work closely in partnership with the servicers of our loans to minimize the frequency of foreclosure as well as the severity of loss. We have developed detailed servicing guidelines and work closely with the loan servicers to ensure that they take appropriate loss mitigation steps on a timely basis. Our loan management strategy begins with payment collection and work-out guidelines designed to minimize the number of borrowers who fall behind on their obligations and to help borrowers who are delinquent from falling further behind on their payments. We seek alternative resolutions of problem loans to reduce the legal and management expenses associated with foreclosing on a home.

In our experience, early intervention is critical to controlling credit losses. We offer Risk Profiler[sm], an internally-developed default prediction model, to our single-family servicers to monitor the performance and risk of each loan and identify those loans that are most likely to default and require the most attention. Risk Profiler uses credit risk indicators such as mortgage payment records, updated borrower credit data, current property values and mortgage product characteristics to evaluate the risk of each loan. Most of the lenders that service loans we buy or that back Fannie Mae MBS use Risk Profiler or a similar default prediction model.

We require our single-family servicers to pursue various resolutions of problem loans as an alternative to foreclosure, including:

repayment plans in which borrowers repay past due principal and interest over a reasonable period of time through a temporarily higher monthly payment;

loan modifications in which past due interest amounts are added to the loan principal amount and recovered over the remaining life of the loan, and other loan adjustments;

long-term forbearances in which the lender agrees to suspend borrower payments for an extended period of time;

accepting deeds in lieu of foreclosure whereby the borrower signs over title to the property without the added expense of a foreclosure proceeding; and

preforeclosure sales in which the borrower, working with the servicer, sells the home and pays off all or part of the outstanding loan, accrued interest and other expenses from the sale proceeds.

The objective of the repayment plan and loan modification strategies is to allow borrowers who have experienced temporary financial distress to remain in their homes and to avoid the losses associated with foreclosure. The objective of the deed in lieu and preforeclosure sale strategies is to minimize the extra costs associated with a traditional foreclosure by obtaining the borrower s cooperation in resolving the default. We use analytical models and work rules to determine which alternative resolution, if any, may be appropriate for each problem loan.

We track the ultimate performance of alternative resolutions in absolute terms and in relation to estimated losses in the event of a traditional single-family loan foreclosure. We adjust our loss mitigation policies as appropriate to be consistent with our risk management objectives. In the case of repayment plans and loan modifications, we focus in particular on the performance of the loans subsequent to our intervention. Of the conventional loans that recover through modifications, long-term forbearances and repayment plans, our performance experience after 36 months following the inception of all such plans, based on the period 1998 to 2002, has been that approximately 65% of these loans remain current or have been paid in full. Approximately 11% have terminated through foreclosure. The remaining loans once again reached a delinquent status.

In those cases when a foreclosure avoidance effort is not successful, we typically foreclose and acquire the property. Our property management and sales operation employs several strategies designed to shorten our holding time, minimize the impact on the neighborhood, maximize our recovery and mitigate credit losses. These strategies include prompt assessment of the property condition and partnering with qualified local real estate brokers to market and refurbish the property when economically feasible to appeal to the broadest market of homebuyers, particularly buyers who plan to live in the home.

The table below presents statistics on the resolution of conventional single-family problem loans for the years ended December 31, 2005, 2004 and 2003.

Table 23: Statistics on Conventional Single-Family Problem Loan Workouts

	For the Year Ended December 31,		
	2005	2004	2003
		(Number of loans)	
Modifications[1]	20,732	22,591	17,119
Repayment plans and long-term forbearances	47,641	39,225	37,271
Pre-foreclosure sales	2,478	2,575	2,052
Deeds in lieu of foreclosure	384	330	320
Total number of problem loan workouts[2]	71,235	64,721	56,762

(1) Modifications include troubled debt restructurings, which result in concessions to borrowers, and other modifications to the contractual terms of the loan that do not result in concessions to the borrower.

(2) Represents approximately 0.5%, 0.4% and 0.4% of the total number of loans in our conventional single-family mortgage credit book for the years ended December 31, 2005, 2004 and 2003, respectively.

Housing and Community Development

When a multifamily loan does not perform, we work closely with our loan servicers to minimize the severity of loss by taking appropriate loss mitigation steps. We permit our multifamily servicers to pursue various options as an alternative to foreclosure, including modifying the terms of the loan, selling the loan, and preforeclosure sales. The resolution strategy depends in part on the borrower s level of cooperation, the performance of the market or submarket, the value of the property, the condition of the property, any remaining equity in the property and the borrower s ability to infuse additional equity into the property. The unpaid principal balance of modified multifamily loans totaled $165 million, $224 million and $196 million for the years ended December 31, 2005, 2004, and 2003, respectively, which represented 0.13%, 0.18% and 0.16% of our total multifamily mortgage credit book of business as of the end of each respective period.

When a non-guaranteed LIHTC investment does not perform, we work closely with our syndicator partner. The resolution strategy depends on:

- the local general partner s ability to meet obligations;
- the value of the property;
- the ability to restructure the debt;
- the financial and workout capacity of the syndicator partner; and
- the strength of the market or submarket.

If a guaranteed LIHTC investment does not perform, the guarantor remits funds to us in an amount that provides us with the contractual underwritten return. Our risk in this situation is that the counterparty will not perform. Refer to Institutional Counterparty Credit Risk Management below for a discussion of how we manage the credit risk associated with our counterparties.

Mortgage Credit Book Performance

Key metrics used to measure credit risk in our mortgage credit book of business and evaluate credit performance include the serious delinquency rate, nonperforming loans and credit losses.

Serious Delinquency

The serious delinquency rate is an indicator of potential future foreclosures, although most loans that become seriously delinquent do not result in foreclosure. The rate at which new loans become seriously delinquent and the rate at which existing seriously delinquent loans are resolved significantly affect the level of future credit losses. Home price appreciation decreases the risk of default. A borrower with enough equity in a home can sell the home or draw on equity in the home to avoid foreclosure. A decline in home prices increases the risk of default. The presence of credit enhancements mitigates credit losses caused by defaults.

We classify single-family loans as seriously delinquent when a borrower has missed three or more consecutive monthly payments, and the loan has not been brought current or extinguished through foreclosure, payoff or other resolution. A loan referred to foreclosure but not yet foreclosed is also considered seriously delinquent. Loans that are subject to a repayment plan are classified as seriously delinquent until the borrower has missed fewer than three consecutive monthly payments. We calculate the single-family serious delinquency rate by dividing the number of seriously delinquent single-family loans by the total number of single-family loans outstanding. We include all of the conventional single-family loans that we own and that back Fannie Mae MBS in our single-family delinquency rate, including those with substantial credit enhancement. We distinguish between loans on which we have some form of credit enhancement and loans on which we do not have credit enhancement.

We classify multifamily loans as seriously delinquent when payment is 60 days or more past due. We calculate the multifamily serious delinquency rate by dividing the unpaid principal balance of seriously delinquent multifamily loans by the unpaid principal balance of all multifamily loans that we own or that back Fannie Mae MBS or housing authority bonds for which we provide credit enhancement. The table below compares the serious delinquency rates for all conventional single-family loans and multifamily loans, in each case with credit enhancements and without credit enhancements.

Table 24: Serious Delinquency Rates

	As of December 31,					
	2005		2004		2003	
	Book Outstanding[1]	Serious Delinquency Rate[2]	Book Outstanding[1]	Serious Delinquency Rate[2]	Book Outstanding[1]	Serious Delinquency Rate[2]
Conventional single-family loans:						
Credit enhanced	18%	2.14%	19%	1.84%	21%	1.65%
Non-credit enhanced	82	0.47	81	0.33	79	0.30
Total conventional single-family loans	100%	0.79%	100%	0.63%	100%	0.60%
Multifamily loans:						
Credit enhanced	95%	0.34%	95%	0.11%	95%	0.29%
Non-credit enhanced	5	0.02	5	0.13	5	0.22
Total multifamily loans	100%	0.32%	100%	0.11%	100%	0.29%

(1) Reported based on unpaid principal balance of loans, where we have detailed loan-level information.

(2) Reported based on number of loans for single-family and unpaid principal balance for multifamily.

The aftermath of Hurricane Katrina during the fourth quarter of 2005 resulted in an increase in our single-family and multifamily serious delinquency rates to 0.79% and 0.32%, respectively, as of December 31, 2005, from 0.63% and 0.11%, respectively, as of December 31, 2004. Our serious delinquency rate for loans not impacted by Hurricane Katrina for single-family and multifamily was 0.64% and 0.12%, respectively, as of December 31, 2005.

The decline in the multifamily serious delinquency rate to 0.11% as of December 31, 2004 from 0.29% as of December 31, 2003 was primarily attributable to loans from two borrowers totaling $137 million at the end of 2003, which were either restructured or were brought current during 2004.

Our conventional single-family serious delinquency rate decreased to 0.65% as of December 31, 2006, and our multifamily serious delinquency rate decreased to 0.08%. The decline in the delinquency rates during 2006 was due primarily to payoffs and the resolution of loans secured by properties in the Gulf Coast region. We expect serious delinquencies to increase in 2007 as a result of the significant slowdown in home price appreciation. As of December 31, 2006, approximately 10% of our conventional single-family mortgage credit book of business had an estimated mark-to-market loan-to-value ratio greater than 80%. Over 76% of these loans were covered by credit enhancement. The remaining loans, which would have required credit enhancement at acquisition if the original loan-to-value ratios were above 80%, were not covered by credit enhancement as of December 31, 2006 because of changes in home price appreciation over time and loan principal payments, which affected the estimated mark-to-market loan value ratio. In examining the geographic concentration of these high LTV loans, there was no metropolitan statistical area with more than 5% of this segment of our conventional single-family mortgage credit book of business. The three largest metropolitan statistical area concentrations were in Atlanta, Detroit and Chicago.

Nonperforming Loans

We classify conventional single-family loans, including delinquent loans purchased from an MBS trust pursuant to the terms of the trust indenture, as nonperforming and place them on nonaccrual status at the earlier of when payment of principal and interest becomes three months or more past due according to the loan s contractual terms or when, in our opinion, collectibility of interest or principal is not reasonably assured. We classify conventional multifamily loans as nonperforming and place them on nonaccrual status at the earlier of when payment of principal and interest is three months or more past due according to the loan s contractual terms or when we determine that collectibility of all principal or interest is not reasonably assured based on an individual loan level assessment. We continue to accrue interest on nonperforming loans that are federally insured or guaranteed by the U.S. government. Table 25 provides statistics on nonperforming single-

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family and multifamily loans as of the end of each year during the five-year period ending December 31, 2005.

Table 25: Nonperforming Single-Family and Multifamily Loans

	As of December 31,				
	2005	2004	2003	2002	2001
	(Dollars in millions)				
Nonperforming loans:					
Nonaccrual loans	$ 8,356	$ 7,987	$ 7,742	$ 6,303	$ 4,664
Troubled debt restructurings[1]	661	816	673	580	503
Total nonperforming loans	$ 9,017	$ 8,803	$ 8,415	$ 6,883	$ 5,167
Interest on nonperforming loans:					
Interest income forgone[2]	$ 184	$ 188	$ 192	$ 149	$ 102
Interest income recognized during year[3]	405	381	376	331	265
Accruing loans past due 90 days or more[4]	$ 185	$ 187	$ 225	$ 251	$ 301

[1] Troubled debt restructurings include loans whereby the contractual terms have been modified that result in concessions to borrowers experiencing financial difficulties.

[2] Forgone interest income represents the amount of interest income that would have been recorded during the year on nonperforming loans as of December 31 had the loans performed according to their contractual terms.

[3] Represents interest income recognized during the year on loans classified as nonperforming as of December 31.

[4] Recorded investment of loans as of December 31 that are 90 days or more past due and continuing to accrue interest include loans insured or guaranteed by the government and loans where we have recourse against the seller of the loan in the event of a default.

Credit Losses

Credit loss performance is a significant indicator of the effectiveness of our credit risk management strategies. Credit-related losses include charge-offs plus foreclosed property expense (income). Credit losses for the years ended December 31, 2005, 2004 and 2003 are presented in Table 26.

Table 26: Single-Family and Multifamily Credit Loss Performance

For the Year Ended December 31,								
2005			2004			2003		
Single-Family	Multifamily	Total	Single-Family	Multifamily	Total	Single-Family	Multifamily	Total
(Dollars in millions)								
$ 437	$ 25	$ 462	$ 189	$ 21	$ 210	$ 196	$ 5	$ 201

Charge-offs, net of recoveries									
Foreclosed property expense (income)	(17)	4	(13)	(17)	28	11	(10)	(2)	(12)
Credit-related losses	$ 420	$ 29	$ 449	$ 172	$ 49	$ 221	$ 186	$ 3	$ 189
Charge-off ratio (basis points)[1]	2.0 bp	1.9 bp	2.0 bp	0.9 bp	1.7 bp	0.9 bp	1.0bp	0.5bp	1.0 bp
Credit loss ratio (basis points)[2]	1.9 bp	2.2 bp	1.9 bp	0.8 bp	4.0 bp	1.0bp	1.0bp	0.3bp	0.9 bp

(1) Represents charge-offs, net of recoveries, divided by average total mortgage credit book of business.

(2) Represents credit-related losses divided by average total mortgage credit book of business.

Interest forgone on nonperforming loans in our mortgage portfolio, which is presented in Table 25, reduces our net interest income but is not reflected in our credit loss total. Other-than-temporary impairment resulting from deterioration in credit quality of our mortgage-related securities is not included in credit-related losses. As shown in Table 26, our total credit-related losses for the years presented was less than 2.0 basis points, or 0.02%, of our average mortgage credit book of business over the periods presented. The rapid acceleration in home prices during the period from 1999 to 2005, combined with our use of credit enhancements, helped in mitigating our credit losses. As a result of the substantial slowdown in home price appreciation during 2006 and economic indicators that suggest home prices are likely to decline modestly in 2007, we expect our credit losses to increase.

Losses from Hurricane Katrina increased our provision for credit losses in 2005. Our exposure to losses as a result of Hurricane Katrina arose primarily from Fannie Mae MBS backed by loans secured by properties in the affected areas, our portfolio holdings of mortgage loans and mortgage-related securities backed by loans secured by properties in the affected areas, and real estate that we own in the affected areas. We initially estimated that our after-tax losses associated with the Gulf Coast Hurricanes would be in a range of $250 million to $550 million, which included both single-family and multifamily properties. Based on our subsequent review and assessment, we recorded a provision for credit losses of $106 million (after-tax loss of $69 million) in the third quarter of 2005 to reflect our most recent estimate. This reduction was due to several factors, including our ongoing assessment, the liquidation of a number of the loans relating to flooded properties from our mortgage portfolio, the receipt of more insurance funds than previously expected on the flooded properties and reduced delinquencies for affected loans outside the flood-damaged areas. Further adjustments to this estimate are possible as we continue to monitor this issue.

We use internally developed models to assess our sensitivity to credit losses based on current data on home values, borrower payment patterns, non-mortgage consumer credit history and management s economic outlook. We closely examine a range of potential economic scenarios to monitor the sensitivity of credit losses. Our models indicate that home price movements are an important predictor of credit performance. Pursuant to the September 1, 2005 agreement with OFHEO, we agreed to provide quarterly assessments of the impact on our expected credit losses from an immediate 5% decline in single-family home prices for the entire United States, which we believe is a stressful scenario based on housing data from OFHEO. Historical statistics from OFHEO s house price index reports indicate the national average rate of home price appreciation over the last 20 years has been about 5.5%, while the lowest national average annual appreciation rate in any single year has been 0.3%. However, we believe that a modest decline in home prices is possible in 2007.

We develop a baseline scenario that estimates the present value of future credit losses over a ten-year period. We then calculate the present value of credit losses assuming an immediate 5% decline in the value of single-family properties securing mortgage loans we own or that back Fannie Mae MBS. Following this decline, we assume home prices will follow a statistically derived long-term path. The sensitivity of future credit losses represents the dollar difference between credit losses in the baseline scenario and credit losses assuming the immediate 5% home price decline. The estimated sensitivity of our expected future credit losses to an immediate 5% decline in home values for single-family mortgage loans as of December 31, 2005 and 2004 is disclosed in the following table. We disclose both the gross credit loss sensitivity prior to the receipt of private mortgage insurance claims or any other credit enhancements and the net credit loss sensitivity after consideration of these items.

Table 27: Single-Family Credit Loss Sensitivity(1)

	As of December 31,	
	2005	2004
	(Dollars in millions)	
Gross credit loss sensitivity(2)	$ 2,310	$ 2,266
Less: Projected credit risk sharing proceeds	(1,167)	(1,179)
Net credit loss sensitivity	$ 1,143	$ 1,087
Single-family whole loans and Fannie Mae MBS	$ 2,035,704	$ 1,980,789
Single-family net credit loss sensitivity as a percentage of single-family whole loans and Fannie Mae MBS	0.06%	0.05%

(1) Represents total economic credit losses, which include net charge-offs/recoveries, foreclosed property expenses, forgone interest and the cost of carrying foreclosed properties.

(2) Measures the gross sensitivity of our expected future credit losses to an immediate 5% decline in home values for first lien single-family whole loans we own or that back Fannie Mae MBS. After the initial shock, we estimate home price growth rates return to the rate projected by our credit pricing models.

The estimates in the preceding paragraphs are based on approximately 92% and 90% of our total single-family mortgage credit book of business as of December 31, 2005 and 2004, respectively. The mortgage loans and mortgage-related securities that are included in these estimates consist of single-family single-class Fannie Mae MBS (whether held in our portfolio or held by third parties) and single-family mortgage loans, excluding mortgages secured only by second liens and reverse mortgages. We expect the inclusion in our estimates of these excluded products may impact the estimated sensitivities set forth in the preceding paragraphs. The above estimated credit loss sensitivities are generated using the same models that we use to estimate fair value and impairment. We have made certain modifications to our models from those used to report previous credit loss sensitivities.

Foreclosure and REO activity affects the level of credit losses. The table below provides information on foreclosures for the years ended December 31, 2005, 2004 and 2003. In light of the continued weakness of economic fundamentals, such as employment levels and lack of home price appreciation in the Midwestern states, we expect increasing foreclosure and REO incidence and credit losses in that region. REO acquisitions in the Midwest increased to 16,000 units in 2006 from less than 12,000 units in 2005.

Table 28: Single-Family and Multifamily Foreclosed Properties

	For the Year Ended December 31, 2005	2004	2003
Single-family foreclosed properties (number of properties):			
Beginning inventory of single-family foreclosed properties (REO)[(1)]	18,361	13,749	9,975
Geographic analysis of acquisitions:[(2)]			
Midwest	11,777	10,149	7,384
Northeast	2,405	2,318	1,997
Southeast	9,470	10,275	8,539
Southwest	8,099	8,422	6,640
West	809	1,739	2,235
Total properties acquired through foreclosure	32,560	32,903	26,795
Dispositions of REO	29,978	28,291	23,021
Ending inventory of single-family foreclosed properties (REO)[(1)]	20,943	18,361	13,749
Multifamily foreclosed properties:			
Ending inventory of multifamily foreclosed properties (REO)	8	18	20
Carrying value of multifamily foreclosed properties (dollars in millions)	$ 51	$ 131	$ 98

(1) Includes deeds in lieu of foreclosure.

(2) See footnote 4 to Table 21 for states included in each geographic region.

Allowance for Loan Losses and Reserve for Guaranty Losses

We maintain a separate allowance for loan losses for single-family and multifamily loans classified as held for investment in our mortgage portfolio and a reserve for guaranty losses for credit-related losses associated with certain mortgage loans that back Fannie Mae MBS held in our portfolio and held by other investors. The allowance for loan losses and reserve for guaranty losses represent our estimate of incurred credit losses inherent in our loans held for investment and loans underlying Fannie Mae MBS, respectively, as of each balance sheet date. We use the same methodology to determine our allowance for loan losses and our reserve for guaranty losses because the relevant factors affecting credit risk are the same. We recognize credit losses and record a provision for credit losses when available information indicates that it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated in accordance with SFAS No. 5, *Accounting for Contingencies.* We also evaluate certain single-family and multifamily loans on an individual basis to recognize and measure impairment and record an allowance for incurred losses in accordance with the provisions of SFAS No. 114, *Accounting by Creditors for Impairment of a Loan (an amendment of FASB Statement No. 5 and 15)* (SFAS 114). We provide additional information on the methodology used in developing our allowance for loan losses and reserve for guaranty losses in Notes to Consolidated Financial Statements Note 1, Summary of Significant Accounting Policies. Because of the significant degree of judgment involved in estimating the allowance for loan losses and reserve for guaranty losses, we identify it as a critical accounting policy and discuss the assumptions involved in our estimation process in Critical Accounting Policies and Estimates Allowance for Loan Losses and Reserve for Guaranty Losses.

We report the allowance for loan losses and reserve for guaranty losses as separate line items in the consolidated balance sheets. The provision for credit losses is reported in the consolidated statements of income. Table 29 summarizes changes in our allowance for loan losses and reserve for guaranty losses for the years ended December 31, 2005, 2004, 2003 and 2002.

Table 29: Allowance for Loan Losses and Reserve for Guaranty Losses

	As of December 31,			
	2005	2004	2003	2002
	(Dollars in millions)			
Allowance for loan losses:				
Beginning balance	$ 349	$ 290	$ 216	$ 168
Provision	124	174	187	128
Charge-offs[1]	(267)	(321)	(270)	(175)
Recoveries	96	131	72	27
Increase from the reserve for guaranty losses[2]		75	85	68
Ending balance	$ 302	$ 349	$ 290	$ 216
Reserve for guaranty losses:				
Beginning balance	$ 396	$ 313	$ 223	$ 138
Provision	317	178	178	156
Charge-offs[3]	(302)	(24)	(7)	(11)
Recoveries	11	4	4	8
Decrease to the allowance for loan losses[2]		(75)	(85)	(68)
Ending balance	$ 422	$ 396	$ 313	$ 223
Combined allowance for loan losses and reserve for guaranty losses:				
Beginning balance	$ 745	$ 603	$ 439	$ 306
Provision	441	352	365	284
Charge-offs[1]	(569)	(345)	(277)	(186)
Recoveries	107	135	76	35
Ending balance	$ 724	$ 745	$ 603	$ 439
Balance at end of each period attributable to:				
Single-family	$ 647	$ 644	$ 516	$ 374
Multifamily	77	101	87	65
Total	$ 724	$ 745	$ 603	$ 439
Percent of combined allowance and reserve in each category to related mortgage credit book of business:[4]				
Single-family	0.03%	0.03%	0.02%	0.02%
Multifamily	0.06%	0.08%	0.07%	0.07%
Total	0.03%	0.03%	0.03%	0.02%

(1) Includes accrued interest of $24 million, $29 million, $29 million and $24 million for the years ended December 31, 2005, 2004, 2003 and 2002, respectively.

(2) Includes decrease in reserve for guaranty losses and increase in allowance for loan losses due to the purchase of delinquent loans from MBS pools. Effective with our adoption of SOP 03-3 on January 1, 2005, we record delinquent loans purchased from Fannie Mae MBS pools at fair value upon acquisition. We no longer record an increase in the allowance for loan losses and reduction in the reserve for guaranty losses when we purchase these loans.

(3) Includes a $251 million charge in 2005 for loans subject to SOP 03-3 where the acquisition price exceeded the fair value of the acquired loan.

(4) Represents ratio of combined allowance and reserve balance by loan type to total mortgage credit book of business by loan type.

Our combined allowance for loan losses and reserve for guaranty losses totaled $724 million as of December 31, 2005, compared with $745 million, $603 million and $439 million as of December 31, 2004, 2003 and 2002, respectively. The increase in our combined allowance for loan losses and reserve for guaranty losses from 2002 to 2004 was primarily due to significant growth in our mortgage credit book of business during this period, combined with the effect of an observed reduction in subsequent recourse proceeds from lenders on certain charged-off loans and an increase in loans with higher risk characteristics. In the fourth quarter of 2004, we recorded an increase of $142 million in our combined allowance for loan losses and reserve for guaranty losses due to the observed reduction in lender recourse proceeds. In 2005, we increased our combined allowance for loan losses and reserve for guaranty losses by $67 million for estimated losses related to Hurricane Katrina, which reflects a reduction in the reserve for guaranty losses for loans acquired in the fourth quarter of 2005 under SOP 03-3. This increase was more than offset by a decrease in the allowance for loan losses and reserve for guaranty losses that resulted from the significant increase in home prices during 2005. The combined allowance for loan losses and reserve for guaranty losses as a percentage of our total mortgage credit book of business has remained relatively stable, averaging between 0.02% and 0.03%. This trend reflects our historically low average default rates and loss severity on foreclosed properties, which we expect to increase as a result of the substantial slowdown in home price appreciation starting in 2006.

Institutional Counterparty Credit Risk Management

Institutional counterparty risk is the risk that institutional counterparties may be unable to fulfill their contractual obligations to us. Our primary exposure to institutional counterparty risk exists with our lending partners and servicers, mortgage insurers, dealers who distribute our debt securities or who commit to sell mortgage pools or loans, issuers of investments included in our liquid investment portfolio, and derivatives counterparties.

Our overall objective in managing institutional counterparty credit risk is to maintain individual counterparty exposures within acceptable ranges based on our rating system. We achieve this objective through the following:

- establishment and observance of counterparty eligibility standards appropriate to each exposure type and level;
- establishment of credit limits;
- requiring collateralization of exposures where appropriate; and
- exposure monitoring and management.

Establishment and Observance of Counterparty Eligibility Standards. The institutions with which we do business vary in size and complexity from the largest international financial institutions to small, local lenders. Because of this, counterparty eligibility criteria vary depending upon the type and magnitude of the risk exposure incurred. We incorporate both the ratings provided by the rating agencies as well as internal ratings in determining eligibility. For significant exposures, we generally require that our counterparties have at least the equivalent of an investment grade rating (*i.e.*, a rating of BBB−/Baa3/BBB− or higher by Standard & Poor s, Moody s and Fitch, respectively.) Due to factors such as the nature, type and scope of counterparty exposure, requirements may be higher. For example, for mortgage insurance counterparties, we have generally required a minimum rating of AA−/Aa3/AA−, whereas we accept comparatively lower ratings for our risk sharing, recourse and mortgage servicing counterparties. In addition to ratings, factors including corporate or third-party support or guaranties, our knowledge of the counterparty, reputation, quality of operations, and experience are also important in determining the initial and continuing eligibility of a counterparty. Specific eligibility criteria are communicated through policies and procedures of the individual businesses or products.

Establishment of Credit Limits. All institutions are assigned a limit to ensure that the risk exposure is maintained at a level appropriate for the institution s rating and the time horizon for the exposure, as well as to diversify exposure so that no single counterparty exceeds a certain percentage of our regulatory capital. Limits are established for the institution as a whole as well as for individual subsidiaries or affiliates. A corporate limit is first established for the aggregate of all activity and then is allocated among individual business units. Our businesses may further allocate limits among products or activities.

Requiring Collateralization of Exposures. We may require collateral, letters of credit or investment agreements as a condition to approving exposure to a counterparty. We may also require that a counterparty post collateral in the event of an adverse event such as a ratings downgrade.

Exposure Monitoring and Management. The risk management functions of the individual business units are responsible for managing the counterparty exposures associated with their activities within corporate limits. An oversight team within the Chief Risk Office is responsible for establishing and enforcing corporate policies and procedures regarding counterparties, establishing corporate limits, and aggregating and reporting institutional counterparty exposure. We calculate exposures by using current exposure information and applying stress scenarios to determine our loss exposure if a default occurs. The stress scenarios incorporate assumptions on shocks to interest rates, home prices or other variables appropriate for the type of risk. We regularly update exposure limits for individual institutions in our risk management system to communicate to business and credit staff throughout the company the capacity for further business activity. We regularly report exposures with our largest counterparties to the Risk Policy and Capital Committee of the Board of Directors.

Lenders with Risk Sharing

The primary risk associated with lenders providing risk sharing agreements is that they will fail to reimburse us for losses as required under these agreements. We had recourse to lenders for losses on single-family loans totaling an estimated $55.0 billion and $54.2 billion as of December 31, 2005 and 2004, respectively. The credit quality of these counterparties is generally high. Investment grade counterparties, based on the lower of Standard & Poor s and Moody s ratings, accounted for 55% and 60% of lender recourse obligations as of December 31, 2005 and 2004, respectively. Only 2% and less than 0.5% of these counterparties were rated by either Standard & Poor s or Moody s as below investment grade as of December 31, 2005 and 2004, respectively. The remaining counterparties were not rated by rating agencies, but were rated internally. In addition, we require some lenders to pledge collateral to secure their recourse obligations. We held $61 million and $66 million in collateral as of December 31, 2005 and 2004, respectively, to secure single-family recourse transactions. In addition, a portion of servicing fees on loans includes recourse to certain lenders, and the credit support for such lender recourse considers the value of the mortgage servicing assets for these counterparties.

We had full or partial recourse to lenders on multifamily loans totaling $111.1 billion and $107.1 billion as of December 31, 2005 and 2004, respectively. Our multifamily recourse obligations generally were partially or fully secured by reserves held in custodial accounts, insurance policies, letters of credit from investment grade counterparties rated A or better, or investment agreements.

Mortgage Servicers

The primary risk associated with mortgage servicers is that they will fail to fulfill their servicing obligations. Mortgage servicers collect mortgage and escrow payments from borrowers, pay taxes and insurance costs from escrow accounts, monitor and report delinquencies, and perform other required activities on our behalf. A servicing contract breach could result in credit losses for us or could cause us to incur the cost of finding a replacement servicer. We mitigate these risks in several ways, including the general maintenance of minimum servicing fees that would be available to compensate a replacement servicer in the event of a servicing contract breach; requiring servicers to follow specific servicing guidelines; monitoring the performance of each servicer using loan-level data; conducting selective on-site reviews to confirm compliance with servicing guidelines and mortgage servicing performance; and working on-site with nearly all of our major servicers to facilitate loan loss mitigation efforts and continuously improve the default management process.

Our ten largest single-family mortgage servicers serviced 72% and 71% of our single-family mortgage credit book of business, and the largest single-family mortgage servicer serviced 22% and 21% of our single-family mortgage credit book of business as of December 31, 2005 and 2004, respectively. Our ten largest multifamily servicers serviced 69% and 67% of our multifamily mortgage credit book of business as of December 31, 2005 and 2004, respectively. The largest multifamily mortgage servicer serviced 10% and 11% of our multifamily mortgage credit book of business as of December 31, 2005 and 2004, respectively.

Custodial Depository Institutions

Servicers deposit, in a depository institution of their choice, borrower payments of principal and interest they receive prior to the date they are scheduled to remit the payments to us. The depository institution serves as custodian of the funds. The primary risk associated with these depository institutions is that they may fail while holding remittances due to us, requiring us to replace the funds due to us and held by the depository institution in order to make payments to Fannie Mae MBS holders. We mitigate this risk by establishing

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qualifying standards for depository custodial institutions, including minimum credit ratings, and limiting depositaries to federally regulated institutions that are classified as well capitalized by their regulator. In addition, we have the right to withdraw custodial funds at any time upon written demand or establish other controls, including requiring more frequent remittances or setting limits on aggregate deposits with a custodian.

A total of $38.4 billion and $45.0 billion in deposits for scheduled MBS payments were held by 371 and 402 custodial institutions as of December 31, 2005 and 2004, respectively. Of this amount, 91% and 76% were held by institutions rated as investment grade by both Standard & Poor s and Moody s as of December 31, 2005 and 2004, respectively. Our ten largest depositary counterparties held 86% and 81% of these deposits as of December 31, 2005 and 2004, respectively.

Mortgage Insurers

The primary risk associated with mortgage insurers is that they will fail to fulfill their obligations to reimburse us for claims under insurance policies. We manage this risk by establishing eligibility requirements that an insurer must meet to become and remain a qualified mortgage insurer. Qualified mortgage insurers generally must obtain and maintain external ratings of claims paying ability, with a minimum acceptable level of Aa3 from Moody s and AA- from Standard & Poor s and Fitch. We regularly monitor our exposure to individual mortgage insurers and mortgage insurer credit ratings. We also perform periodic on-site reviews of mortgage insurers to confirm compliance with eligibility requirements and to evaluate their management and control practices.

Mortgage insurers may provide primary mortgage insurance or pool mortgage insurance. Primary mortgage insurance is insurance on an individual loan, while pool mortgage insurance is insurance that applies to a defined group of loans. Pool mortgage insurance benefits typically are based on actual loss incurred and are subject to an aggregate loss limit.

We were the beneficiary of primary mortgage insurance coverage on $263.1 billion of single-family loans in our portfolio or underlying Fannie Mae MBS as of December 31, 2005, which represented approximately 13% of our single-family mortgage credit book of business, compared with $285.4 billion, or approximately 13%, of our single-family mortgage credit book of business as of December 31, 2004. As of December 31, 2005, we were the beneficiary of pool mortgage insurance coverage on $71.7 billion of single-family loans, including conventional and government loans, in our portfolio or underlying Fannie Mae MBS, compared with $55.1 billion as of December 31, 2004. Seven mortgage insurance companies, all rated AA (or its equivalent) or higher by Standard & Poor s, Moody s or Fitch, provided approximately 99% of the total coverage as of December 31, 2005 and 2004.

On February 6, 2007, two major mortgage insurers, MGIC Investment Corporation and Radian Group Inc. announced an agreement to merge. The anticipated completion of this merger or any similar future consolidations within the mortgage industry will increase further our concentration risk to individual companies and may require us to take additional steps to mitigate this risk.

Debt Security and Mortgage Dealers

The primary credit risk associated with dealers who commit to place our debt securities is that they will fail to honor their contracts to take delivery of the debt, which could result in delayed issuance of the debt through another dealer. The primary credit risk associated with dealers who make forward commitments to deliver mortgage pools to us is that they may fail to deliver the agreed-upon loans to us at the agreed-upon date, which could result in our having to replace the mortgage pools at higher cost to meet a forward commitment to sell the MBS.

Mortgage Originators and Investors

We are routinely exposed to pre-settlement risk through the purchase, sale and financing of mortgage loans and mortgage-related securities with mortgage originators and mortgage investors. The risk is the possibility that the market moves against us at the same time the counterparty is unable or unwilling to either deliver mortgage assets or pay a pair-off fee. On average, the time between trade and settlement is about 35 days. We manage this risk by determining position limits with these counterparties, based upon our assessment of their creditworthiness, and we monitor and manage these exposures. Based upon this assessment, we may, in some cases, require counterparties to post collateral.

Liquid Investment Portfolio

The primary credit exposure associated with investments held in our liquid investment portfolio is that issuers will not repay principal and interest in accordance with the contractual terms. We believe the risk of default is low because we restrict these investments to high credit quality short- and medium-term instruments, such as commercial paper, asset-backed securities and corporate floating rate notes, which are broadly traded in the financial markets. Our non-mortgage securities, which account for the majority of our liquid assets, totaled $37.1 billion and $43.9 billion as of December 31, 2005 and 2004, respectively. Approximately 98% and 93% of our non-mortgage securities as of December 31, 2005 and 2004, respectively, had a credit rating of A (or its equivalent) or higher, based on the lowest of Standard & Poor s, Moody s or Fitch ratings. We monitor the fair value of these securities and periodically evaluate any impairment to assess whether the impairment is required to be recognized in earnings because it is considered other than temporary.

Derivatives Counterparties

The primary credit exposure that we have on a derivative transaction is that a counterparty will default on payments due, which could result in us having to acquire a replacement derivative from a different counterparty at a higher cost. Our derivative credit exposure relates principally to interest rate and foreign currency derivative contracts. Typically, we manage this exposure by contracting with experienced counterparties that are rated A (or its equivalent) or better. These counterparties consist of large banks, broker-dealers and other financial institutions that have a significant presence in the derivatives market, most of which are based in the United States. As an additional precaution, we have a conservative collateral management policy with provisions for requiring collateral on aggregate gain positions with each interest rate and foreign currency derivative counterparty. Also, we enter into master agreements that provide for netting of amounts due to us and amounts due to counterparties under those agreements. We monitor credit exposure on these derivative contracts daily and make collateral calls as appropriate based on the results of our internal models and dealer quotes. To date, we have never experienced a loss on a derivative transaction due to credit default by a counterparty.

Counterparties use the notional amounts of derivative instruments as the basis from which to calculate contractual cash flows to be exchanged. However, the notional amount is significantly greater than the potential market or credit loss that could result from such transactions and therefore does not represent our actual risk. Rather, we estimate our exposure to credit loss on derivative instruments by calculating the replacement cost, on a present value basis, to settle at current market prices all outstanding derivative contracts in a net gain position by counterparty where the right of legal offset exists, such as master netting agreements. Derivatives in a gain position are reported in the consolidated balance sheet as Derivative assets at fair value. Table 30 presents our assessment of our credit loss exposure by counterparty credit rating on outstanding risk management derivative contracts as of December 31, 2005 and 2004. We show the outstanding notional amount and activity for our risk management derivatives in Table 31.

Table 30: Credit Loss Exposure of Derivative Instruments

	As of December 31, 2005					
	Credit Rating[1]					
	AAA	AA	A	Subtotal	Other[2]	Total
	(Dollars in millions)					
Credit loss exposure[3]	$	$ 3,012	$ 2,641	$ 5,653	$ 72	$ 5,725
Less: Collateral held[4]		2,515	2,476	4,991		4,991
Exposure net of collateral	$	$ 497	$ 165	$ 662	$ 72	$ 734
Additional information:						
Notional amount	$ 775	$ 323,141	$ 319,423	$ 643,339	$ 776	$ 644,115
Number of counterparties	1	14	6	21		

	As of December 31, 2004					
	Credit Rating[1]					
	AAA	AA	A	Subtotal	Other[2]	Total
	(Dollars in millions)					
Credit loss exposure[3]	$ 57	$ 3,200	$ 3,182	$ 6,439	$ 88	$ 6,527
Less: Collateral held[4]		2,984	3,001	5,985		5,985
Exposure net of collateral	$ 57	$ 216	$ 181	$ 454	$ 88	$ 542
Additional information:						
Notional amount	$ 842	$ 327,895	$ 360,625	$ 689,362	$ 732	$ 690,094
Number of counterparties	3	12	8	23		

(1) We manage collateral requirements based on the lower credit rating, as issued by Standard & Poor s and Moody s, of the legal entity. The credit rating reflects the equivalent Standard & Poor s rating for any ratings based on Moody s scale.

(2) Includes MBS options, defined benefit mortgage insurance contracts, forward starting debt and swap credit enhancements accounted for as derivatives.

(3) Represents the exposure to credit loss on derivative instruments, which is estimated by calculating the cost, on a present value basis, to replace all outstanding contracts in a gain position. Derivative gains and losses with the same counterparty are presented net where a legal right of offset exists under an enforceable master settlement agreement. This table excludes mortgage commitments accounted for as derivatives.

(4) Represents the collateral amount held as of December 31, 2005 and 2004, adjusted for any collateral transferred subsequent to December 31, based on credit loss exposure limits on derivative instruments as of December 31,

2005 and 2004. The actual collateral settlement dates, which vary by counterparty, ranged from one to three business days after the December 31, 2005 and 2004 credit loss exposure valuation dates. The value of the collateral is reduced in accordance with counterparty agreements to help ensure recovery of any loss through the disposition of the collateral. We posted non-cash collateral of $476 million and $56 million related to our counterparties credit exposure to us as of December 31, 2005 and 2004, respectively.

Our credit exposure on risk management derivatives, after consideration of the value of collateral held, was $734 million and $542 million as of December 31, 2005 and 2004, respectively. We expect the credit exposure on derivative contracts to fluctuate with changes in interest rates, implied volatility and the collateral thresholds of the counterparties. To reduce our credit risk concentration, we diversify our derivative contracts among different counterparties. We had 21 and 23 interest rate and foreign currency derivatives counterparties as of December 31, 2005 and 2004, respectively. Of the 21 counterparties as of December 31, 2005, seven counterparties accounted for approximately 79% of the total outstanding notional amount, and each of these seven counterparties accounted for between approximately 6% and 17% of the total outstanding notional amount. Each of the remaining counterparties accounted for less than 5% of the total outstanding notional amount as of December 31, 2005. In comparison, eight counterparties accounted for approximately 83% of the total outstanding notional amount as of December 31, 2004. Each of these eight counterparties accounted for between approximately 7% and 14% of the total outstanding notional amount, with each of the remaining counterparties accounting for less than 5% of the total outstanding notional amount.

Approximately 68% of our net derivatives exposure of $734 million as of December 31, 2005 was with 11 interest rate and foreign currency derivative counterparties rated AA- or better by Standard & Poor s and Aa3 or better by Moody s. In comparison, approximately 50% of our net derivatives exposure of $542 million as of December 31, 2004 was with ten interest rate and foreign currency derivative counterparties rated AA- or better by Standard & Poor s and Aa3 or better by Moody s. The percentage of our net exposure with these counterparties ranged from approximately 0.6% to 12%, or approximately $4 million to $87 million, as of December 31, 2005, and from less than 0.1% to 13%, or less than $1 million to $70 million, as of December 31, 2004.

We mitigate our net exposure on interest rate and foreign currency derivative transactions through a collateral management policy, which consists of four primary components.

Minimum Collateral Threshold. Our derivatives counterparties are obligated to post collateral when exposure to credit losses exceeds agreed-upon thresholds that are based on credit ratings. The amount of collateral generally must equal the excess of exposure over the threshold amount.

Collateral Valuation Percentages. We require counterparties to post specific types of collateral to meet their collateral requirements. The collateral posted by our counterparties as of December 31, 2005 consisted of cash, U.S. Treasury securities, agency debt and agency mortgage-related securities. We assign each type of collateral a specific valuation percentage based on its relative risk. In cases where the valuation percentage for a certain type of collateral is less than 100%, we require counterparties to post an additional amount of collateral to meet their requirements.

Over-collateralization Based on Low Credit Ratings. We further reduce our net exposure on derivatives by generally requiring over-collateralization from counterparties whose credit ratings have dropped below predetermined levels. Counterparties with credit ratings falling below these levels must post collateral beyond the amounts previously noted to meet their overall requirements.

Daily Monitoring Procedures. On a daily basis, we value our derivative collateral positions for each counterparty using both internal and external pricing models, compare the exposure to counterparty limits, and determine whether additional collateral is required. We evaluate any additional exposure to a counterparty beyond our model tolerance level based on our corporate credit policy framework for managing counterparty risk.

Interest Rate Risk Management and Other Market Risks

Our most significant market risks are interest rate risk and spread risk, which arise primarily from the prepayment uncertainty associated with investing in mortgage-related assets with prepayment options and from the changing supply and demand for mortgage assets. The majority of our mortgage assets are intermediate-term or long-term fixed-rate loans that borrowers have the option to pay at any time before the scheduled maturity date or continue paying until the stated maturity. An inverse relationship exists between changes in interest rates and the value of fixed-rate investments, including mortgages. As interest rates decline, the value or price of fixed-rate mortgages held in our portfolio will generally increase because mortgage assets originated at the prevailing interest rates are likely to have lower yields and prices than the assets we currently hold in our portfolio. Conversely, an increase in interest rates tends to result in a reduction in the value of our assets. As interest rates decline prepayment rates tend to increase because more favorable financing is available to the borrower, which shortens the duration of our mortgage assets. The opposite effect occurs as interest rates increase.

One way of reducing the interest rate risk associated with investing in long-term, fixed-rate mortgages is to fund these investments with long-term debt with similar offsetting characteristics. This strategy is complicated by the fact that most borrowers have the option of prepaying their mortgages at any time, a factor that is beyond our control and driven to a large extent by changes in interest rates. In addition, funding mortgage investments with debt results in mortgage-to-debt OAS risk, or basis risk, which is the risk that interest rates in different market sectors will not move in the same direction or amount at the same time.

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Our Capital Markets group is responsible for managing interest rate risk subject to corporate risk policies and limits. Our policies and procedures include interest rate risk dollar limits and requires escalation to senior management and the Board of Directors if risk limits are exceeded. The Chief Risk Officer provides corporate oversight of the interest rate risk management process and is responsible for measuring and monitoring interest rate risk and providing regular reports to senior management and the Board of Directors. The Market Risk Committee, which focuses on enterprise-wide market, liquidity and model risk management activities, meets at least monthly to review our aggregate market risk profile and monitor our exposure relative to market risk limits. The Capital Markets Investment Committee, a management-level business unit committee that includes senior officers in the Capital Markets group, meets weekly to review our current interest rate risk position relative to risk limits. The Capital Markets Investment Committee develops and monitors near-term strategies that comply with our risk objectives and policies. The Capital Markets Investment Committee reports interest rate risk measures on a weekly basis. As discussed in Supplemental Non-GAAP Information Fair Value Balance Sheet, we do not attempt to actively manage or hedge the impact of changes in mortgage-to-debt OAS after we purchase mortgage assets, other than through asset monitoring and disposition. We accept period-to-period volatility in our financial performance due to mortgage-to-debt OAS consistent with our corporate risk principles.

Interest Rate Risk Management Strategies

Our portfolio of interest rate-sensitive instruments includes our investments in mortgage loans and securities, the debt issued to fund those assets, and the derivatives we use to manage interest rate risk. These assets and liabilities have a variety of risk profiles and sensitivities. We employ an integrated interest rate risk management strategy that includes asset selection and structuring of our liabilities to match and offset the interest rate characteristics of our balance sheet assets and liabilities as much as possible. Our strategy consists of:

- issuing a broad range of both callable and non-callable debt instruments to manage the duration and prepayment risk of expected cash flows of the mortgage assets we own;

- supplementing our issuance of debt with derivative instruments to further reduce duration and prepayment risks; and

- on-going monitoring of our risk positions and actively rebalancing our portfolio of interest rate-sensitive financial instruments to maintain a close match between the duration of our assets and liabilities.

Debt Instruments

The primary tool we use to manage the interest rate risk implicit in our mortgage assets is the variety of debt instruments we issue. Our ability to issue both short- and long-term debt helps in managing the duration risk associated with an investment in long-term fixed-rate assets. We issue callable debt to help us manage the prepayment risk associated with fixed-rate mortgage assets. The duration of callable debt changes when interest rates change in a manner similar to changes in the duration of mortgage assets. See Item 1 Business Business Segments Capital Markets Funding of Our Investments for additional information on our various types of debt securities and Liquidity and Capital Management Liquidity Debt Funding.

Derivative Instruments

Why We Use Derivatives

Derivatives also are an integral part of our strategy in managing interest rate risk. We use interest rate swaps and interest rate options, in combination with our issuance of debt securities, to better match both the duration and prepayment risk of our mortgages. We are generally an end user of derivatives and our principal purpose in using derivatives is to manage our aggregate interest rate risk profile within prescribed risk parameters. We generally only use derivatives that are highly liquid and relatively straightforward to value. We have derivative transaction policies and controls to minimize our derivative counterparty risk that are described in Credit Risk

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Management Institutional Counterparty Credit Risk Management Derivatives Counterparties. We use derivatives for three primary purposes:

(1) As a substitute for notes and bonds that we issue in the debt markets.

When we purchase mortgages, we fund the purchase with a combination of equity and debt. The debt we issue is a mix that typically consists of short- and long-term, non-callable debt and callable debt. The varied maturities and flexibility of these debt combinations help us in reducing the mismatch of cash flows between assets and liabilities.

We can use a mix of debt issuances and derivatives to achieve the same duration matching that would be achieved by issuing only debt securities. The primary types of derivatives used for this purpose include pay-fixed and receive-fixed interest rate swaps (used as substitutes for non-callable debt) and pay-fixed and receive-fixed swaptions (used as substitutes for callable debt).

Below are examples of equivalent funding alternatives for a mortgage purchase with funding derived solely from debt securities versus funding with a blend of debt securities and derivatives. As illustrated below, we can achieve similar economic results by funding our mortgage purchases with either debt securities or a combination of debt securities and derivatives, as follows:

Rather than issuing a ten-year non-callable fixed-rate note, we could issue short-term debt and enter into a ten-year interest rate swap with a highly rated counterparty. The derivative counterparty would pay a floating rate of interest to us on the swap that we would use to pay the interest expense on the short-term debt, which we would continue to reissue. We would pay the counterparty a fixed rate of interest on the swap, thus achieving the economics of a ten-year fixed-rate note issue. The combination of the pay-fixed interest rate swap and short-term debt serves as a substitute for non-callable fixed-rate debt.

Similarly, instead of issuing a ten-year fixed-rate note callable after three years, we could issue a ten-year non-callable fixed-rate note and enter into a receive-fixed swaption that would have the same economics as a ten-year callable note. If we want to call the debt after three years, the swaption would give us the option to enter into a swap agreement where we would receive a fixed rate of interest from the derivative counterparty over the remaining seven-year period that would offset the fixed-rate interest payments on the long-term debt. The combination of the receive-fixed swaption and ten-year non-callable note serves as a substitute for callable debt.

(2) To achieve risk management objectives not obtainable with debt market securities.

We sometimes have risk management objectives that cannot be fully accomplished by securities generally available in the debt markets. For example, we can use the derivative markets to purchase swaptions to add features to our debt not obtainable in the debt markets. Some of the features of the option embedded in a callable bond are dependent on the market environment at issuance and the par issuance price of the bond. Thus, in a callable bond we can not specify certain features, such as specifying an out-of-the-money option, which could allow us to more closely match the interest rate risk being hedged. We use option-based derivatives, such as swaptions, because they provide the added flexibility to fully specify the features of the option, thereby allowing us to more closely match the interest rate risk being hedged.

(3) To quickly and efficiently rebalance our portfolio.

We seek to keep our assets and liabilities matched within a duration tolerance of plus or minus six months. When interest rates are volatile, we often need to lengthen or shorten the average duration of our liabilities to keep them closely matched with our mortgage durations, which change as expected mortgage prepayments change.

While we have a number of rebalancing tools available to us, it is often most efficient for us to rebalance our portfolio by adding new derivatives or by terminating existing derivative positions. For example, when interest rates fall and mortgage durations shorten, we can shorten the duration of our debt by entering into receive-fixed interest rate swaps that convert longer-duration, fixed-term debt into shorter-duration, floating-rate debt or by terminating existing pay-fixed interest rate swaps. This use of derivatives helps increase our funding flexibility while maintaining our low risk tolerance. The types of derivative instruments we use most often to rebalance our portfolio include pay-fixed and receive-fixed interest rate swaps.

In addition to our three primary uses of derivatives, we may also use derivatives for the following purpose:

(4) To hedge foreign currency exposure.

We occasionally issue debt in a foreign currency. Because all of our assets are denominated in U.S. dollars, we enter into currency swaps to effectively convert the foreign-denominated debt into U.S. dollar-denominated debt. By swapping out of foreign currencies completely at the time of the debt issue, we minimize our exposure to any currency risk. Our foreign-denominated debt represents less than 1% of our total debt outstanding.

Types of Derivatives We Use

Derivative instruments may be privately negotiated contracts, which are often referred to as OTC derivatives, or they may be listed and traded on an exchange. Our derivatives consist primarily of OTC contracts that fall into three broad categories.

Interest rate swap contracts. An interest rate swap is a transaction between two parties in which each agrees to exchange payments tied to different interest rates or indices for a specified period of time, generally based on a notional amount of principal. The types of interest rate swaps we use include:

Pay-fixed, receive variable an agreement whereby we pay a predetermined fixed rate of interest based upon a set notional amount and receive a variable interest payment based upon a stated index, with the index resetting at regular intervals over a specified period of time. These contracts generally increase in value as interest rates rise.

Receive-fixed, pay variable an agreement whereby we make a variable interest payment based upon a stated index, with the index resetting at regular intervals, and receive a predetermined fixed rate of interest based upon a set notional amount and over a specified period of time. These contracts generally increase in value as interest rates fall.

Basis swap an agreement that provides for the exchange of variable interest payments, based on notional amounts, tied to two different underlying interest rate indices.

Interest rate option contracts. These contracts primarily include the following:

Pay-fixed swaptions an option that allows us to enter into a pay-fixed, receive variable interest rate swap at some point in the future. These contracts generally increase in value as interest rates rise.

Receive-fixed swaptions an option that allows us to enter into a receive-fixed, pay variable interest rate swap at some point in the future. These contracts generally increase in value as interest rates fall.

Interest rate caps although an interest rate cap is not an option it has option-like characteristics. It is a contract in which we receive money when a reference interest rate, typically LIBOR, exceeds an agreed-upon referenced strike price (cap). The value generally increases as reference interest rates rise.

Foreign currency swaps. Swaps that convert debt we issue in foreign-denominated currencies into U.S. dollars. We enter into foreign currency swaps only to the extent that we issue foreign currency debt.

Summary of Derivative Activity

The decisions to reposition our derivative portfolio are based upon current assessments of our interest rate risk profile and economic conditions, including the composition of our consolidated balance sheets and expected trends, the relative mix of our debt and derivative positions, and the interest rate environment. Table 31 presents our risk management derivative activity by type for the year ended December 31, 2005, along with the stated maturities of derivatives outstanding as of December 31, 2005. Table 31 does not include mortgage commitments that are accounted for as derivatives. We discuss our mortgage commitments in Business Segment Results Capital Markets Group.

Table 31: Activity and Maturity Data for Risk Management Derivatives(1)

	Interest Rate Swaps				Interest Rate Swaptions				
	Pay-Fixed(2)	Receive-Fixed(3)	Basis	Foreign Currency	Pay-Fixed	Receive-Fixed	Interest Rate Caps	Other(4)	T
				(Dollars in millions)					
balance r 31,									
	$ 364,377	$ 201,229	$ 32,303	$ 5,195	$ 163,980	$ 141,195	$ 130,350	$ 379	$ 1,
	138,442	207,269	33,700	13,650	31,575	49,145	17,800	5,243	
ons(5)	(360,802)	(327,305)	(33,730)	(7,392)	(24,850)	(42,770)	(44,000)	(4,889)	(
balance r 31,									
	$ 142,017	$ 81,193	$ 32,273	$ 11,453	$ 170,705	$ 147,570	$ 104,150	$ 733	$
	141,775	156,475	1,300	9,147	14,750	25,250		7,409	
ons(5)	(95,005)	(113,761)	(29,573)	(14,955)	(36,050)	(34,225)	(71,150)	(7,366)	(
balance r 31,									
	$ 188,787	$ 123,907	$ 4,000	$ 5,645	$ 149,405	$ 138,595	$ 33,000	$ 776	$
aturities al 6)									
1 year	$ 6,090	$ 10,525	$ 3,800	$ 1,474	$ 21,575	$ 12,975	$ 19,000	$ 347	$
5 years	70,535	80,660	200	3,441	33,600	22,100	13,250	19	
	76,260	27,557			86,430	85,420	750	410	
ears	35,902	5,165		730	7,800	18,100			
	$ 188,787	$ 123,907	$ 4,000	$ 5,645	$ 149,405	$ 138,595	$ 33,000	$ 776	$
-average te as of r 31,									
	5.02%	4.36%	4.04%		5.94%				
ate	4.37	4.38	4.13			5.03%			
							2.97%		
-average te as of									

r 31,						
	5.23%	2.13%	2.14%	5.73%		
ate	2.39	2.84	2.32		5.16%	
						2.30%

(1) Excludes mortgage commitments accounted for as derivatives. Dollars represent notional amounts that indicate only the amount on which payments are being calculated and do not represent the amount at risk of loss.

(2) Notional amounts include swaps callable by Fannie Mae of $14.3 billion as of December 31, 2005 and $13.8 billion as of December 31, 2004.

(3) Notional amounts include swaps callable by derivatives counterparties of $3.6 billion as of December 31, 2005 and $22.8 billion as of December 31, 2004.

(4) Includes MBS options, forward starting debt and swap credit enhancements.

(5) Includes matured, called, exercised, assigned and terminated amounts. Also includes changes due to foreign exchange rate movements.

(6) Based on contractual maturities.

During 2005, we decreased the outstanding notional balance of our risk management derivatives by $46.0 billion to $644.1 billion as of December 31, 2005. The key driver of this decline was the termination of derivatives in connection with the elimination of debt that was used to fund mortgage assets that we sold. During 2004, we decreased the outstanding notional balance of our risk management derivatives by $348.9 billion to $690.1 billion as of December 31, 2004, primarily as a result of terminating pay-fixed and receive-fixed swaps that economically offset one another. We periodically review our derivatives portfolio and terminate offsetting derivative positions as market conditions permit.

The outstanding notional balance of our risk management derivatives increased to $745.7 billion as of December 31, 2006. The $101.6 billion increase during 2006 reflects higher balances of both pay-fixed and

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receive-fixed swaps, partially offset by a reduction in interest rate swaptions. In response to the general increase in interest rates during the first half of 2006, which lengthened the durations of our mortgage assets, we generally added to our net pay-fixed swap position. During the second half of the year, when interest rates generally declined and the durations of our mortgage assets shortened, we added to our net receive-fixed swap position.

Monitoring and Active Portfolio Rebalancing

Because single-family borrowers typically can prepay a mortgage at any time prior to maturity, the borrower s mortgage is economically similar to callable debt. By investing in mortgage assets, we assume this prepayment risk. As described above, we attempt to offset the prepayment risk and cover our short position either by issuing callable debt that we can redeem at our option or by purchasing option-based derivatives that we can exercise at our option. We also manage the prepayment risk of our assets relative to our funding through active portfolio rebalancing. We develop rebalancing actions based on a number of factors, including an assessment of key risk measures such as our duration gap and net asset fair value sensitivity, as well as analyses of additional risk measures and current market conditions.

Measuring Interest Rate Risk

Our Capital Markets group utilizes a wide range of risk measures and analyses to manage the interest rate risk inherent in the mortgage portfolio. We produce a series of daily, weekly, monthly and quarterly analyses of interest rate risk measures. Many of our projections of mortgage cash flows in our interest rate risk measures depend on our internally developed proprietary prepayment models. The models contain many assumptions, including those regarding borrower behavior in certain interest rate environments and borrower relocation rates. Other market inputs, such as interest rates, mortgage prices and interest rate volatility, are also critical components to our interest rate risk measures. The historical patterns that serve as inputs for our models may not continue in the future. We maintain a research program to constantly evaluate, update and enhance these assumptions, models and analytical tools as appropriate to reflect our best assessment of the environment.

Our primary interest rate risk measures include duration gap, convexity and net asset fair value sensitivity measures. On a daily basis, we calculate base duration and convexity gaps as well as the expected change in the value of our investments for relatively moderate changes in interest rates. On a weekly basis, we also calculate the expected change in the value of our investments for larger movements in interest rates and other factors such as implied volatility of option prices. We also perform other standard risk measures on our portfolio that are based on historical changes in key variables, such as value-at-risk measures and sensitivities to non-parallel changes in the yield curve.

Duration Gap

The duration gap is a measure of the difference between the estimated durations of our assets and liabilities (debt and risk management derivatives). Duration gap summarizes the extent to which estimated cash flows for assets and liabilities are matched, on average, over time and across interest rate scenarios. A positive duration gap signals a greater exposure to rising interest rates because it indicates that the duration of our assets exceeds the duration of our liabilities.

Because our duration gap does not incorporate projected future business activity, it is considered a run-off measure of interest rate risk. It reflects our existing mortgage portfolio, including priced asset, debt and derivatives commitments. We also include the interest rate risk impact of derivative instruments in calculating the duration of liabilities. Our reported duration gap for periods prior to November 2005 excludes non-mortgage investments. We began including non-mortgage investments in our duration gap calculation in November 2005. These incremental assets are primarily short-term, liquid investments included in our liquid investment portfolio. Based on our historical experience, we expect that the guaranty fee income generated from future business activity will largely replace any guaranty fee income lost as a result of mortgage prepayments. Accordingly, we do not actively manage or hedge expected changes in the fair value of our net guaranty assets related to changes in interest rates. The fair values of our guaranty assets and guaranty obligations are presented in Table 17 in Supplemental Non-GAAP Information Fair Value Balance Sheet.

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Pursuant to the September 1, 2005 agreement with OFHEO, we agreed to provide periodic public disclosures regarding the monthly averages of our duration gap. We disclose the duration gap on a monthly basis in our Monthly Summary Report, which is available on our Web site and submitted to the SEC in a current report on Form 8-K. Our monthly duration gap, which is presented below for the period January 1, 2003 to December 31, 2005 reflects the estimate used contemporaneously by management as of the reported date to manage the interest rate risk of our portfolio. During 2006 and 2007 to date, our monthly duration gap has not exceeded plus or minus one month.

Month	**2005**	**2004**	**2003**
January	(1)	(1)	(3)
February	0	(1)	(5)
March	1	0	(2)
April	(1)	3	(2)
May	(1)	3	(5)
June	0	2	(1)
July	1	0	6
August	0	(2)	4
September	1	(2)	1
October	1	0	1
November	0	(1)	(1)
December	0	(1)	(1)

Convexity

Convexity reflects the degree to which the duration and price of our mortgage assets change in response to a given change in interest rates. Because of the prepayment option that exists in mortgage assets, they tend to exhibit negative convexity. Negative convexity refers to the tendency of fixed-rate mortgage assets to fall in price faster in periods of rising interest rates compared to the rate at which they appreciate in periods of falling interest rates. We use convexity measures to provide us with information on how quickly and by how much the portfolio s duration gap may change in different interest rate environments. Our primary strategy for managing convexity risk is to either issue callable debt or purchase option-based derivatives.

Interest Rate Sensitivity of Net Asset Fair Value

We perform various sensitivity analyses that quantify the impact of changes in interest rates on the estimated fair value of our interest rate sensitive assets and liabilities. Our analyses incorporate assumed changes in the interest rate environment, including selected hypothetical, instantaneous shifts in both the level and slope of the yield curve. Table 32 discloses the estimated fair value of our net assets as of December 31, 2005 and 2004, and the impact on the estimated fair value from a hypothetical instantaneous shock in interest rates of a 50 basis points decrease and a 100 basis points increase. We selected these interest rate changes because we believe they reflect reasonably possible near-term outcomes. We discuss how we derive the estimated fair value of our net assets, which serves as the base case for our sensitivity analysis, in Supplemental Non-GAAP Information Fair Value Balance Sheet.

Table 32: Interest Rate Sensitivity of Net Asset Fair Value

	As of December 31, 2005					
			Effect on Estimated Fair Value			
	Carrying Value	Estimated Fair Value	−50 Basis Points $	−50 Basis Points %	+100 Basis Points $	+100 Basis Points %
	(Dollars in millions)					
Trading financial instruments[1]	$ 15,110	$ 15,110	$ 262	1.73%	$ (641)	(4.24)%
Non-trading mortgage assets and consolidated debt[2]	760,586	760,187	9,315	1.23	(23,734)	(3.12)
Debt[2]	(754,320)	(760,002)	(8,617)	1.13	17,640	(2.32)
Subtotal before derivatives	21,376	15,295	960	6.28	(6,735)	(44.03)
Derivative assets and liabilities, net	4,374	4,374	(1,577)	(36.05)	5,696	130.22
Subtotal after derivatives	25,750	19,669	(617)	(3.14)	(1,039)	(5.28)
Guaranty assets and guaranty obligations, net[2]	(2,274)	7,860	(1,163)	(14.80)	1,791	22.79
Net market sensitive assets[2][3]	23,476	27,529	(1,780)	(6.47)	752	2.73
Other non-financial assets and liabilities, net[4]	15,826	14,670	489	3.33	(397)	(2.71)
Net assets[5][6]	$ 39,302	$ 42,199	$ (1,291)	(3.06)%	$ 355	0.84%

	As of December 31, 2004					
			Effect on Estimated Fair Value			
	Carrying Value	Estimated Fair Value	−50 Basis Points $	−50 Basis Points %	+100 Basis Points $	+100 Basis Points %
	(Dollars in millions)					
Trading financial instruments[1]	$ 35,287	$ 35,287	$ 476	1.35%	$ (1,417)	(4.02)%
Non-trading mortgage assets and consolidated debt[2]	928,104	936,530	9,930	1.06	(28,596)	(3.05)
Debt[2]	(943,017)	(958,237)	(9,215)	0.96	19,181	(2.00)
Subtotal before derivatives	20,374	13,580	1,191	8.77	(10,832)	(79.76)
Derivative assets and liabilities, net	5,444	5,444	(3,150)	(57.86)	8,525	156.59

Subtotal after derivatives		25,818		19,024		(1,959)	(10.30)		(2,307)	(12.13)
Guaranty assets and guaranty obligations, net[2]		(1,826)		6,450		(1,499)	(23.24)		1,498	23.22
Net market sensitive assets[2][3]		23,992		25,474		(3,458)	(13.57)		(809)	(3.18)
Other non-financial assets and liabilities, net[4]		14,910		14,620		1,210	8.28		283	1.94
Net assets[5][6]	$	38,902	$	40,094	$	(2,248)	(5.61)%	$	(526)	(1.31)%

(1) Consists of securities classified in the consolidated balance sheets as trading and carried at fair estimated value.

(2) Includes a reclassification of consolidated debt with a carrying value of $10.4 billion and estimated fair value of $10.5 billion as of December 31, 2005, respectively, and a carrying value of $12.5 billion and estimated fair value of $12.2 billion as of December 31, 2004, respectively. In addition, certain amounts have been reclassified from securities to Guaranty assets and guaranty obligations, net to reflect how the risk of these securities is managed by the business.

(3) Includes net financial assets and financial liabilities reported in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments and additional market sensitive instruments that consist of master servicing assets, master servicing liabilities and credit enhancements.

(4) The sensitivity changes related to other non-financial assets and liabilities represent the tax effect on net assets under these scenarios and do not include any interest rate sensitivity related to these items.

(5) The carrying value for net assets equals total stockholders equity as reported in the consolidated balance sheets.

(6) The net asset sensitivities, excluding the sensitivity of the Guaranty assets and guaranty obligations, net, net of tax was (1.3)% for a −50 bp shock and (1.9)% for a +100 bp shock as of December 31, 2005, and (3.2)% for a −50 bp shock and (3.7)% for a +100 bp shock as of December 31, 2004.

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As discussed above, we structure our debt and derivatives to match and offset the interest rate risk of our mortgage investments as much as possible. The interest rate sensitivities presented in Table 32 convey the extent to which changes in the estimated fair value of our mortgage assets are offset by changes in the estimated fair value of our debt and derivatives. Based on our sensitivity analyses, as of December 31, 2005 we estimate that a 50 basis point instantaneous decrease in interest rates and a 100 basis point instantaneous increase in interest rates would reduce the estimated fair value of our net assets by approximately 3.1% and increase the estimated fair value of our net assets by 0.8%, respectively. We estimate that a 50 basis point instantaneous decrease in interest rates and a 100 basis point instantaneous increase in interest rates would reduce the estimated fair value of our net assets as of December 31, 2004 by approximately 5.6% and 1.3%, respectively. These sensitivities, which were relatively stable from the end of 2004 to the end of 2005, indicate a relatively low level of interest rate risk.

We also show in footnote 6 of Table 32 the sensitivity of the estimated fair value of our net assets, excluding the sensitivity of our guaranty assets and guaranty obligations, net (net of tax). We evaluate the sensitivity of the fair value of our net assets, excluding the sensitivity of our guaranty assets and guaranty obligations, because, as previously discussed, we do not actively manage the interest rate risk of our guaranty business.

These sensitivity analyses are limited in that they contemplate only certain movements in interest rates and are performed at a particular point in time based on the estimated fair values of our existing assets and liabilities. The sensitivity analyses do not incorporate other factors that may have a significant impact, most notably the value from expected future business activities and strategic actions that management may take to manage interest rate risk. Moreover, our sensitivity analyses require numerous assumptions, including prepayment factors and discount rates, which require management judgment. While we believe the assumptions and methodology used in our sensitivity analyses are reasonable, there is no standard methodology for estimating the sensitivity of net asset fair value and different assumptions could produce materially different sensitivity estimates.

In October 2000 we made a voluntary commitment to publicly disclose the results of interest rate risk sensitivity analyses on a monthly basis and began a monthly disclosure of net interest income at risk. Because our restatement affected net interest income at risk, we suspended this disclosure beginning in December 2004. Pursuant to our September 1, 2005 agreement with OFHEO, we have agreed to provide public disclosure of the estimated impact on our financial condition of a 50 basis point shift in rates and a 25 basis point change in the slope of the yield curve. We will begin providing this disclosure using data from the second quarter of 2007.

Operational Risk Management

Operational risk can manifest itself in many ways, including accounting or operational errors, business disruptions, fraud, technological failures and other operational challenges resulting from failed or inadequate internal controls. These events may potentially result in financial losses and other damage to our business, including reputational harm.

We currently manage operational risk through an enterprise-wide framework. In 2006, we established an independent Operational Risk Oversight (ORO) function within the Chief Risk Office with responsibility for oversight of the business units operational risk management activities. In accordance with our Policy on Operational Risk Management established in October 2006, ORO regularly reports to senior management and the Board of Directors on the quality of our operational risk management and on identified operational risk exposures. The Operational Risk Committee, which provides a governance forum for the oversight of operational risk policies and programs of the company, meets at least four times annually to review the corporate operational risk position. ORO is also responsible for the design and implementation of operational risk management processes pertaining to capturing loss and near miss event data, risk and control assessments by the business units, key risk indicators, and analysis of scenarios representing significant potential losses to our business. To further strengthen our existing operational risk programs, in 2006, we centralized oversight of our business continuity efforts, information security programs, fraud management and our corporate insurance program under this new operational risk oversight function. In 2007, we consolidated our SOX Finance Team as part of the operational risk oversight function, with accountability to both the Chief

Risk Officer and the Chief Financial Officer. We continue to work on improving our internal controls and procedures relating to the management of operational risk.

Our business units have direct responsibility for the identification, assessment, control and mitigation of the operational risks associated with their business activities. The Division Risk Office has responsibility for the implementation and monitoring of operational risk management, SOX, and compliance programs throughout the company. ORO and the Division Risk Office work closely throughout the design and implementation effort to ensure that roles and responsibilities are properly identified and staffed, and that programs are effectively integrated into standard business practices. In addition, the ORO and Division Risk Office work closely with our Chief Compliance Officer to coordinate implementation efforts and reinforce new operational discipline frameworks within the company.

OFHEO s September 2004 interim report on its special examination concluded that we had experienced breakdowns in operational controls that contributed to our accounting failures and safety and soundness problems. Paul Weiss s independent investigation into the issues raised in OFHEO s interim report affirmed this conclusion. In 2005, we engaged an independent firm to assess our existing operational risk management capabilities and identify gaps in skill sets, processes and other elements. The results of this assessment identified several deficiencies in our operational risk management structure that we have been working to remediate. For a description of the material weaknesses in our internal control over financial reporting relating to our operational controls and operational risk management, see Item 9A Controls and Procedures.

To remedy the deficiencies in our operational risk management process, we have developed new policies for managing operational risks and an overall operational risk management framework to identify, measure, monitor and manage operational risks across the company. We are in the initial stage of a multi-year program to implement our new operational risk management framework. In November 2006, we submitted a detailed three-year plan on the design and implementation of this framework to OFHEO as required by our consent order with OFHEO. Our operational risk management framework is based on the Basel Committee guidance on sound practices for the management of operational risk broadly adopted by U.S. commercial banks comparable in size to Fannie Mae. The framework incorporates elements such as the monitoring of operational loss events, tracking of key risk indicators, use of common terminology to describe risks and self-assessments of risks and controls in place to mitigate operational risks. We have recently hired several new senior officers with significant expertise in operational risk management to implement this new framework.

In addition to the corporate operational risk oversight function, we also maintain programs for the management of our exposure to mortgage fraud, breaches in information security and external disruptions to business continuity, as outlined below.

Mortgage Fraud

We implemented a mortgage fraud policy and program in 2005. OFHEO issued a regulation in July 2005 on the detection and reporting of mortgage fraud that required us to establish adequate and efficient internal controls and procedures and an operational training program to assure an effective system to detect and report mortgage fraud or possible mortgage fraud. We have operated in compliance with this regulation since its effective date in August 2005.

As part of our mortgage fraud program, we assist our lender customers in preventing the origination of fraudulent loans, including through the use of a series of detection algorithms provided in conjunction with our automated underwriting technology that alerts lenders to possible fraud at loan origination. We maintain contracts with our lender customers that require them to represent and warrant that loans being sold meet the requirements of our selling and servicing guides, and to repurchase loans sold or delivered to us when misrepresentations are made that we determine may involve mortgage fraud. We also carry insurance to provide further coverage in the event of failure of the lender to perform under fraudulent circumstances. We continue to work to improve our internal controls and procedures relating to the detection and reporting of mortgage fraud.

Information Security

Recognizing the importance and sensitivity of our information assets, we have established an information security program designed to protect the security and privacy of confidential information, including non-public personal information and sensitive business data. Our current information security program was launched in late 2003 to address acknowledged industry-wide security concerns in areas such as access management, change management, secure application development and system monitoring.

Our security infrastructure is designed for the protection of sensitive information assets, and includes sophisticated network defenses and software designed to prevent hackers, spam, virus, phishing and other types of cyber attack, while our information security practices are intended to minimize risks due to process failure or misuse. We employ several firms specializing in information security assessment to uncover control gaps and risks to our information assets. We acknowledge the constant need to update and improve our defenses in response to changes in the threat environment.

We continue to work to improve our information security program, with the implementation of additional controls to protect our confidential data. These have included increased information security and privacy assessment and monitoring within our business units, a multi-year effort to improve access management, encryption of data on our employees computers, as well as improved tools to monitor and block information loss from within our network, email and other communication systems.

Business Continuity and Crisis Management

Our ORO function has established business continuity and crisis management policies and programs, with execution of these programs implemented by our technology, operations, human resources and facilities functions in concert with the business units that are responsible for the affected processes and business applications. These policies and programs are designed to ensure that our critical business functions continue to operate under emergency conditions. Our business continuity program is subject to regulatory review by OFHEO.

We have installed redundant systems within each business critical system, as well as redundant systems in two geographically separate data centers. These redundant systems are designed to provide continuity of operations for up to one week without significant loss of service to constituents or significant loss of revenue. We also have developed longer-term recovery plans. In addition, we have implemented strategies for access to critical business systems by employees and staff, such as alternate work facilities in geographically diverse locations for our back office and wire transfer functions. We have also established redundant communications systems for external partners and customers. For staff functions that are considered most critical, such as cash wire operations and securities settlements, we have instituted multi-site, simultaneous operations from three separate locations. Dual-site market room activities are conducted on a quarterly basis for front office functions. We recently successfully completed a disaster recovery test of critical operations using a recently constructed alternate data center.

To enable recovery from large-scale, catastrophic events, we copy all production data to backup media on a real-time or nightly basis. The data is transported and stored in multiple locations, including an offsite storage facility located out of the region. In addition, a limited tertiary operating site is available out of the region. The tertiary site complies with the sound practices established by the Federal Reserve Board, Office of the Comptroller of the Currency, and the SEC for resiliency of key U.S. financial institutions, and is designed to enable us to fulfill our critical obligations until automated processing is able to resume.

LIQUIDITY AND CAPITAL MANAGEMENT

Liquidity is essential to our business. We actively manage our liquidity and capital position with the objective of preserving stable, reliable and cost-effective sources of cash to meet all of our current and future operating financial commitments and regulatory capital requirements. We obtain the funds we need to operate our business primarily from the proceeds we receive from the issuance of debt. We seek to maintain sufficient excess liquidity in the event that factors, whether internal or external to our business, temporarily prevent us from issuing debt in the capital markets.

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Liquidity

Liquidity Risk Management

Liquidity risk is the risk to our earnings and capital that would arise from an inability to meet our cash obligations in a timely manner. Because liquidity is essential to our business, we have adopted a comprehensive liquidity risk policy that is designed to provide us with sufficient flexibility to address both liquidity events specific to our business and market-wide liquidity events. Our liquidity risk policy governs our management of liquidity risk and outlines our methods for measuring and monitoring liquidity risk. Our liquidity risk policy, which has been approved by our Board of Directors, outlines the roles and responsibilities for managing liquidity risk within the company. Our Capital Markets group is responsible for monitoring and managing our liquidity risk, with oversight provided by the Chief Risk Office, several management-level committees and the Risk Policy and Capital Committee of the Board of Directors.

We conduct daily liquidity management activities to achieve the goals of our liquidity risk policy. The primary tools that we employ for liquidity management include the following:

- daily monitoring and reporting of our liquidity position;
- daily forecasting of our ability to meet our liquidity needs over a 90-day period without relying upon the issuance of unsecured debt;
- daily monitoring of market and economic factors that may impact our liquidity;
- a defined escalation process for bringing any liquidity issues or concerns that may arise to the attention of higher levels of our management;
- routine testing of our ability to rely upon identified sources of liquidity;
- periodic reporting to management and the Board of Directors regarding our liquidity position;
- periodic review and testing of our liquidity management controls by our Internal Audit department;
- maintaining unencumbered mortgage assets that are available as collateral for secured borrowings pursuant to repurchase agreements or for sale; and
- maintaining an investment portfolio of liquid non-mortgage assets that are readily marketable or have short-term maturities so that we can quickly and easily convert these assets into cash.

Sources and Uses of Cash

We manage our cash position on a daily basis.

Our primary source of cash is proceeds from the issuance of our debt securities. Our other sources of cash currently consist primarily of:

- principal and interest payments received on our mortgage portfolio assets;

principal and interest payments received on our liquid investments;

borrowings under secured and unsecured intraday funding lines of credit we have established with several large financial institutions;

sales of mortgage loans, mortgage-related securities and liquid assets;

borrowings against mortgage-related securities and other investment securities we hold pursuant to repurchase agreements and loan agreements;

guaranty fees earned on Fannie Mae MBS;

mortgage insurance counterparty payments; and

net receipts on derivative instruments.

Our uses of cash currently consist primarily of:

- the repayment of matured, redeemed and repurchased debt;
- the purchase of mortgage loans, mortgage-related securities and other investments;
- the payment of interest payments on outstanding debt;
- net payments on derivative agreements;
- the pledging and delivery of cash and cash equivalents as collateral under derivative instruments;
- the payment of administrative expenses;
- the payment of federal income taxes;
- losses incurred in connection with our Fannie Mae MBS guaranty obligations; and
- the payment of dividends on our common and preferred stock.

Debt Funding

Because our primary source of cash is proceeds from the issuance of our debt securities, we depend on our continuing ability to issue debt securities in the capital markets to meet our cash requirements. We issue a variety of non-callable and callable debt securities in the domestic and international capital markets in a wide range of maturities to meet our large and continuous funding needs. Our Capital Markets group is responsible for the issuance of debt securities to meet our funding needs. Table 33 below provides a summary of our debt activity for the years ended December 31, 2005, 2004 and 2003. Table 34 below shows our outstanding short-term borrowings for the years ended December 31, 2005, 2004 and 2003.

Table 33: Debt Activity

	For the Year Ended December 31, 2005	2004	2003
	(Dollars in millions)		
Issued during the year:(1)			
Short-term:(2)			
Amount:(3)	$ 2,795,854	$ 2,055,759	$ 2,234,000
Weighted average interest rate:	3.20%	1.50%	1.07%
Long-term:			
Amount:(3)	$ 156,437	$ 252,658	$ 348,112
Weighted average interest rate:	4.41%	2.90%	2.58%
Total issued:			
Amount:(3)	$ 2,952,291	$ 2,308,417	$ 2,582,112
Weighted average interest rate:	3.26%	1.66%	1.28%
Redeemed during the year:(1)(4)			

Short-term:(2)			
Amount:(3)	$ 2,944,027	$ 2,081,726	$ 2,191,992
Weighted average interest rate:	3.03%	1.34%	1.12%
Long-term:			
Amount:(3)	$ 196,957	$ 238,686	$ 279,168
Weighted average interest rate:	3.51%	3.26%	3.66%
Total redeemed:			
Amount:(3)	$ 3,140,984	$ 2,320,412	$ 2,471,160
Weighted average interest rate:	3.06%	1.54%	1.41%

(1) Excludes debt activity resulting from consolidations.

(2) Includes Federal funds purchased and securities sold under agreements to repurchase.

(3) Represents the face amount at issuance or redemption.

(4) Represents all payments on debt, including regularly scheduled principal payments, payments at maturity, payments as the result of a call and payments for any other repurchases.

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Table 34: Outstanding Short-Term Borrowings

	2005				
	As of December 31,		Average During the Year		
	Outstanding	Weighted Average Interest Rate[1]	Outstanding[2]	Weighted Average Interest Rate[1]	Maximum Outstanding[3]
	(Dollars in millions)				
Federal funds purchased and securities sold under agreements to repurchase	$ 705	3.90%	$ 2,202	2.88%	$ 6,143
Fixed short-term debt					
U.S. discount notes	$ 166,645	4.08%	$ 205,152	3.15%	$ 281,117
Foreign exchange discount notes	1,367	2.66	3,931	2.00	8,191
Other fixed short-term debt	941	3.75	1,429	3.03	3,570
Floating short-term debt	645	4.16	3,383	3.26	6,250
Debt from consolidations	3,588	4.25	4,394	3.25	4,891
Total short-term debt	$ 173,186	4.07%			

	2004				
	As of December 31,		Average During the Year		
	Outstanding	Weighted Average Interest Rate[1]	Outstanding[2]	Weighted Average Interest Rate[1]	Maximum Outstanding[3]
	(Dollars in millions)				
Federal funds purchased and securities sold under agreements to repurchase	$ 2,400	1.90%	$ 2,704	0.80%	$ 10,455
Fixed short-term debt					
U.S. discount notes	$ 299,728	2.14%	$ 306,539	1.42%	$ 323,289
Foreign exchange discount notes	6,591	0.84	3,064	1.10	7,089
Other fixed short-term debt	3,724	1.59	3,236	1.43	3,779
Floating short-term debt	6,250	2.19	7,548	1.41	9,135
Debt from consolidations	3,987	2.20	2,989	1.54	3,987
Total short-term debt	$ 320,280	2.11%			

	2003				
	As of December 31,		Average During the Year		
	Outstanding	Weighted Average Interest Rate(1)	Outstanding(2)	Weighted Average Interest Rate(1)	Maximum Outstanding(3)
	(Dollars in millions)				
Federal funds purchased and securities sold under agreements to repurchase	$ 3,673	1.03%	$ 7,276	0.58%	$ 21,773
Fixed short-term debt					
U.S. discount notes	$ 327,967	1.11%	$ 320,987	1.20%	$ 351,793
Foreign exchange discount notes	1,214	1.37	1,432	1.48	3,291
Other fixed short-term debt	1,863	1.53	726	1.13	2,250
Floating short-term debt	10,235	1.03	5,343	1.16	10,235
Debt from consolidations	2,383	1.14	1,360	1.23	2,383
Total short-term debt	$ 343,662	1.11%			

(1) Includes discounts, premiums and other cost basis adjustments.

(2) Average amount outstanding during the year has been calculated using month-end balances.

(3) Maximum outstanding represents the highest month-end outstanding balance during the year.

For information regarding our outstanding long-term debt as of December 31, 2005 and 2004, refer to Notes to Consolidated Financial Statements Note 8, Short-term Borrowings and Long-term Debt.

We are one of the world s largest issuers of unsecured debt securities. We issue debt on a regular basis in significant amounts in the capital markets and have a diversified funding base of domestic and international investors. Purchasers of our debt securities include fund managers, commercial banks, pension funds, insurance companies, foreign central banks, state and local governments, and retail investors. Purchasers of our debt securities are also geographically diversified, with a significant portion of our investors located in the United States, Europe and Asia. The diversity of our debt investors enhances our financial flexibility and limits our dependence on any one source of funding. Our status as a GSE and our current AAA (or its equivalent) senior long-term unsecured debt credit ratings are critical to our ability to continuously access the debt capital markets to borrow at attractive rates. The U.S. government does not guarantee our debt, directly or indirectly, and our debt does not constitute a debt or obligation of the U.S. government.

Our sources of liquidity have consistently been adequate to meet both our short-term and long-term funding needs, and we anticipate that they will remain adequate in the next year. Due to the reduction in the size of our mortgage portfolio subsequent to December 31, 2004 pursuant to our capital restoration plan, our debt funding requirements have been lower in 2005, 2006 and 2007 than in 2003 and 2004. As of December 31, 2005, we had total debt outstanding of $764.7 billion, as compared to an estimated total debt outstanding of $774.4 billion as of December 31, 2006. However, we remain an active issuer of short-term and long-term debt securities. Our short-term and long-term funding needs during 2007 and 2008 are generally expected to be consistent with our needs during 2005 and 2006, and with the uses of cash described above under Sources and Uses of Cash. As described below under Capital Management Capital Activity OFHEO Oversight of Our Capital Activity, pursuant to our May 2006 consent order with OFHEO, we are currently not permitted to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO as of December 31, 2005 ($727.75 billion). We expect that, over the long term, our funding needs and sources of liquidity will remain relatively consistent with current needs and sources. We may increase our issuance of debt in future years if we decide to increase our purchase of mortgage assets following any modification or expiration of the current limitation on the size of our mortgage portfolio.

We have experienced no limitations on our ability to borrow funds through the issuance of debt securities in the capital markets and do not anticipate any change in our ability to do so in the foreseeable future. Significant changes in our current regulatory status, however, could adversely affect our access to some or all debt investors and lead to a reduction in our credit ratings, thereby potentially increasing our debt funding costs and reducing the amount of debt that we can issue at any given time. Other factors that could negatively impact our ability to issue debt securities at attractive rates include significant changes in interest rates, increased interest rate volatility, a significant adverse change in foreign exchange rates, a significant adverse change in our financial condition or financial results, significant events relating to our business or industry, a significant change in the public s perception of the risks to and financial prospects of our business or our industry, regulatory constraints, disruptions in the capital markets and general economic conditions in the United States or abroad. Refer to Item 1A Risk Factors for a discussion of the risks relating to our ability to issue debt in sufficient quantities and at attractive rates, the risks associated with a reduction in our current credit ratings and the risks associated with proposed changes in the regulation of our business. On June 13, 2006, the U.S. Department of the Treasury announced that it would undertake a review of its process for approving our issuances of debt, which could adversely impact our flexibility in issuing debt securities in the future. We cannot predict whether the outcome of this review will materially impact our current debt issuance activities.

Change in the Federal Reserve Board s Payments System Risk Policy

On July 20, 2006, the Federal Reserve Banks implemented changes to the Federal Reserve Board s Policy Statement on Payments System Risk. The changes pertain to the processing of principal and interest payments, via the Fedwire system, for securities issued by GSEs and certain international organizations, including us.

Prior to July 2006, the Federal Reserve Bank had exempted us from overdraft fees relating to the processing of interest and redemption payments on our debt and Fannie Mae MBS. We were permitted to overdraw our account at the Federal Reserve Bank for these payments and would make periodic payments throughout the business day until our account balance was zero. Since July 2006, we have been required to fund interest and redemption payments on our debt and Fannie Mae MBS before the Federal Reserve Banks, acting as our fiscal agent, will execute the payments on our behalf. We compensate the Federal Reserve Banks for this service.

Because we receive funds and make payments throughout each business day, we have implemented actions, including revising our funding strategies, to ensure that we will have access to funds to meet our payment obligations in a timely manner. We have established and periodically may use secured and unsecured intraday funding lines of credit with several large financial institutions. We are currently funding security holder payments on a daily basis and are fully compliant with the revised Federal Reserve policy.

Credit Ratings and Risk Ratings

Our ability to borrow at attractive rates is highly dependent upon our credit ratings. Our senior unsecured debt (both long-term and short-term), qualifying benchmark subordinated debt and preferred stock are rated and continuously monitored by Standard & Poor s, Moody s and Fitch, each of which is a nationally recognized statistical rating organization. Table 35 below sets forth the credit ratings issued by each of these rating agencies of our long-term and short-term senior unsecured debt, qualifying benchmark subordinated debt and preferred stock as of December 7, 2006.

Table 35: Fannie Mae Debt Credit Ratings

	Senior Long-Term Unsecured Debt	Senior Short-Term Unsecured Debt	Benchmark Subordinated Debt	Preferred Stock
Standard & Poor s	AAA	A−1+	AA−(1)	AA−(1)
Moody s Investors Service	Aaa	P-1	Aa2(2)	Aa3(2)
Fitch, Inc.	AAA	F1+	AA−(3)	AA−(4)

(1) On September 23, 2004, Standard & Poor s placed our preferred stock and subordinated debt ratings on credit watch negative. On December 7, 2006, Standard & Poor s removed our preferred stock and subordinated debt ratings from credit watch negative and placed these ratings on a negative outlook.

(2) On September 28, 2004, Moody s placed our preferred stock and subordinated debt ratings on a negative outlook. On December 15, 2005, Moody s confirmed our preferred stock and subordinated debt ratings with a stable outlook.

(3) On September 29, 2004, Fitch downgraded our subordinated debt rating from AA to AA− . On December 23, 2004, Fitch placed our subordinated debt rating on rating watch negative. On December 7, 2006, Fitch removed our subordinated debt rating from rating watch negative and affirmed the AA- rating.

(4) On September 29, 2004, Fitch downgraded our preferred stock rating from AA to AA− . On December 23, 2004, Fitch downgraded our preferred stock rating from AA− to A+ and placed our preferred stock rating on rating watch negative. On December 7, 2006, Fitch removed our preferred stock rating from rating watch negative and upgraded the rating from A+ to AA− .

Pursuant to our September 1, 2005 agreement with OFHEO, we agreed to seek to obtain a rating, which will be continuously monitored by at least one nationally recognized statistical rating organization, that assesses, among other things, the independent financial strength or risk to the government of Fannie Mae operating under its authorizing legislation but without assuming a cash infusion or extraordinary support of the government in the event of a financial crisis. We also agreed to provide periodic public disclosure of this rating.

Standard & Poor s risk to the government rating for us as of April 26, 2007 was AA− with a negative outlook. On December 7, 2006, Standard & Poor s removed this rating from credit watch negative and placed the rating on a negative outlook. Standard & Poor s continually monitors this rating.

Moody s Bank Financial Strength Rating for us as of April 26, 2007 was B+ with a stable outlook. This rating was downgraded from A− on March 28, 2005. Moody s continually monitors this rating.

We do not have any covenants in our existing debt agreements that would be violated by a downgrade in our credit ratings. To date, we have not experienced any limitations in our ability to access the capital markets due to a credit ratings downgrade. See Item 1A Risk Factors for a discussion of the risks associated with a reduction in our credit ratings.

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Liquidity Contingency Plan

Our Liquidity Risk Policy includes a contingency plan in the event that factors, whether internal or external to our business, temporarily compromise our ability to access capital through normal channels. Our contingency plan provides for alternative sources of liquidity that would allow us to meet all of our cash obligations for 90 days without relying upon the issuance of unsecured debt. If our access to the capital markets becomes impaired, our contingency plan designates our unencumbered mortgage portfolio as our primary source of liquidity. Our unencumbered mortgage portfolio consists of unencumbered mortgage loans and mortgage-related securities that could be pledged as collateral for borrowing in the market for mortgage repurchase agreements or sold to generate additional funds. As of December 31, 2005 and 2004, substantially all of our mortgage portfolio would have been eligible to be pledged as collateral under repurchase agreements. As of December 31, 2004, $1.7 billion of the mortgage-related securities held in our portfolio had been pledged as collateral under repurchase agreements. As of December 31, 2005, we did not have any outstanding securities sold under agreements to repurchase, and therefore, we did not pledge any securities. We have not pledged any mortgage loans held in our portfolio as collateral under repurchase agreements.

Our liquid investment portfolio is also a source of liquidity in the event that we cannot access the capital markets. Our liquid investment portfolio consists primarily of high-quality non-mortgage investments that are readily marketable or have short-term maturities. As of December 31, 2005 and 2004, we had approximately $52.2 billion and $55.1 billion, respectively, in liquid assets, net of any cash and cash equivalents pledged as collateral. Our investments in non-mortgage securities, which account for the majority of our liquid assets, totaled $37.1 billion and $43.9 billion as of December 31, 2005 and 2004, respectively. Approximately 98% and 93% of our non-mortgage securities as of December 31, 2005 and 2004, respectively, had a credit rating of A (or its equivalent) or higher, based on the lowest of Standard & Poor s, Moody s or Fitch ratings.

OFHEO Supervision

Pursuant to its role as our safety and soundness regulator, OFHEO monitors our liquidity management practices and audits our liquidity position on a continuous basis. On September 1, 2005, we entered into an agreement with OFHEO that formalized and updated the voluntary initiatives that we announced in October 2000 to enhance market discipline, liquidity and capital. Pursuant to this agreement, we agreed to certain commitments pertaining to management of our liquidity, including:

- complying with principles of sound liquidity management consistent with industry practice;
- maintenance of a portfolio of highly liquid assets;
- maintenance of a functional contingency plan providing for at least three months liquidity without relying upon the issuance of unsecured debt; and
- periodic testing of our contingency plan in consultation with an OFHEO examiner.

Each of these commitments is addressed in our Liquidity Risk Policy described above. We further agreed to periodic public disclosure regarding our compliance with the plan for maintaining three months liquidity and meeting the commitment for periodic testing. We believe we were in compliance with our commitment to maintain and test our functional contingency plan as of March 31, 2007. We are currently in the process of revising our liquidity management policies in consultation with OFHEO. We expect that OFHEO will finalize its review of our implementation of our liquidity management commitments during the second quarter of 2007.

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Contractual Obligations

Table 36 summarizes our expectation as to the effect of our minimum debt payments and other material noncancelable contractual obligations as of December 31, 2005 on our liquidity and cash flows in future periods. Our current contractual obligations as of the date of this report are different than the contractual obligations as of December 31, 2005 presented in the table below, primarily with respect to our debt obligations. As of December 31, 2005, we had total debt outstanding of $764.7 billion, as compared to an estimated total debt outstanding of $774.4 billion as of December 31, 2006.

Table 36: Contractual Obligations

	Payments Due by Period as of December 31, 2005				
	Total	Less than 1 Year	1 to 3 Years	3 to 5 Years	More than 5 Years
	(Dollars in millions)				
Long-term debt obligations(1)	$ 584,017	$ 129,138	$ 197,438	$ 105,754	$ 151,687
Contractual interest on long-term debt obligations(2)	135,478	24,005	35,596	22,541	53,336
Operating lease obligations(3)	203	35	59	37	72
Purchase obligations:					
Mortgage commitments(4)	23,673	23,636	37		
Other purchase obligations(5)	95	51	44		
Other long-term liabilities reflected in the consolidated balance sheet:(6)					
Government penalty(7)	400	400			
Other(8)	5,118	4,073	1,045		
Total contractual obligations	$ 748,984	$ 181,338	$ 234,219	$ 128,332	$ 205,095

(1) Represents the carrying amount of our long-term debt assuming payments are made in full at maturity. Amounts exclude approximately $6.8 billion in long-term debt from consolidations. Amounts include unamortized net premium and cost basis adjustments of approximately $10.7 billion.

(2) Excludes contractual interest on long-term debt from consolidations.

(3) Includes certain premises and equipment leases.

(4) Includes on- and off-balance sheet commitments to purchase loans and mortgage-related securities.

(5) Includes only unconditional purchase obligations that are subject to a cancellation penalty for certain telecom services, software and computer services, and agreements. Excludes arrangements that may be cancelled without penalty.

(6)

Excludes risk management derivative transactions that may require cash settlement in future periods and our obligations to stand ready to perform under our guaranties relating to Fannie Mae MBS and other financial guaranties, because the amount and timing of payments under these arrangements are generally contingent upon the occurrence of future events. For a description of the amount of our on- and off-balance sheet Fannie Mae MBS and other financial guaranties as of December 31, 2005, see Off-Balance Sheet Arrangements and Variable Interest Entities.

(7) Represents a $400 million civil penalty to the U.S. government pursuant to May 23, 2006 settlements with the SEC and OFHEO. This penalty is included in the consolidated balance sheet under Other Liabilities.

(8) Includes future cash payments due under our contractual obligations to fund LIHTC and other partnerships that are unconditional and legally binding, as well as cash received as collateral from derivative counterparties, which are included in the consolidated balance sheets under Partnership liabilities and Other liabilities, respectively. Amounts also include our obligation to fund partnerships that have been consolidated.

Cash Flows

Cash Flows for the Year Ended December 31, 2005

During the year ended December 31, 2005, cash and cash equivalents increased by $165 million, or 6%, to $2.8 billion as of December 31, 2005 as compared to the prior year.

We generated net cash of $78.1 billion in operating activities in 2005, primarily due to net income and a net decrease in trading securities. Our cash generated by operating activities was partially offset by purchases of HFS loans.

We generated net cash of $139.4 billion in investing activities in 2005, primarily due to proceeds we received from sales and maturities of AFS securities and proceeds from the sale of held-for-investment (HFI) loans as we reduced our portfolio. The cash increases were partially offset by advances to lenders and purchases of AFS securities and HFI loans.

We used net cash of $217.4 billion in financing activities in 2005, primarily for the net redemption of short-term and long-term debt.

Cash Flows for the Year Ended December 31, 2004

During the year ended December 31, 2004, cash and cash equivalents decreased by $740 million, or 22%, to $2.7 billion as of December 31, 2004 as compared to the prior year.

We generated net cash of $41.6 billion in operating activities in 2004, primarily due to net income and a net decrease in trading securities. Our cash generated by operating activities was partially offset by purchases of HFS loans.

We used net cash of $16.8 billion in investing activities in 2004, primarily due to advances to lenders and purchases of AFS securities and HFI loans. The cash we used in investing activities was partially offset by proceeds we received from maturities of AFS securities and repayments of HFI loans.

We used net cash of $25.5 billion in financing activities in 2004, primarily for the redemption of short-term and long-term debt. The cash we used in financing activities was offset primarily by issuances of our short-term and long-term debt.

Cash Flows for the Year Ended December 31, 2003

During the year ended December 31, 2003, our cash and cash equivalents increased by $1.7 billion, or 97%, to $3.4 billion as of December 31, 2003 as compared to the prior year.

We generated net cash of $58.2 billion in operating activities in 2003, primarily due to net income and a net decrease in trading securities. Our cash generated by operating activities was partially offset by purchases of HFS loans.

We used net cash of $152.7 billion in investing activities in 2003, primarily due to advances to lenders and purchases of AFS securities and HFI loans. Our cash used in investing activities was partially offset by proceeds we received from maturities and sales of AFS securities and repayments of HFI loans.

We raised net cash of $96.2 billion in financing activities in 2003, primarily by issuing short-term and long-term debt. Our cash provided by financing activities was partially offset primarily by redemption of short-term and long-term debt.

Capital Management

Our objective in managing capital is to maximize long-term stockholder value through the pursuit of business opportunities that provide attractive returns while maintaining capital at levels sufficient to ensure compliance with both regulatory and internal capital requirements.

Capital Adequacy Requirements

We are subject to capital adequacy requirements established by the 1992 Act. The statutory capital framework incorporates two different quantitative assessments of capital both a minimum capital requirement and a risk-based capital requirement. While the minimum capital requirement is ratio-based, the risk-based capital requirement is based on simulated stress test performance. Pursuant to the 1992 Act, we are required to maintain sufficient capital to meet both of these requirements in order to be classified as adequately capitalized. In addition, pursuant to our May 2006 consent order with OFHEO, we are currently required to maintain a 30% capital surplus over our statutory minimum capital requirement, which is referred to as the

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OFHEO-directed minimum capital requirement. We are subject to continuous examination by OFHEO to ensure that we meet these capital adequacy requirements on an ongoing basis.

Statutory Minimum Capital Requirement

OFHEO s ratio-based minimum capital standard ties our capital requirements to the size of our book of business. For purposes of the minimum capital requirement, we are in compliance if our core capital equals or exceeds our minimum capital requirement. Core capital is defined by statute as the sum of the stated value of outstanding common stock (common stock less treasury stock), the stated value of outstanding non-cumulative perpetual preferred stock, paid-in capital and retained earnings, as determined in accordance with GAAP. Our minimum capital requirement is generally equal to the sum of:

2.50% of on-balance sheet assets;

0.45% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and

up to 0.45% of other off-balance sheet obligations.

Each quarter, OFHEO publishes our standing relative to the statutory minimum capital requirement and, commencing for the quarter ended September 30, 2005, the OFHEO-directed minimum capital requirement as part of its capital classification announcement. For a description of the amounts by which our core capital exceeded or was less than our statutory minimum capital requirement as of December 31, 2005 and 2004, see Table 37 under Capital Classification Measures below.

Statutory Risk-Based Capital Requirement

OFHEO s risk-based capital standard ties our capital requirements to the risk in our book of business, as measured by a stress test model. The stress test simulates our financial performance over a ten-year period of severe economic conditions characterized by both extreme interest rate movements and high mortgage default rates. Simulation results indicate the amount of capital required to survive this prolonged period of economic stress absent new business or active risk management action. In addition to this model-based amount, the risk-based capital requirement also includes an additional 30% surcharge to cover unspecified management and operations risks.

Our total capital base is used to meet our risk-based capital requirement. Total capital is defined by statute as the sum of core capital plus the total allowance for loan losses and reserve for guaranty losses in connection with Fannie Mae MBS, less the specific loss allowance (that is, the allowance required on individually-impaired loans). Each quarter, OFHEO runs a detailed profile of our book of business through the stress test simulation model. The model generates cash flows and financial statements to evaluate our risk and measure our capital adequacy during the ten-year stress horizon. As part of its quarterly capital classification announcement, OFHEO makes these stress test results publicly available. For a description of the amounts by which our total capital exceeded our statutory risk-based capital requirement as of December 31, 2005 and 2004, see Table 37 under Capital Classification Measures below.

Capital Restoration Plan and OFHEO-Directed Minimum Capital Requirement

OFHEO concluded in its September 2004 interim report on its special examination that we had misapplied GAAP relating to hedge accounting and the amortization of purchase premiums and discounts on securities and loans and on other deferred charges. The SEC s Office of the Chief Accountant affirmed OFHEO s conclusion and, on December 15, 2004, advised us that we should restate our financial statements filed with the SEC to eliminate the use of hedge accounting in order to be consistent with GAAP. At that time, we estimated that the disallowed hedge accounting treatments resulted in a $9 billion cumulative reduction in our core capital as of September 30, 2004. As a result, on December 21, 2004, OFHEO classified us as significantly undercapitalized as of September 30, 2004 and directed us to submit a capital restoration plan that would provide for compliance with our statutory minimum capital requirement plus a surplus of 30% over the statutory minimum capital requirement. Pursuant to OFHEO s directive, we submitted a capital restoration plan which indicated our intention to achieve a 30% capital surplus over our minimum capital requirement by September 30, 2005. The capital restoration plan was accepted by OFHEO on February 17, 2005.

OFHEO announced on November 1, 2005 that we had achieved a 30% surplus over minimum capital requirement at September 30, 2005. In addition to generating capital through retained earnings, we achieved this capital surplus by taking the following actions pursuant to our capital restoration plan:

- significantly reducing the size of our investment portfolio, through both normal mortgage liquidations and selected sales of mortgage assets, which reduced the amount of assets in the consolidated balance sheets and thereby reduced our overall minimum capital requirements;

- issuing $5.0 billion in non-cumulative preferred stock in December 2004;

- reducing our quarterly dividend rate by 50% on January 18, 2005, from $0.52 per share of common stock to $0.26 per share of common stock; and

- canceling our plans to build major new corporate facilities in Southwest Washington, DC and undertaking other cost-cutting efforts.

Under our May 23, 2006 consent order with OFHEO, we agreed to continue our commitment to maintain a 30% capital surplus over our statutory minimum capital requirement until such time as the Director of OFHEO determines that the requirement should be modified or allowed to expire, considering factors such as resolution of accounting and internal control issues. OFHEO actively monitors our compliance with the capital restoration plan. We believe that we continue to be in compliance with the plan as of the date of this filing.

Statutory Critical Capital Requirement

Our critical capital requirement is the amount of core capital below which we would be classified as critically undercapitalized and generally would be required to be placed in conservatorship. Our critical capital requirement is generally equal to the sum of:

- 1.25% of on-balance sheet assets;

- 0.25% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and

- up to 0.25% of other off-balance sheet obligations.

For a description of the amounts by which our core capital exceeded our statutory critical capital requirement as of December 31, 2005 and 2004, see Table 37 under Capital Classification Measures below.

Capital Classification Measures

The table below shows our core capital, total capital and other capital classification measures as of December 31, 2005 and 2004.

Table 37: Regulatory Capital Surplus

	As of December 31,	
	2005[1]	2004
	(Dollars in millions)	
Core capital[2]	$ 39,433	$ 34,514
Required minimum capital[3]	28,233	32,121
Surplus of core capital over required minimum capital	11,200	$ 2,393
Surplus of core capital percentage over required minimum capital[4]	39.7%	7.4%
Total capital[5]	$ 40,091	$ 35,196
Required risk-based capital[6]	12,636	10,039
Surplus of total capital over required risk-based capital	$ 27,455	$ 25,157
Surplus of total capital percentage over required risk-based capital[7]	217.3%	250.6%
Core capital[2]	$ 39,433	$ 34,514
Required critical capital[8]	14,536	16,435
Surplus of core capital over required critical capital	$ 24,897	$ 18,078
Surplus of core capital percentage over required critical capital[9]	171.3%	110.0%

(1) Except for required risk-based capital amounts, all amounts represent estimates that will be resubmitted to OFHEO for their certification. Required risk-based capital amounts represent previously announced results by OFHEO. OFHEO may determine that results require restatement in the future based upon analysis provided by us.

(2) The sum of (a) the stated value of our outstanding common stock (common stock less treasury stock); (b) the stated value of our outstanding non-cumulative perpetual preferred stock; (c) our paid-in capital; and (d) our retained earnings. Core capital excludes AOCI.

(3) Generally, the sum of (a) 2.50% of on-balance sheet assets; (b) 0.45% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and (c) up to 0.45% of other off-balance sheet obligations, which may be adjusted by the Director of OFHEO under certain circumstances (See 12 CFR 1750.4 for existing adjustments made by the Director of OFHEO).

(4) Defined as the surplus of core capital over required minimum capital expressed as a percentage of required minimum capital.

(5) The sum of (a) core capital and (b) the total allowance for loan losses and reserve for guaranty losses, less (c) the specific loss allowance (that is, the allowance required on individually-impaired loans). The specific loss allowance totaled $66 million and $63 million as of December 31, 2005 and 2004, respectively.

(6) Defined as the amount of total capital required to be held to absorb projected losses flowing from future adverse interest rate and credit risk conditions specified by statute (see 12 CFR 1750.13 for conditions), plus 30% mandated by statute to cover management and operations risk.

(7) Defined as the surplus of total capital over required risk-based capital expressed as a percentage of risk-based capital.

(8) Generally, the sum of (a) 1.25% of on-balance sheet assets; (b) 0.25% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and (c) up to 0.25% of other off-balance sheet obligations, which may be adjusted by the Director of OFHEO under certain circumstances.

(9) Defined as the surplus of core capital over required critical capital, expressed as a percentage of required critical capital.

On May 19, 2005, OFHEO classified us as significantly undercapitalized as of December 31, 2004 and adequately capitalized as of March 31, 2005. For each subsequent quarter through December 31, 2006 (the most recent quarter for which OFHEO has published its capital classification), we have been classified by OFHEO as adequately capitalized. On March 30, 2007, OFHEO announced that we were classified as

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adequately capitalized as of December 31, 2006. Our core capital of $42.3 billion as of December 31, 2006 exceeded our statutory minimum capital requirement by $13.0 billion, or 44.2%, and our OFHEO-directed minimum capital requirement by $4.2 billion, or 10.9%. Our total capital of $43.0 billion as of December 31, 2006 exceeded our statutory risk-based capital requirement by $16.2 billion, or 60.2%. Because we have not yet prepared audited consolidated financial statements for any periods after December 31, 2005, OFHEO s capital classifications for periods after December 31, 2005 are based on our estimates of our financial condition as of those periods and remain subject to revision.

Capital Management Framework

Our capital management practices are intended to ensure ongoing compliance with not only our regulatory capital requirements, but also internal economic capital requirements. Our internal economic capital requirements represent management s view of the capital required to support our risk posture and are used to guide capital deployment decisions to maximize long-term stockholder value. Our economic capital framework relies upon both stress test and value-at-risk analyses that measure capital solvency using long-term financial simulations and near-term market value shocks. We currently target a combined corporate economic capital requirement that is less than our regulatory capital requirements.

To ensure compliance with each of our regulatory capital requirements, we maintain different levels of capital surplus for each capital requirement. The optimal surplus amount for each capital measure is directly tied to the volatility of the capital requirement and related core capital base. Because it is explicitly tied to risk, the statutory risk-based capital requirement tends to be more volatile than the ratio-based minimum capital requirement. Quarterly changes in economic conditions (such as interest rates, spreads and home prices) can materially impact the calculated risk-based capital requirement. As a consequence, we generally seek to maintain a larger surplus over the risk-based capital requirement to ensure continued compliance.

While we are able to reasonably estimate the size of our book of business and therefore our minimum capital requirement, the amount of our reported core capital holdings at each period end is less certain without hedge accounting treatment. Changes in the fair value of our derivatives may result in significant fluctuations in our capital holdings from period to period. Accordingly, we target a surplus above the statutory minimum capital requirement and OFHEO-directed minimum capital requirement to accommodate a wide range of possible valuation changes that might adversely impact our core capital base.

Capital Activity

OFHEO Oversight of Our Capital Activity

Our capital requirements as set forth by the 1992 Act and as administered by OFHEO may restrict the ability of our Board of Directors to pay dividends, repurchase our preferred or common stock, or make any other capital distributions. If such an action would decrease our total capital below the risk-based capital requirement or our core capital below the minimum capital requirement, we may not make the distribution without the approval of OFHEO.

In addition, in the May 2006 OFHEO consent order, we agreed to the following additional restrictions relating to our capital activity:

We must continue our commitment to maintain a 30% capital surplus over our statutory minimum capital requirement until such time as the Director of OFHEO determines that the requirement should be modified or allowed to expire, taking into account factors such as the resolution of accounting and internal control issues.

As long as the capital restoration plan is in effect, we must seek the approval of the Director of OFHEO before engaging in any transaction that could have the effect of reducing our capital surplus below an amount equal to 30% more than our statutory minimum capital requirement.

We must submit a written report to OFHEO detailing the rationale and process for any proposed capital distribution before making the distribution.

> We are not permitted to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO as of December 31, 2005 ($727.75 billion), except in limited circumstances at the discretion of OFHEO. We will be subject to this limitation on portfolio growth until the Director of OFHEO has determined that expiration of the limitation is appropriate in light of information regarding: our capital; market liquidity issues; housing goals; risk management improvements; outside auditor s opinion that our consolidated financial statements present fairly in all material respects our financial condition; receipt of an unqualified opinion from an outside audit firm that our internal controls are effective pursuant to section 404 of the Sarbanes-Oxley Act of 2002; or other relevant information.

Pursuant to the capital restoration plan, we provide a quarterly capital plan update to OFHEO.

Common Stock

Shares of common stock outstanding, net of shares held in treasury, totaled approximately 972 million, 971 million and 969 million as of December 31, 2006, 2005 and 2004, respectively. During 2006, 2005 and 2004, we issued 1.6 million, 1.5 million and 5.8 million shares of common stock, respectively, from treasury for our employee benefit plans. We have not issued any common stock during 2004, 2005, 2006 and 2007 other than in accordance with these plans. Our ability to issue common stock will be limited until we have returned to timely financial reporting.

In January 2003, our Board of Directors approved a share repurchase program (the General Repurchase Authority) authorizing us to repurchase up to 5% of our shares of common stock outstanding as of December 31, 2002, as well as additional shares to offset stock issued, or expected to be issued, under our employee benefit plans. Under this General Repurchase Authority, which does not have a specified expiration date, we repurchased 7.2 million shares of common stock at a weighted average cost per share of $73.67 in 2004. We have not repurchased any shares from the open market pursuant to this General Repurchase Authority since July 2004.

In November 2004, OFHEO agreed that our September 27, 2004 agreement with OFHEO did not impair our ability to repurchase shares from employees under certain employee benefit plan transactions, including reacquiring shares for: payment of withholding taxes on the vesting of restricted stock; payment of withholding taxes due upon the exercise of employee stock options; and payment of the exercise price on stock options. OFHEO also approved our request to repurchase shares from employees in limited circumstances relating to financial hardship.

Since April 2005, we have prohibited all of our employees from engaging in purchases or sales of our securities except in limited circumstances relating to financial hardship. In November 2005, our Board of Directors authorized the creation of a stock repurchase program that permits us to repurchase up to $100 million of our shares from our non-officer employees, who are employees below the level of vice president. Under the program, we may repurchase shares weekly at fair market value only during the 30-trading day period following our quarterly filings on Form 12b-25 with the SEC. Officers and members of our Board of Directors are not permitted to participate in the program. On March 22, 2006, OFHEO advised us that it had no objection to our proceeding with the program on the terms described to OFHEO. We implemented the program in May 2006. From May 31, 2006 to February 28, 2007, we have purchased an aggregate of 47,440 shares of common stock from our employees under the program. The employee stock repurchase program does not have a specified expiration date.

Non-Cumulative Preferred Stock

In December 2004, we sold two issues of non-cumulative preferred stock to institutional investors for aggregate total proceeds of $5.0 billion, which included $2.5 billion in convertible preferred stock. These preferred stock issuances represent the largest capital placement we have ever undertaken and were a key component of our capital restoration plan. We did not redeem any preferred stock during 2006, 2005 or 2004. We redeemed our Series J Preferred stock on February 28, 2007, and our Series K Preferred Stock on April 2, 2007. Our ability to issue preferred stock in the public market may be limited until we return to timely financial reporting. We have not issued preferred stock since December 31, 2004.

Subordinated Debt

On September 1, 2005, we agreed with OFHEO to make specific commitments relating to the issuance of qualifying subordinated debt. These commitments replaced our October 2000 voluntary initiatives relating to the maintenance of qualifying subordinated debt. We agreed to issue qualifying subordinated debt, rated by at least two nationally recognized statistical rating organizations, in a quantity such that the sum of our total capital plus the outstanding balance of our qualifying subordinated debt equals or exceeds the sum of (1) outstanding Fannie Mae MBS held by third parties times 0.45% and (2) total on-balance sheet assets times 4%. We must also take reasonable steps to maintain sufficient outstanding subordinated debt to promote liquidity and reliable market quotes on market values. We also agreed to provide periodic public disclosure of our compliance with these commitments, including a comparison of the quantities of qualifying subordinated debt and total capital to the levels required by our agreement with OFHEO.

Every six months, commencing January 1, 2006, we are required to submit to OFHEO a subordinated debt management plan that includes any issuance plans for the upcoming six months. Although it is not a component of core capital, qualifying subordinated debt supplements our equity capital. It is designed to provide a risk-absorbing layer to supplement core capital for the benefit of senior debt holders. In addition, the spread between the trading prices of our qualifying subordinated debt and our senior debt serves as a market indicator to investors of the relative credit risk of our debt. A narrow spread between the trading prices of our qualifying subordinated debt and senior debt implies that the market perceives the credit risk of our debt to be relatively low. A wider spread between these prices implies that the market perceives our debt to have a higher relative credit risk.

The sum of our total capital plus the outstanding balance of our qualifying subordinated debt exceeded the sum of (1) outstanding Fannie Mae MBS held by third parties times 0.45% and (2) total on-balance sheet assets times 4% by an estimated $8.9 billion, or 21.3%, as of December 31, 2006, and by an estimated $8.3 billion, or 20.4%, as of December 31, 2005. Qualifying subordinated debt with a remaining maturity of less than five years receives only partial credit in this calculation. One-fifth of the outstanding amount is excluded each year during the instrument s last five years before maturity and, when the remaining maturity is less than one year, the instrument is entirely excluded.

Qualifying subordinated debt is defined as subordinated debt that contains an interest deferral feature that requires us to defer the payment of interest for up to five years if either:

- our core capital is below 125% of our critical capital requirement; or
- our core capital is below our minimum capital requirement, and the U.S. Secretary of the Treasury, acting on our request, exercises his or her discretionary authority pursuant to Section 304(c) of the Charter Act to purchase our debt obligations.

Core capital is defined by OFHEO and represents the sum of the stated value of our outstanding common stock (common stock less treasury stock), the stated value of our outstanding non-cumulative perpetual preferred stock, our paid-in capital and our retained earnings, as determined in accordance with GAAP.

During any period in which we defer payment of interest on qualifying subordinated debt, we may not declare or pay dividends on, or redeem, purchase or acquire, our common stock or preferred stock. To date, no triggering events have occurred that would require us to defer interest payments on our qualifying subordinated debt.

Prior to our September 1, 2005 agreement with OFHEO, pursuant to our voluntary initiatives, we sought to maintain sufficient qualifying subordinated debt to bring the sum of total capital and outstanding qualifying subordinated debt to at least 4% of on-balance sheet assets, after providing adequate capital to support Fannie Mae MBS held by third parties that is not included in the consolidated balance sheets. We had qualifying subordinated debt with a carrying amount of $12.5 billion as of both December 31, 2004 and 2003, which, together with our total capital, constituted 4.0% and 3.3% of our on-balance sheet assets as of December 31, 2004 and 2003, respectively. Under the voluntary initiatives, qualifying subordinated debt with a remaining maturity of less than five years did not receive a partial credit in this calculation.

We issued $4.0 billion of qualifying subordinated debt securities in 2003. We have not issued any subordinated debt securities since 2003. Under our agreement with OFHEO, we intend to resume the issuance of qualifying subordinated debt once we return to timely financial reporting. We had qualifying subordinated debt totaling $1.5 billion and $2.0 billion, based on redemption value, that matured in May 2006 and January 2007, respectively. As of the date of this filing, we have $9.0 billion in outstanding qualifying subordinated debt.

Dividends

In January 2005, our Board of Directors reduced our quarterly dividend rate by 50%, from $0.52 per share of common stock to $0.26 per share of common stock. We reduced our common stock dividend rate in order to increase our capital surplus, which was a component of our capital restoration plan. In December 2006, the Board of Directors increased our quarterly dividend rate to $0.40 per share of common stock, beginning in the fourth quarter of 2006, and increased our dividend rate again to $0.50 per share of common stock, beginning in the second quarter of 2007.

We paid quarterly common stock dividends of:

- $0.52 per share for each quarter of 2004;

- $0.26 per share for each quarter of 2005 and for the first, second and third quarters of 2006; and

- $0.40 per share for the fourth quarter of 2006 and first quarter of 2007.

Our Board of Directors declared common stock dividends of $0.50 per share which are payable on May 25, 2007. Our Board of Directors has also approved preferred stock dividends for periods commencing December 31, 2004, up to but excluding June 30, 2007. See Notes to Consolidated Financial Statements Note 16, Preferred Stock for detailed information on our preferred stock dividends.

OFF-BALANCE SHEET ARRANGEMENTS AND VARIABLE INTEREST ENTITIES

We enter into certain business arrangements to facilitate our statutory purpose of providing liquidity to the secondary mortgage market and to reduce our exposure to interest rate fluctuations. We form arrangements to meet the financial needs of our customers and manage our credit, market or liquidity risks. Some of these arrangements are not recorded in the consolidated balance sheets or may be recorded in amounts different from the full contract or notional amount of the transaction, depending on the nature or structure of, and accounting required to be applied to, the arrangement. These arrangements are commonly referred to as off-balance sheet arrangements, and expose us to potential losses in excess of the amounts recorded in the consolidated balance sheets.

The most significant off-balance sheet arrangements that we engage in result from the mortgage loan securitization and resecuritization transactions that we routinely enter into as part of the normal course of our business operations. Our Single-Family Credit Guaranty business generates most of its revenues through the guaranty fees earned from these securitization transactions. In addition, our HCD business generates a significant amount of its revenues through the guaranty fees earned from these securitization transactions. We also enter into other guaranty transactions and hold LIHTC partnership interests that may involve off-balance sheet arrangements.

Fannie Mae MBS Transactions and Other Financial Guaranties

As described in Item 1 Business, both our Single-Family Credit Guaranty business and our HCD business generate revenue through guaranty fees earned in connection with the issuance of Fannie Mae MBS. In a typical Fannie Mae

MBS transaction, we receive mortgage loans or mortgage-related securities from lenders and transfer the assets to a trust or special purpose entity. Upon creation of the trust, we deliver back beneficial interests in the trust to investors in the form of Fannie Mae MBS. In holding Fannie Mae MBS created from a pool of whole loans, an investor has securities that are generally more liquid than whole loans, which provides the investor with greater financial flexibility. In particular, by holding readily marketable Fannie Mae MBS, lenders increase their ability to replenish their funds for use in making additional loans.

We guarantee to each MBS trust that we will supplement amounts received by the MBS trust as required to permit timely payments of principal and interest on the related Fannie Mae MBS, irrespective of the cash flows received from borrowers. In connection with our guaranties issued or modified on or after January 1, 2003, we record in the consolidated balance sheets a guaranty obligation based on an estimate of our non-contingent obligation to stand ready to perform under these guaranties. We also record in the consolidated balance sheets a reserve for guaranty losses based on an estimate of our incurred credit losses on all of our guaranties, irrespective of the issuance date.

While we hold some Fannie Mae MBS in our mortgage portfolio, the substantial majority of outstanding Fannie Mae MBS is held by third parties and therefore is generally not reflected in the consolidated balance sheets. Of the $1.9 trillion in total Fannie Mae MBS outstanding as of December 31, 2005, $234.5 billion was held in our portfolio and $1.6 trillion was held by third-party investors. The $234.5 billion in Fannie Mae MBS held in our portfolio is reflected in the consolidated balance sheets as Investments in securities. We consolidate certain Fannie Mae MBS trusts depending on the significance of our interest in those MBS trusts. Upon consolidation, we recognize the assets of the consolidated trust. As of December 31, 2005, we had recognized $111.3 billion of assets as Mortgage loans in the consolidated balance sheets as a result of consolidating MBS trusts. Accordingly, as of December 31, 2005, there was approximately $1.6 trillion in outstanding and unconsolidated Fannie Mae MBS held by third parties, which is not included in the consolidated balance sheets.

While our guaranties relating to Fannie Mae MBS represent the substantial majority of our guaranty activity, we also provide other financial guaranties. Our HCD business provides credit enhancements primarily for taxable and tax-exempt bonds issued by state and local governmental entities to finance multifamily housing for low- and moderate-income families. Under these credit enhancement arrangements, we guarantee to the trust that we will supplement proceeds as required to permit timely payment on the related bonds, which improves the bond ratings and thereby results in lower-cost financing for multifamily housing. Our HCD business generates revenue from the fees earned on these transactions. These transactions also contribute to our housing goals and help us meet other mission-related objectives.

Our maximum potential exposure to credit losses relating to our outstanding and unconsolidated Fannie Mae MBS held by third parties and our other financial guaranties is significantly higher than the carrying amount of the guaranty obligations and reserve for guaranty losses that are reflected in the consolidated balance sheets. In the case of outstanding and unconsolidated Fannie Mae MBS held by third parties, our maximum potential exposure arising from these guaranties is primarily represented by the unpaid principal balance of the mortgage loans underlying these Fannie Mae MBS, which was $1.6 trillion as of December 31, 2005. In the case of our other financial guaranties, our maximum potential exposure is primarily represented by the unpaid principal balance of the underlying bonds and loans, which was $19.2 billion as of December 31, 2005.

Based on our historical credit losses, which represent less than 0.02% of our mortgage credit book of business for each year from 2003 to 2005, we do not believe that the maximum exposure on our Fannie Mae MBS and other credit-related guaranties is representative of our actual credit exposure relating to these guaranties. In the event that we were required to make payments under these guaranties, we would pursue recovery of these payments by exercising our rights to the collateral backing the underlying loans or through available credit enhancements (which includes all recourse with third parties and mortgage insurance).

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The table below presents a summary of our on- and off-balance sheet Fannie Mae MBS and other guaranty obligations as of December 31, 2005 and 2004.

Table 38: On- and Off-Balance Sheet MBS and Other Guaranty Arrangements

	As of December 31,	
	2005	2004
	(Dollars in millions)	
Fannie Mae MBS and other guaranties outstanding[1]	$ 1,852,521	$ 1,767,276
Less: Fannie Mae MBS held in portfolio[2]	234,451	344,404
Fannie Mae MBS held by third parties and other guaranties	$ 1,618,070	$ 1,422,872

(1) Includes $19.2 billion and $14.8 billion in unpaid principal balance of other guaranties as of December 31, 2005 and 2004, respectively. Excludes $111.3 billion and $150.1 billion in unpaid principal balance of consolidated Fannie Mae MBS as of December 31, 2005 and 2004, respectively.

(2) Amounts represent unpaid principal balance and are recorded in Investments in Securities in the consolidated balance sheets.

For more information on our securitization transactions, including the interests we retain in these transactions, cash flows from these transactions, and our accounting for these transactions, see Notes to Consolidated Financial Statements Note 6, Portfolio Securitizations, Notes to Consolidated Financial Statements Note 7, Financial Guaranties and Master Servicing and Notes to Consolidated Financial Statements Note 17, Concentrations of Credit Risk. For information on the revenues and expenses associated with our Single-Family Credit Guaranty and HCD businesses, refer to Business Segment Results.

LIHTC Partnership Interests

Our HCD business s Community Investment Group makes equity investments in numerous limited partnerships that sponsor affordable housing projects utilizing the low-income housing tax credit pursuant to Section 42 of the Internal Revenue Code. We invest in LIHTC partnerships in order to increase the supply of affordable housing in the United States and to serve communities in need. In addition, our investments in LIHTC partnerships generate both tax credits and net operating losses that reduce our federal income tax liability. The tax benefits associated with these LIHTC partnerships were the primary reasons for our effective tax rate in 2005 being 17% versus the federal statutory rate of 35%.

LIHTC partnerships own interests in rental housing that the partnerships have developed or rehabilitated. By renting a specified portion of the housing units to qualified low-income tenants over a 15-year period, the partnerships become eligible for the federal low-income housing tax credit. To qualify for this tax credit, among other requirements, the project owner must irrevocably elect that either (1) a minimum of 20% of the residential units will be rent-restricted and occupied by tenants whose income does not exceed 50% of the area median gross income, or (2) a minimum of 40% of the residential units will be rent-restricted and occupied by tenants whose income does not exceed 60% of the area median gross income. Failure to qualify as an affordable housing project over the entire 15-year period may result in the recapture of a portion of the tax credits. The LIHTC partnerships are generally organized by fund manager sponsors who seek out investments with third-party developers who in turn develop or rehabilitate the properties, and subsequently manage them. We invest in these partnerships as a limited partner with the fund manager acting as the general partner. In making investments in these LIHTC partnerships, our HCD business s Community Investment Group identifies qualified sponsors and structures the terms of our investment.

In certain instances, we have been determined to be the primary beneficiary of these LIHTC partnership investments, and therefore all of the partnership assets and liabilities have been recorded in the consolidated balance sheets, and the portion of these investments owned by third parties is recorded in the consolidated balance sheets as an offsetting minority interest. In most instances, we are not the primary beneficiary of the investments, and therefore our consolidated balance sheets reflect only our investment in the partnership, rather than the full amount of the partnership s assets and liabilities. Our investments in LIHTC partnerships are recorded in the consolidated balance sheets as Partnership investments.

In cases where we are not the primary beneficiary of these investments, we account for our investments in LIHTC partnerships by using the equity method of accounting or the effective yield method of accounting, as appropriate. In each case, we record in the consolidated financial statements our share of the income and losses of the partnerships, as well as our share of the tax credits and tax benefits of the partnerships. Our share of the operating losses generated by our LIHTC partnerships is recorded in the consolidated statements of income under Loss from partnership investments. The tax credits and benefits associated with any operating losses incurred by these LIHTC partnerships are recorded in the consolidated statements of income within our Provision for federal income taxes.

As of December 31, 2005, we had a recorded investment in these LIHTC partnerships of $7.7 billion. Our risk exposure relating to these LIHTC partnerships is limited to the amount of our investment and the possible recapture of the tax benefits we have received from the partnership. Neither creditors of, nor equity investors in, these partnerships have any recourse to our general credit. To manage the risks associated with a partnership, we track compliance with the LIHTC requirements, as well as the property condition and financial performance of the underlying investment throughout the life of the investment. In addition, we evaluate the strength of the partnership s sponsor through periodic financial and operating assessments. Further, in some of our LIHTC partnership investments, our exposure to loss is further mitigated by our having a guaranteed economic return from an investment grade counterparty.

The table below provides information regarding our LIHTC partnership investments as of and for the year ended December 31, 2005:

Table 39: LIHTC Partnership Investments

	2005 Consolidated	2005 Non-Consolidated
	(Dollars in millions)	
As of December 31:		
Obligation to fund LIHTC partnerships	$ 833	$ 1,698
For the year ended December 31:		
Tax credits from investments in LIHTC partnerships	$ 366	$ 467
Losses from investments in LIHTC partnerships	275	518
Tax benefits on credits and losses from investments in LIHTC partnerships	462	649
Contributions to LIHTC partnerships	484	743
Distributions from LIHTC partnerships	2	1

For more information on our off-balance sheet transactions, see Notes to Consolidated Financial Statements Note 17, Concentrations of Credit Risk.

IMPACT OF FUTURE ADOPTION OF NEW ACCOUNTING PRONOUNCEMENTS

SFAS No. 123R, Share-Based Payment and SAB No. 107

In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment* (SFAS 123R), which revises SFAS No. 123 and supersedes APB Opinion No. 25, and its related implementation guidance. SFAS 123R eliminates the alternative of applying the intrinsic value measurement provisions of APB 25 to stock compensation awards issued to employees. Rather, SFAS 123R requires measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. With respect to options, SFAS 123R requires that they be measured at fair value using an option-pricing model that takes into account the options unique characteristics and recognition of the cost as expense over the period the employee provides services to earn the award, which is generally the vesting period. Also, SFAS 123R requires that excess tax benefits be classified as a financing cash inflow in the consolidated statements of cash flows.

This standard includes measurement requirements for employee stock options that are similar to those under the fair-value-based method of SFAS 123; however, SFAS 123R requires initial and ongoing estimates of the amount of shares that will vest while SFAS 123 provided entities the option of assuming that all shares would vest and then recognizing actual forfeitures as they occur. SFAS 123R also clarifies and expands the guidance in SFAS 123 regarding classification of an award as equity or as a liability.

Additionally, SEC Staff Accounting Bulletin 107, Share-Based Payment, provides guidance related to the interaction between SFAS 123R and certain SEC rules and regulations, as well as the staff s views regarding the valuation of share-based payment arrangements.

SFAS 123R is effective for annual periods beginning after June 15, 2005 and allows use of the modified prospective application method to be applied to new awards, unvested awards and to awards modified, repurchased or cancelled after the effective date. We prospectively adopted the fair value expense recognition provisions of SFAS 123 effective January 1, 2003, using a model to estimate the fair value of the majority of our stock awards. We adopted SFAS 123R effective January 1, 2006 with no material impact to the consolidated financial statements.

SFAS No. 154, Accounting Changes and Error Corrections

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154), which replaces APB Opinion No. 20, Accounting Changes (APB 20) and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 applies to all voluntary changes in accounting principle and changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions.

APB 20 requires that the cumulative effect of most voluntary changes in accounting principles be included in net income in the period of adoption. The new statement requires retrospective application to prior periods financial statements of a voluntary change in accounting principle, unless it is impracticable to determine either period-specific effects or the cumulative effect of the change. In addition, SFAS 154 requires that we account for a change in method of depreciation, amortization or depletion for long-lived, non-financial assets as a change in accounting estimate that is effected by a change in accounting principle. APB 20 previously required that we report such a change as a change in accounting principle.

SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 effective January 1, 2006 had no impact on the consolidated financial statements.

SFAS No. 155, Accounting for Certain Hybrid Financial Instruments and DIG Issue No. B40, Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* (SFAS 155), an amendment of SFAS 133 and SFAS 140. This statement: (i) clarifies which interest-only strips and principal-only strips are not subject to SFAS 133; (ii) establishes a requirement to evaluate interests in securitized financial instruments that contain an embedded derivative requiring bifurcation; (iii) clarifies that concentration of credit risks in the form of subordination are not embedded derivatives; and (iv) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation.

In January 2007, FASB issued Derivatives Implementation Group (DIG) Issue No. B40 (DIG B40). The objective of DIG B40 is to provide a narrow scope exception to certain provisions of SFAS 133 for securitized interests that contain only an embedded derivative that is tied to the prepayment risk of the underlying financial assets. SFAS 155 and DIG B40 are effective for all financial instruments acquired or issued after the beginning of the first fiscal year that begins after September 15, 2006. We adopted SFAS 155 effective January 1, 2007 and elected fair value remeasurement for hybrid financial instruments that contain embedded derivatives that otherwise require bifurcation, which includes buy-ups and guaranty assets arising from portfolio securitization transactions. We also elected to classify investment securities that may contain embedded derivatives as trading securities under SFAS No. 115, *Accounting for Certain Investments in Debt* *and Equity Securities.* SFAS 155 is a prospective standard and had no impact on the consolidated financial statements on the date of adoption.

SFAS No. 156, Accounting for Servicing of Financial Assets

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*, *an amendment of FASB Statement No. 133 and 140* (SFAS 156). SFAS 156 modifies SFAS 140 by requiring that mortgage servicing rights (MSRs) be initially recognized at fair value and by providing the option to either (i) carry MSRs at fair value with changes in fair value recognized in earnings or (ii) continue recognizing periodic amortization expense and assess the MSRs for impairment as was originally required by SFAS 140. This option is available by class of servicing asset or liability. This statement also changes the calculation of the gain from the sale of financial assets by requiring that the fair value of servicing rights be considered part of the proceeds received in exchange for the sale of the assets.

SFAS 156 is effective for all separately recognized servicing assets and liabilities acquired or issued after the beginning of a fiscal year that begins after September 15, 2006, with early adoption permitted. We adopted SFAS 156 effective January 1, 2007, with no material impact to the consolidated financial statements. We do not believe SFAS 156 will have a material effect on the consolidated financial statements, because we do not intend to measure MSRs at fair value subsequent to their initial recognition.

FIN 48, Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 supplements SFAS No. 109, *Accounting for Income Taxes* (SFAS 109), by defining a threshold for recognizing tax benefits in the consolidated financial statements.

FIN 48 provides a two-step approach to recognizing and measuring tax benefits when a benefit s realization is uncertain. First, we must determine whether the benefit is to be recognized and then the amount to be recognized. Income tax benefits should be recognized when, based on the technical merits of a tax position, we believe that if upon examination, including resolution of any appeals or litigation process, it is more likely than not (a probability of greater than 50%) that the tax position would be sustained as filed. The benefit recognized for a tax position that meets the more-likely-than-not criterion is measured based on the largest amount of tax benefit that is more than 50% likely to be realized upon ultimate settlement with the taxing authority, taking into consideration the amounts and probabilities of the outcomes upon settlement.

In March 2007, FSP FIN 48-a, *Definition of Settlement in FASB Interpretation 48* (FSP FIN 48-a), was proposed by the FASB. The objective of FSP FIN 48-a is to replace the term ultimate settlement, originally introduced in FIN 48, with the term effective settlement and to provide guidance to determine whether or not a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. Final guidance of FSP FIN 48-a is expected in the second quarter of 2007 with an effective date that coincides with that of FIN 48.

FIN 48 is effective for consolidated financial statements beginning in the first quarter of 2007. The cumulative effect of applying the provisions of FIN 48 upon adoption will be reported as an adjustment to beginning retained earnings. We are evaluating the impact of the adoption of FIN 48 and FSP FIN 48-a on the consolidated financial statements.

SFAS No. 157, Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement* (SFAS 157). SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities and requires companies to provide expanded information about assets and liabilities measured at fair value, including the effect of fair value measurements on earnings. This statement applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, but does not expand the use of fair value in any new circumstances.

Under SFAS 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. This statement clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, this standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data (for example, a company s own data). Under this statement, fair value measurements would be separately disclosed by level within the fair value hierarchy.

SFAS 157 is effective for consolidated financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We intend to adopt SFAS 157 effective January 1, 2008 and are evaluating the impact of its adoption on the consolidated financial statements.

SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158). SFAS 158 requires the recognition of a plan s over-funded or under-funded status as an asset or liability and recognition of actuarial gains and losses and prior service costs and credits as an adjustment to AOCI, net of income tax. Additionally, it requires determination of benefit obligations and the fair values of a plan s assets at a company s year-end. SFAS 158 is effective as of the end of the fiscal year ending after December 15, 2006. We adopted SFAS 158 effective December 31, 2006 and reduced shareholders equity by approximately $100 million to record the underfunded status of our plans.

SFAS No. 159, Fair Value Option

In February 2007, the FASB issued SFAS No. 159, *Fair Value Option* (SFAS 159). SFAS 159 permits companies to make a one-time election to report certain financial instruments at fair value with the changes in fair value included in earnings. SFAS 159 is effective for consolidated financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not plan to elect early adoption and are still evaluating how we will adopt SFAS 159. We have not yet determined the impact, if any, on the consolidated financial statements of adopting this standard.

2005 QUARTERLY REVIEW

We provide certain selected unaudited quarterly financial statement information for the year ended December 31, 2005 and 2004 in Notes to Consolidated Financial Statements Note 20, Selected Quarterly Financial Information (Unaudited). The selected financial information includes the following:

Condensed consolidated statements of income for the quarters ended March 31, 2005, June 30, 2005, September 30, 2005 and December 31, 2005.

Condensed consolidated statements of income for the quarters ended March 31, 2004, June 30, 2004, September 30, 2004 and December 31, 2004.

Condensed consolidated balance sheets as of March 31, 2005, June 30, 2005, September 30, 2005 and December 31, 2005.

Condensed business segment results of operations for the quarters ended March 31, 2005, June 30, 2005, September 30, 2005 and December 31, 2005.

Table 40: 2005 Quarterly Condensed Consolidated Statements of Income

	For the Quarter Ended			
	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005
	(Dollars and shares in millions, except per share amounts)			
Net interest income	$ 3,787	$ 2,897	$ 2,664	$ 2,157
Guaranty fee income	870	1,208	832	869
Investment gains (losses), net	(1,454)	596	(169)	(307)
Derivatives fair value losses, net	(749)	(2,641)	(539)	(267)
Debt extinguishment gains (losses), net	(142)	18	86	(30)
Loss from partnership investments	(200)	(210)	(211)	(228)
Fee and other income	353	459	298	416
Administrative expenses	(363)	(507)	(567)	(678)
Provision for credit losses	(57)	(125)	(172)	(87)
Other expenses	(53)	(22)	(68)	(93)
Income before federal income taxes and extraordinary gains (losses)	1,992	1,673	2,154	1,752
Provision for federal income taxes	217	333	406	321
Income before extraordinary gains (losses)	1,775	1,340	1,748	1,431
Extraordinary gains (losses), net of tax effect	65	(2)	(3)	(7)
Net income	$ 1,840	$ 1,338	$ 1,745	$ 1,424
Preferred stock dividends	(121)	(122)	(122)	(121)
Net income available to common stockholders	$ 1,719	$ 1,216	$ 1,623	$ 1,303
Basic earnings (loss) per share:				
Earnings before extraordinary gains	$ 1.71	$ 1.25	$ 1.68	$ 1,35
Extraordinary gains (losses), net of tax effect	.06			(0.01)
Basic earnings per share	$ 1.77	$ 1.25	$ 1.68	$ 1.34
Diluted earnings (loss) per share:				
Earnings before extraordinary gains (losses)	$ 1.70	$ 1.25	$ 1.66	$ 1.35
Extraordinary gains (losses), net of tax effect	0.06			(0.01)
Diluted earnings per share	$ 1.76	$ 1.25	$ 1.66	$ 1.34
Weighted-average common shares outstanding:				
Basic	969	970	970	970

Diluted[1]	998	971	998	998

(1) For the quarter ended June 30, 2005, diluted shares excludes the effect of our convertible preferred stock as inclusion would be antidilutive for that period.

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Table 41: 2004 Quarterly Condensed Consolidated Statements of Income

	For the Quarter Ended			
	March 31, 2004	June 30, 2004	September 30, 2004	December 31, 2004
	(Dollars and shares in millions, except per share amounts)			
Net interest income	$ 5,062	$ 4,836	$ 4,000	$ 4,183
Guaranty fee income	891	727	1,067	919
Investment gains (losses), net	525	(1,518)	887	(256)
Derivatives fair value gains (losses), net	(6,446)	2,269	(7,136)	(943)
Debt extinguishment gains (losses), net	(78)	(7)	(21)	(46)
Loss from partnership investments	(145)	(177)	(177)	(203)
Fee and other income	56	413	103	(168)
Administrative expenses	(406)	(372)	(367)	(511)
Provision for credit losses	(13)	(55)	(65)	(219)
Other expenses	(50)	(43)	(50)	(467)
Income (loss) before federal income taxes and extraordinary gains (losses)	(604)	6,073	(1,759)	2,289
Provision (benefit) for federal income taxes	(529)	1,753	(910)	710
Income (loss) before extraordinary gains (losses)	(75)	4,320	(849)	1,579
Extraordinary gains (losses), net of tax effect	10	(3)	(18)	3
Net income (loss)	$ (65)	$ 4,317	$ (867)	$ 1,582
Preferred stock dividends and issuance costs at redemption	(43)	(40)	(41)	(41)
Net income (loss) available to common stockholders	$ (108)	$ 4,277	$ (908)	$ 1,541
Basic earnings (loss) per share:				
Earnings before extraordinary gains (losses)	$ (0.12)	$ 4.41	$ (0.92)	$ 1.59
Extraordinary gains (losses), net of tax effect	0.01		(0.02)	
Basic earnings (loss) per share	$ (0.11)	$ 4.41	$ (0.94)	$ 1.59
Diluted earnings (loss) per share:				
Earnings before extraordinary gains (losses)	$ (0.12)	$ 4.40	$ (0.92)	$ 1.59
Extraordinary gains (losses), net of tax effect	0.01		(0.02)	
Diluted earnings (loss) per share	$ (0.11)	$ 4.40	$ (0.94)	$ 1.59
Weighted-average common shares outstanding:				

Basic	972	969	968	969
Diluted	972	973	968	972

Table 42: 2005 Quarterly Condensed Consolidated Balance Sheets

	As of			
	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005
	(Dollars in millions)			
Assets:				
Cash and cash equivalents	$ 3,186	$ 2,597	$ 2,797	$ 2,820
Investments in securities:				
Trading, at fair value	29,670	24,291	16,401	15,110
Available-for-sale, at fair value	496,591	466,045	391,503	390,964
Total investments	$ 526,261	490,336	407,904	406,074
Mortgage loans:				
Loans held for sale, at lower of cost or market	10,587	7,654	5,973	5,064
Loans held for investment, at amortized cost	385,528	366,203	359,372	362,781
Allowance for loan losses	(302)	(312)	(319)	(302)
Total loans	395,813	373,545	365,026	367,543
Derivative assets at fair value	7,602	6,405	6,355	5,803
Guaranty assets	5,982	5,765	6,425	6,848
Deferred tax assets	7,053	5,039	6,099	7,684
Other assets	30,308	32,371	32,590	37,396
Total assets	$ 976,205	$ 916,058	$ 827,196	$ 834,168
Liabilities and Stockholders Equity:				
Liabilities:				
Short-term debt	$ 284,776	$ 219,837	$ 151,906	$ 173,186
Long-term debt	625,686	628,148	607,873	590,824
Derivative liabilities at fair value	825	1,904	1,253	1,429
Reserve for guaranty losses	381	391	471	422
Guaranty obligations	9,146	8,755	9,461	10,016
Other liabilities	17,761	15,737	16,887	18,868
Total liabilities	938,575	874,772	787,851	794,745
Minority interests in consolidated subsidiaries	73	73	74	121
Stockholders Equity:				
Retained earnings	32,171	33,134	34,505	35,555
Accumulated other comprehensive income (loss)	1,610	4,272	928	(131)
Other stockholders equity	3,776	3,807	3,838	3,878
Total stockholders equity	37,557	41,213	39,271	39,302

Total liabilities and stockholders equity	$ 976,205	$ 916,058	$ 827,196	$ 834,168

Table 43: 2005 Quarterly Condensed Business Segment Results

	For the Quarter Ended March 31, 2005			
	Single-Family Credit Guaranty	HCD	Capital Markets	Total
	(Dollars in millions)			
Net interest income (expense)[1]	$ 163	$ (58)	$ 3,682	$ 3,787
Guaranty fee income (expense)[2]	1,099	93	(322)	870
Investment gains (losses), net	27		(1,481)	(1,454)
Derivatives fair value losses, net			(749)	(749)
Debt extinguishment losses, net			(142)	(142)
Losses from partnership investments		(200)		(200)
Fee and other income	67	96	190	353
Administrative expenses	(198)	(71)	(94)	(363)
Provision for credit losses	(88)	31		(57)
Other expenses	(36)	(15)	(2)	(53)
Income (loss) before federal income taxes and extraordinary gains	1,034	(124)	1,082	1,992
Provision (benefit) for federal income taxes	348	(258)	127	217
Income before extraordinary gains	686	134	955	1,775
Extraordinary gain, net of tax effect			65	65
Net income	$ 686	$ 134	$ 1,020	$ 1,840

(1) Includes cost of capital charge.

(2) Includes intercompany guaranty fee income (expense) of $259 million allocated to Single-Family Credit Guaranty and HCD from Capital Markets for absorbing the credit risk on mortgage loans and Fannie Mae MBS held in our portfolio.

	For the Quarter Ended June 30, 2005			
	Single-Family Credit Guaranty	HCD	Capital Markets	Total
	(Dollars in millions)			
Net interest income (expense)[1]	$ 226	$ (49)	$ 2,720	$ 2,897
Guaranty fee income (expense)[2]	1,431	82	(305)	1,208
Investment gains, net	44		552	596

Derivatives fair value losses, net			(2,641)	(2,641)
Debt extinguishment gains, net			18	18
Losses from partnership investments		(210)		(210)
Fee and other income	71	135	253	459
Administrative expenses	(253)	(93)	(161)	(507)
Provision for credit losses	(107)	(18)		(125)
Other expenses	(2)	(19)	(1)	(22)
Income (loss) before federal income taxes and extraordinary losses	1,410	(172)	435	1,673
Provision (benefit) for federal income taxes	481	(273)	125	333
Income before extraordinary losses	929	101	310	1,340
Extraordinary loss, net of tax effect			(2)	(2)
Net income	$ 929	$ 101	$ 308	$ 1,338

(1) Includes cost of capital charge.

(2) Includes intercompany guaranty fee income (expense) of $247 million allocated to Single-Family Credit Guaranty and HCD from Capital Markets for absorbing the credit risk on mortgage loans and Fannie Mae MBS held in our portfolio.

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	For the Quarter Ended September 30, 2005			
	Single-Family Credit Guaranty	HCD	Capital Markets	Total
	(Dollars in millions)			
Net interest income (expense)[1]	$ 261	$ (53)	$ 2,456	$ 2,664
Guaranty fee income (expense)[2]	1,038	88	(294)	832
Investment gains (losses), net	57		(226)	(169)
Derivatives fair value losses, net			(539)	(539)
Debt extinguishment gains, net			86	86
Losses from partnership investments		(211)		(211)
Fee and other income	60	180	58	298
Administrative expenses	(258)	(114)	(195)	(567)
Provision for credit losses	(172)			(172)
Other expenses	(43)	(23)	(2)	(68)
Income (loss) before federal income taxes and extraordinary losses	943	(133)	1,344	2,154
Provision (benefit) for federal income taxes	317	(261)	350	406
Income before extraordinary losses	626	128	994	1,748
Extraordinary losses, net of tax effect			(3)	(3)
Net income	$ 626	$ 128	$ 991	$ 1,745

(1) Includes cost of capital charge.

(2) Includes intercompany guaranty fee income (expense) of $241 million allocated to Single-Family Credit Guaranty and HCD from Capital Markets for absorbing the credit risk on mortgage loans and Fannie Mae MBS held in our portfolio.

	For the Quarter Ended December 31, 2005			
	Single-Family Credit Guaranty	HCD	Capital Markets	Total
	(Dollars in millions)			
Net interest income (expense)[1]	$ 256	$ (57)	$ 1,958	$ 2,157
Guaranty fee income (expense)[2]	1,081	79	(291)	869
Investment gains (losses), net	41		(348)	(307)
Derivatives fair value losses, net			(267)	(267)
Debt extinguishment losses, net			(30)	(30)
Losses from partnership investments		(228)		(228)
Fee and other income	52	217	147	416

Administrative expenses	(311)	(139)	(228)	(678)
Provision for credit losses	(87)			(87)
Other expenses	(58)	(33)	(2)	(93)
Income (loss) before federal income taxes and extraordinary losses	974	(161)	939	1,752
Provision (benefit) for federal income taxes	326	(260)	255	321
Income before extraordinary losses	648	99	684	1,431
Extraordinary losses, net of tax effect			(7)	(7)
Net income	$ 648	$ 99	$ 677	$ 1,424

(1) Includes cost of capital charge.

(2) Includes intercompany guaranty fee income (expense) of $243 million allocated to Single-Family Credit Guaranty and HCD from Capital Markets for absorbing the credit risk on mortgage loans and Fannie Mae MBS held in our portfolio.

During the year ended December 31, 2005, our earnings fluctuated from a net income of $1.8 billion for the quarter ended March 31, 2005, to a net income of $1.3 billion for the quarter ended June 30, 2005, to a net income of $1.7 billion for the quarter ended September 30, 2005 and to a net income of $1.4 billion for the quarter ended December 31, 2005. As discussed in Consolidated Results of Operations above, we expect that our annual and quarterly results will be volatile, primarily due to changes in market conditions that result in periodic fluctuations in the estimated fair value of our derivative instruments. This is reflected in the consolidated statements of income as Derivatives fair value losses, net. The following is a quarterly review of our results for the interim periods during 2005, as compared to those periods during 2004.

First Quarter Ended March 31, 2005 versus March 31, 2004

We recorded net income of $1.8 billion in the first quarter of 2005, compared with a net loss of $65 million in the first quarter of 2004. The improvement in our results was primarily due to lower derivatives fair value losses, partially offset by the reduction in our net interest income, higher investment losses and a provision for taxes compared to a tax benefit from a net loss recorded in the first quarter of 2004.

Net interest income totaled $3.8 billion in the first quarter of 2005 as compared to $5.1 billion in the first quarter of 2004. The first quarter of 2005 saw a continued decrease in our average yield as compared to the first quarter of 2004 as a significant rise in short-term interest rates increased the cost of our short-term debt.

Investment losses totaled $1.5 billion in the first quarter of 2005 as compared to investment gains of $525 million in the first quarter of 2004. The first quarter of 2005 losses were primarily related to higher other-than-temporary impairment on available-for-sale securities and unrealized losses on trading securities as the fair value of our mortgage assets declined due to rising interest rates during 2005. In comparison, the gains in the first quarter of 2004 were primarily comprised of unrealized gains on trading securities and realized gains on securities sold during the first quarter of 2004 driven by a decline in interest rates. The gains in the first quarter of 2004 were slightly offset by impairments of securities.

We recorded derivatives fair value losses of $749 million in the first quarter of 2005 as compared to losses of $6.4 billion in the first quarter of 2004. The 2005 losses were primarily the result of losses of $538 million in net periodic contractual interest expense and losses of $125 million related to changes in fair value of open derivative positions as of March 31, 2005. The loss in the first quarter of 2004 was primarily due to losses of $1.6 billion in net periodic contractual interest expense, $790 million losses in the fair value of terminated derivatives from the beginning of the quarter to the date of termination and $4.0 billion losses in the fair value of open derivative positions as of March 31, 2004 primarily due to declines in interest rates during the first quarter of 2004.

We recorded tax expense of $252 million, including tax expense on extraordinary gains, in the first quarter of 2005 as compared to a benefit for federal income taxes of $524 million in the first quarter 2004. Tax expense in the first quarter of 2005 includes taxes at the federal statutory rate of 35% adjusted for tax credits recognized for our LIHTC partnership investments and other tax credits. The benefit in the first quarter of 2004 relates to taxes on our loss at the federal statutory rate of 35% adjusted for tax credits recognized for our LIHTC partnership investments and other tax credits.

Second Quarter Ended June 30, 2005 versus June 30, 2004

We recorded net income of $1.3 billion in the second quarter of 2005, compared with net income of $4.3 billion in the second quarter of 2004. The reduction in our net income during the second quarter of 2005 relative to the second quarter of 2004 was primarily due to increases of derivative fair value losses and a reduction in net interest income, which were partially offset by an increase in investment gains and guaranty fee income and a lower provision for taxes.

Net interest income totaled $2.9 billion in the second quarter of 2005 as compared to $4.8 billion in the second quarter 2004. The second quarter of 2005 saw a continued decrease in our average yield as compared to the second quarter of

2004 related to our declining portfolio balance, coupled with a significant rise in short-term interest rates which increased the cost of our short-term debt.

Guaranty fee income increased to $1.2 billion in the second quarter of 2005 as compared to $727 million in the second quarter of 2004. The increase in the second quarter of 2005 as compared to 2004 was due to an acceleration of deferred fee amounts resulting from the decrease in interest rates during the quarter.

Investment gains in the second quarter of 2005 totaled $596 million as compared to investment losses of $1.5 billion in the second quarter of 2004. Investment gains in the second quarter of 2005 were primarily attributable to unrealized gains on trading securities as interest rates dropped during the second quarter of 2005. The investment losses in the second quarter of 2004 were primarily due to unrealized losses on trading securities and LOCOM adjustments on HFS loans as interest rates increased significantly in the second quarter of 2004.

We recorded derivatives fair value losses of $2.6 billion in the second quarter of 2005 as compared to derivatives fair value gains of $2.3 billion in the second quarter of 2004. The second quarter of 2005 losses were primarily the result of losses in the fair value of open derivative positions at quarter-end caused by a decrease in interest rates during the second quarter of 2005. We recorded derivatives fair value gains of $2.3 billion in the second quarter of 2004 primarily as a result of a $4.1 billion gain in the fair value of open derivative positions at quarter-end caused by a rise in interest rates. This gain was reduced by a $1.4 billion loss from net periodic contractual interest expense, a $139 million loss in the fair value of terminated derivatives from the beginning of the quarter to the date of termination, and a $273 million loss on commitments.

We recorded tax expense of $332 million, including tax benefit on extraordinary losses, in the second quarter of 2005 as compared to $1.8 billion in the second quarter of 2004. The provision for federal income taxes includes taxes at the federal statutory rate of 35% adjusted for tax credits recognized for our LIHTC partnership investments and other tax credits.

Third Quarter Ended September 30, 2005 versus September 30, 2004

We recorded net income of $1.7 billion in the third quarter of 2005, compared with a net loss of $867 million in the third quarter of 2004. The increase in our net income was primarily due to lower derivatives fair value losses, partially offset by the reduction in our net interest income, higher investment losses and a provision for taxes compared to a tax benefit from a net loss recorded in the third quarter of 2004.

Net interest income totaled $2.7 billion in the third quarter of 2005 from $4.0 billion in the third quarter of 2004. The compression of our average yield continued during the third quarter of 2005 as our portfolio balance declined as a result of higher sales activity and the composition of our mortgage portfolio shifted to a higher share of adjustable rate loans and floating-rate securities. In the third quarter of 2005, portfolio sales were $52.9 billion, up from $3.8 billion during the third quarter of 2004 and $29.8 billion in the second quarter of 2005. In addition, rising short-term interest rates increased the cost of our short-term debt, further contributing to the decline in net interest income.

Guaranty fee income decreased to $832 million in the third quarter of 2005 as compared to $1.1 billion in the third quarter of 2004. In the third quarter of 2005, we saw a decrease in our effective guaranty fee primarily due to slower recognition of deferred fee amounts, resulting from an increasing interest rate environment.

Investment losses in the third quarter of 2005 totaled $169 million as compared to investment gains of $887 million in the third quarter of 2004. The third quarter of 2005 losses were primarily due to unrealized losses on trading securities as the fair value of our mortgage assets declined due to rising interest rates on the third quarter of 2005 versus a decline in interest rates during the third quarter of 2004.

We recorded derivatives fair value losses of $539 million in the third quarter of 2005 as compared to a loss of $7.1 billion in the third quarter of 2004. The loss in derivative fair value in the third quarter of 2005 primarily related to losses of $225 million in net periodic contractual interest expense and losses of $218 million related to changes in fair value of open derivative positions as of September 31, 2005. Losses in the third quarter of 2004 was comprised of a $4.7 billion loss in the fair value of open derivative positions at quarter-end caused by declines in interest rates, a

$1.2 billion loss in net periodic contractual interest expense, and a $1.4 billion loss on the fair value of terminated derivatives from the beginning of the quarter to the date of termination. These decreases were slightly mitigated by a $163 million gain on commitments in the third quarter of 2004.

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Administrative expense totaled $567 million in the third quarter of 2005 as compared to $367 million in the third quarter of 2004. The increase in administrative expenses in the third quarter of 2005 primarily related to costs associated with our restatement and related regulatory examinations, investigations and litigation defense.

The provision for credit losses totaled $172 million in the third quarter of 2005 as compared to $65 million in the third quarter of 2004. The provision in the third quarter of 2005 includes $106 million for our estimate related to losses incurred as a result of Hurricane Katrina. Refer to Item 7- Management Discussion and Analysis- Consolidated Results of Operations for additional information on the impact of this hurricane on our results.

We recorded tax expense of $404 million, including tax benefit on extraordinary losses, in the third quarter of 2005 as compared to a benefit for federal income taxes of $920 million in the third quarter 2004. Tax expense for the third quarter of 2005 includes taxes at the federal statutory rate of 35% adjusted for tax credits recognized for our LIHTC partnership investments and other tax credits. The benefit in the third quarter of 2004 relates to taxes on our loss at the federal statutory rate of 35% adjusted for tax credits recognized for our LIHTC partnership investments and other tax credits.

Fourth Quarter Ended December 31, 2005 versus December 31, 2004

We recorded net income of $1.4 billion in the fourth quarter of 2005, compared with net income of $1.6 billion recorded in the fourth quarter of 2004. The decrease in net income was primarily due to a reduction in net interest income offset by a decrease in derivative fair value losses.

Net interest income totaled $2.2 billion in the fourth quarter of 2005 as compared to $4.2 billion in the fourth quarter 2004. In the fourth quarter of 2005, our average yield was impacted by the continued decline in our interest-earning assets due to liquidations and notable sales activity during the year. Furthermore, the shift in our mortgage portfolio composition to a higher share of adjustable rate loans and floating-rate securities continued to drive net interest income down.

We recorded derivatives fair value losses of $267 million in the fourth quarter of 2005 as compared to a loss of $943 million in the fourth quarter of 2004. The loss in the fourth quarter of 2005 primarily related to losses of $186 million in net periodic contractual interest expense and losses of $123 million related to changes in fair value of terminated derivative positions during the fourth quarter. Losses in the fourth quarter of 2004 were comprised of a $791 million loss in net periodic contractual interest expense and a $134 million loss in the fair value of open derivative positions at quarter-end caused by minor movements in interest rates.

Fee and other income totaled $416 million in the fourth quarter of 2005 as compared to an expense of $168 million in the fourth quarter of 2004, primarily due to the recognition of foreign currency transaction gains on our foreign currency-denominated debt in the fourth quarter of 2005 as the dollar strengthened against the Japanese yen in 2005 as compared to 2004. As discussed in Risk Management Interest Rate Risk Management and Other Market Risks , when we issue foreign-denominated debt, we swap out of the foreign currency completely at the time of the debt issue in order to minimize our exposure to currency risk. As such, the aforementioned gains are offset by losses on fair value of the related derivatives.

Administrative expense totaled $678 million in the fourth quarter of 2005 as compared to $511 million in the fourth quarter of 2004. The increase in administrative expenses in the fourth quarter of 2005 primarily related to costs associated with our restatement and related regulatory examinations, investigations and litigation defense; however, the fourth quarter of 2004 included a $116 million charge for the write-off of previously capitalized software.

The provision for credit losses totaled $87 million in the fourth quarter of 2005 as compared to $219 million in the fourth quarter of 2004. The provision in the fourth quarter of 2005 is lower than in the fourth quarter of 2004 due to lower default rates in 2005. In the fourth quarter of 2004, we increased our provision for credit losses recorded in the first nine months of 2004 due to an observed trend of reduced levels of recourse proceeds from lenders on charged-off loans.

Other expenses totaled $93 million in the fourth quarter of 2005 as compared to $467 million in the fourth quarter of 2004. The decrease from the fourth quarter of 2004 is primarily due to recording a $400 million charge for the civil penalty as a result of our settlement agreements with OFHEO and the SEC.

We recorded tax expense of $317 million, including tax benefit on extraordinary losses, in the fourth quarter of 2005 of as compared to $712 million in the fourth quarter of 2004. The provision for federal income taxes includes taxes at the federal statutory rate of 35% adjusted for tax credits recognized for our LIHTC partnership investments and other tax credits.

Consolidated Balance Sheets

Our consolidated assets totaled $834.2 billion as of December 31, 2005, a decrease of $186.8 billion, or 18%, from December 31, 2004. The decrease in our assets was primarily due to a reduction in our portfolio balances that resulted from the notable increase in mortgage asset sales during 2005 that were conducted within the context of our capital restoration plan combined with lower purchase volumes. Our consolidated liabilities totaled $794.7 billion as of December 31, 2005, a decrease of $187.3 billion, or 19%, from December 31, 2004. The decrease in our liabilities primarily resulted from a reduction in debt issuances that was partially attributable to reduced purchase volumes. Stockholders equity increased by $400 million, or 1%, to $39.3 billion as of December 31, 2005, from $38.9 billion as of December 31, 2004. The increase in our equity was generated primarily from our 2005 earnings, offset by the reversal of unrealized gains on AFS securities.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Quantitative and qualitative disclosure about market risk is set forth on pages 138 through 146 of this Annual Report on Form 10-K under the caption Item 7 MD&A Risk Management Interest Rate Risk Management and Other Market Risks.

Item 8. Financial Statements and Supplementary Data

Our consolidated financial statements and notes thereto are included elsewhere in this Annual Report on Form 10-K as described below in Item 15 Exhibits, Financial Statement Schedules.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

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Item 9A. Controls and Procedures

OVERVIEW

This section discusses management s identification of, and efforts to remediate, material weaknesses in internal control over financial reporting over the period from December 31, 2004 to the date of this filing, beginning with an overview of remediation status of each of the material weaknesses reported as of December 31, 2004 through December 31, 2005 to the date of this filing. This overview is followed by a discussion of management s evaluation of disclosure controls and procedures, management s report on internal control over financial reporting, and management s efforts to remediate the material weaknesses, as set forth in the table below.

As shown in the following table, a number of the material weaknesses reported as of December 31, 2004 were remediated as of December 31, 2005, while others continued to be material weaknesses at such date but have been remediated as of the date of this filing. The description of the material weaknesses reported as of December 31, 2004 and identified in the table is attached as Exhibit 99.6 hereto and is incorporated by reference herein.

Material Weakness Reported as of December 31, 2004	**Status as of December 31, 2005**	**Status as the date of this Filing**
Control Environment:		
Tone at the Top	Remediated	*
Accounting Policy	Remediation in process	Remediated
Board of Directors and Executive Roles	Remediated	*
Enterprise-Wide Risk Oversight	Remediation in process	Remediated
Internal Audit	Remediation in process	Remediated
Human Resources	Remediation in process	Remediated
Fraud Risk Management Program	Remediated	*
Whistleblower Program	Remediated	*
Accounting/Finance Staffing Levels	Remediated	*
Information Technology Policy	Remediation in process	Remediated
Policies and Procedures	Remediation in process	Remediated
Application of GAAP	Remediation in process	Remediated
Financial Reporting Process:		
Financial Statement Preparation and Reporting	Remediation in process	Remediation in process
Disclosure Controls	Remediation in process	Remediation in process
General Ledger Controls	Remediation in process	Remediated

Journal Entry Controls	Remediation in process	Remediation in process
Reconciliation Controls	Remediation in process	Remediation in process
Information Technology and Infrastructure:		
Access Control	Remediation in process	Remediation in process
Change Management	Remediation in process	Remediated
End User Computing	Remediation in process	Remediated
Independent Model Review Process	Remediation in process	Remediated
Treasury and Trading Operations	Remediation in process	Remediated
Pricing and Independent Price Verification Processes	Remediation in process	Pricing Controls - Remediation in process Independent Price Verification Process - Remediated
Wire Transfer Controls	Remediation in process	Remediated
New Material Weakness as of December 31, 2005		
Multifamily Lender Loan Loss Sharing Modifications	Newly identified	Remediation in process

* Since remediation as of December 31, 2005 of the material weakness that existed as of December 31, 2004, these components of the control environment have continued to be effective at a reasonable assurance level.

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In our 2004 Form 10-K, we identified five material weaknesses in our internal control over financial reporting as of December 31, 2004 relating to tone at the top, our Board of Directors and executive roles, our whistleblower program, our fraud risk management program and our accounting/finance staff levels. These material weaknesses are not described below because they were remediated as of December 31, 2005. We describe the actions that we took during 2004 and 2005 to remediate these material weaknesses under the heading Description of Remediation Actions Actions Relating to Material Weaknesses Remediated as of December 31, 2005.

This section then describes the remediation activities undertaken in 2004, 2005, 2006 and 2007 through the date of this filing with respect to material weaknesses in internal control over financial reporting that were remediated as of the date of this filing, and concludes with a discussion of the remaining remediation activities underway as of the date of this filing.

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

As required by Rule 13a-15 under the Securities Exchange Act of 1934, or the Exchange Act, management has evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. In addition, management has performed this same evaluation as of the date of filing this report. Disclosure controls and procedures refer to controls and other procedures designed to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding our required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes 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 was required to apply its judgment in evaluating and implementing possible controls and procedures.

Management identified material weaknesses in our internal control over financial reporting, which management considers an integral component of our disclosure controls and procedures. The Public Company Accounting Oversight Board s Auditing Standard No. 2 defines a material weakness as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We have not filed periodic reports on a timely basis, as required by the rules of the SEC and the NYSE, since June 30, 2004. Our review of our accounting policies and practices in 2005 and 2006, and the restatement of our consolidated financial statements for the years ended December 31, 2003 and 2002, has resulted in an inability to timely file our Annual Reports on Form 10-K for the years ended December 31, 2004, 2005 and 2006, and our Quarterly Reports on Form 10-Q for the quarters ended September 30, 2004, March 31, 2005, June 30, 2005, September 30, 2005, March 31, 2006, June 30, 2006, September 30, 2006 and March 31, 2007. We filed our 2004 Form 10-K on December 6, 2006. As a result of these material weaknesses, as well as the reasons noted above, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of December 31, 2005 or as of the date of filing this report.

We have made progress in improving our internal control over financial reporting. Specifically, we have taken, and are taking, the actions described below under Remediation Activities and Changes in Internal Control Over Financial Reporting to remediate the material weaknesses in our internal control over financial reporting. In addition, we made several enhancements to other disclosure controls, which include:

revision and adoption of a new charter by the Disclosure Committee;

an annual review of the Disclosure Committee charter;

clarification of authority and role of the Disclosure Committee;

- formal training for Disclosure Committee members;
- preparation and maintenance of agendas for Disclosure Committee meetings;
- implementation of a Disclosure Committee voting process; and
- implementation of new disclosure policies and procedures covering, among other things, the relevant documents reviewed by the Disclosure Committee and the process for raising and resolving disclosure questions in a timely manner.

We continue to strive to improve our disclosure controls and procedures to enable us to provide complete and accurate public disclosure on a timely basis. Management believes that this material weakness relating to our disclosure controls will not be remediated until we are able to file required reports with the SEC and the NYSE on a timely basis.

To address the material weaknesses described in this Item 9A, management performed additional analyses and other post-closing procedures designed to ensure that our consolidated financial statements were prepared in accordance with GAAP. These procedures included data validation and certification procedures from the source systems to the general ledger, pre- and post-closing analytics, model validation procedures for financial models supporting the consolidated financial statements, and independent third-party reviews of selected accounting systems and accounting conclusions. As a result, management believes that the consolidated financial statements included in this report fairly present in all material respects the company s financial position, results of operations and cash flows for the periods presented.

MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Overview

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting, as defined in rules promulgated under the Exchange Act, is a process designed by, or under the supervision of, our Chief Executive Officer and Chief Financial Officer and effected by our Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and members of our Board of Directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on our financial statements.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process, and it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2005. In making its assessment, management used the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Management s assessment of our internal control over financial reporting as of December 31, 2005 identified

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the continuation of numerous material weaknesses in our control environment, our application of GAAP, our financial reporting process, and our information technology applications and infrastructure as of December 31, 2005. Further, management identified the continuation of other material weaknesses as of December 31, 2005 in our independent model review process, treasury and trading operations, pricing and independent price verification processes, wire transfer controls, and a new material weakness related to multifamily lender loss sharing modifications.

Because of the material weaknesses described below, management has concluded that our internal control over financial reporting was not effective as of December 31, 2005. Our independent registered public accounting firm, Deloitte & Touche LLP, has issued an audit report on management s assessment of our internal control over financial reporting, expressing an unqualified opinion on management s assessment and an adverse opinion on the effectiveness of our internal control over financial reporting as of December 31, 2005. This report is included on page 193 below.

Description of Material Weaknesses as of December 31, 2005

Control Environment

We did not maintain an effective control environment related to internal control over financial reporting. Specifically, we identified the following material weaknesses in our control environment as of December 31, 2005:

Accounting Policy

We lacked a written, comprehensive set of GAAP-compliant financial accounting policies and a formalized process for determining, monitoring, disseminating, implementing and updating our accounting policies and procedures.

Enterprise-Wide Risk Oversight

We did not maintain a properly staffed, comprehensive and independent risk oversight function. Specifically, our risk oversight function lacked enterprise-wide coordination, dedicated senior leadership and sufficient staffing. Comprehensive risk policies did not exist, and existing policies applicable to each business unit required enhancement.

Internal Audit

We did not maintain an effective and independent Internal Audit function. Internal Audit did not maintain a sufficient complement of personnel with an appropriate level of accounting and auditing knowledge, experience and training to effectively execute an appropriate audit plan. In addition, our Internal Audit function lacked clarity regarding its risk assessment process, communications and audit plans. Our ineffective Internal Audit function adversely affected our ability to adequately identify our control weaknesses.

Human Resources

Our human resources function did not have clear enterprise-wide coordination, which resulted in ineffective definition and communication of employee roles and responsibilities. In addition, training and performance evaluations were not always effective. As a result, we did not have a sufficient number of qualified staff, clear job descriptions, and appropriate policies and procedures relating to human resources. Lines of delegated authority were not always clear.

Information Technology Policy

We did not maintain and clearly communicate information technology policies and procedures. This weakness contributed to our inadequate internal control over financial reporting systems.

Policies and Procedures

We did not maintain adequate policies and procedures related to initiating, authorizing, recording, processing and reporting transactions. This lack of documentation led to (a) inconsistent execution of business practices, (b) inability to ensure practices were in accordance with management standards and (c) ambiguity in delegation of authority.

Application of GAAP

We did not maintain effective internal control over financial reporting relating to designing our process and information technology applications to comply with GAAP. We identified numerous material and immaterial misapplications of GAAP related to 2004 and years prior which had not been remediated as of December 31, 2005 and; therefore, continue to constitute a material weakness as of that date. We identified misapplications of GAAP in the following primary categories:

- our accounting for debt and derivatives;
- our accounting for commitments;
- our accounting for investments in securities;
- our accounting for MBS trust consolidations and sale accounting;
- our accounting for financial guaranties and master servicing;
- our amortization of cost basis adjustments; and
- other adjustments, including accounting for income taxes.

A detailed description of the material misapplications of GAAP is attached in Exhibit 99.7 hereto and is incorporated herein by reference. Additionally, due to our focus on restating prior years financial statements, we did not have the process and information technology applications in place to comply with Statement of Position No. 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* as of December 31, 2005.

Financial Reporting Process

We did not maintain an effective, timely and accurate financial reporting process. Specifically, we identified the following material weaknesses in our financial reporting process as of December 31, 2005:

Financial Statement Preparation and Reporting

Our systems and processes were not designed and in operation to enable us to prepare accurate consolidated financial statements in accordance with GAAP. These systems and processes, coupled with our other material weaknesses, resulted in our inability to prepare and complete accurate financial information.

Disclosure Controls and Procedures

We did not maintain effective disclosure controls and procedures, including an effective Disclosure Committee, designed to ensure complete and accurate disclosure as required by GAAP. In addition, we have not filed periodic reports on a timely basis as required by the rules of the SEC and the NYSE.

General Ledger Controls

We did not maintain effective internal control over financial reporting relating to the general ledger and the periodic closing of the general ledger. Specifically, the design and operation of this control was inadequate for managing the addition or deletion of specific balance sheet or consolidated statements of income accounts. In addition, personnel were granted access to the general ledger that was not appropriate to their scope of responsibility and we lacked a formalized process with adequate controls to ensure that the general ledger was closed properly at the end of each period.

Journal Entry Controls

We did not maintain effective internal control over financial reporting relating to the recording of journal entries, both recurring and non-recurring. Specifically, the design and operation of this control was

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inadequate for ensuring that journal entries were prepared by personnel with adequate knowledge of the activity being posted. The entries were not supported by appropriate documentation and were not reviewed at the appropriate level to ensure the accuracy and completeness of the entries recorded.

Reconciliation Controls

We did not maintain effective internal control over financial reporting relating to the reconciliation of many of our financial statement accounts and other data records that served as inputs to those accounts. Specifically, the design and operation of this control was inadequate for ensuring that our accounts were complete, accurate and in agreement with detailed supporting documentation. In addition, this control did not ensure proper review and approval of reconciliations by appropriate personnel.

Information Technology Applications and Infrastructure

We did not maintain effective internal control over financial reporting related to information technology applications and infrastructure, and the references in this section to controls refer to our internal control over financial reporting. Specifically, we identified the following material weaknesses relating to our information technology applications and infrastructure as of December 31, 2005:

Access Control

We did not maintain effective design of controls over access to financial reporting applications and data. Specifically, ineffective controls included unrestricted access to programs and data, lack of periodic review and monitoring of such access, and lack of clearly communicated policies and procedures governing information technology security and access. Furthermore, we did not maintain effective logging and monitoring of servers and databases to ensure that access was both appropriate and authorized.

Change Management

We did not maintain effective controls to ensure that information technology program and data changes were authorized and that the program and data changes were adequately tested for accuracy and appropriate implementation.

End User Computing

We did not maintain effective controls over end user computing (EUC) applications, such as spreadsheets. Specifically, controls were not designed and in operation to ensure that access to these applications was restricted to appropriate personnel and that changes to data or formulas were authorized.

Independent Model Review Process

We identified a material weakness as of December 31, 2005 related to the design of our internal control over financial reporting related to our independent model review process. Specifically, we did not independently review that: (i) the models and assumptions used as inputs in the production of our financial statements were appropriate; and (ii) that outputs used to produce our financial statements were calculated accurately according to the model specifications. Our loan loss allowance, amortization, guaranty and financial instrument valuation processes each used models. We also incorrectly valued our derivatives, mortgage loan and security commitments, security investments, guaranties and other instruments.

Treasury and Trading Operations

We identified a material weakness as of December 31, 2005 related to the design of our internal control over financial reporting related to our treasury and trading operations. Specifically, our internal control over financial reporting was inadequate with respect to the process of authorizing, approving, validating and settling trades, including inadequate segregation of duties among trading, settlement and valuation activities within both our treasury and trading operations.

Pricing and Independent Price Verification Processes

We identified a material weakness as of December 31, 2005 related to the design of our internal control over financial reporting related to our pricing and independent price verification processes. Specifically, our internal control over financial reporting was inadequate with respect to the process used to price assets and liabilities, and did not maintain appropriate segregation of duties between the pricing function and the function responsible for independently verifying such prices.

Wire Transfer Controls

We identified a material weakness as of December 31, 2005 related to the design of our internal control over financial reporting related to our wire transfer function. Specifically, the design of our internal control over financial reporting was insufficient with respect to the initiation, authorization, segregation of duties and anti-fraud measures related to wire transfer transactions and with respect to the reconciliation of cash balances and wire transfer activity. In addition, approvals were not consistent with approval policies and funds movements lacked verifications.

Multifamily Lender Loss Sharing Modifications

We identified a material weakness as of December 31, 2005 related to the design of our internal control over financial reporting related to maintaining accurate loss sharing information in our information systems. Specifically, we did not have a control in place to ensure that loss sharing amendments related to credit facilities with our multifamily lenders were appropriately recorded in our information systems. As a result, our accounting conclusions, including certain conclusions related to consolidation, could have been materially affected.

REMEDIATION ACTIVITIES AND CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

Overview

Management has evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, whether any changes in our internal control over financial reporting that occurred during the period from January 1, 2005 through the date of this filing have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on the evaluation management conducted, substantial changes were implemented and tested during the period from January 1, 2005 through the date of this filing to remediate our material weaknesses in internal control over financial reporting.

With respect to the remaining material weaknesses described above, we are implementing new internal controls and will be testing to assess their effectiveness. Management will not make a final determination that we have completed our remediation of these remaining material weaknesses until we have completed testing of our newly implemented internal controls. We currently estimate that we will not complete implementing and testing of all of these new controls until the filing of our Annual Report on Form 10-K for the year ended December 31, 2007; however, we anticipate that we may complete testing with respect to some of our remaining material weaknesses prior to that time. Further, we believe that we will not have remediated the material weakness relating to our disclosure controls and procedures until we are able to file required reports with the SEC and the NYSE on a timely basis. Deloitte & Touche will independently assess the effectiveness of our internal control over financial reporting, but will make that assessment only in connection with its audit of our consolidated financial statements for the year ended December 31, 2006. In addition, our internal control environment will continue to be modified and enhanced in order to enable us to file periodic reports with the SEC on a current basis in the future.

Management believes the measures that we have implemented to remediate the material weaknesses in internal control over financial reporting have had a material impact on our internal control over financial reporting since December 31, 2004. Changes in our internal control over financial reporting that have materially

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affected, or are reasonably likely to materially affect, our internal control over financial reporting have been described below.

Description of Remediation Actions

Actions Relating to Material Weaknesses Remediated as of December 31, 2005

In our 2004 Form 10-K we identified five material weaknesses in our internal control over financial reporting as of December 31, 2004 relating to tone at the top, our Board of Directors and executive roles, our whistleblower program, our fraud risk management program and our accounting/finance staff levels that are not described above because they were remediated as of December 31, 2005. The discussion below describes the actions that management took during 2004 and 2005 to remediate these material weaknesses in internal control over financial reporting.

Tone at the Top

We made significant changes to our Board of Directors, our management team and our corporate structure prior to December 31, 2005 in order to establish and maintain a consistent and proper tone as to the importance of internal control over financial reporting. The Board and management emphasized the importance of internal control over financial reporting through communication and action. In 2005, our Board of Directors appointed a new Chief Executive Officer from within the company and appointed a new Chief Financial Officer from outside the company who joined us in early 2006. Over 37% of our senior officers, including our Chief Financial Officer, Controller, Chief Audit Executive, Chief Risk Officer, General Counsel and all senior officers in our Controller s and Accounting Policy functions, joined the company after December 2004. In addition, with the assistance of an independent consulting firm, we assessed the organizational design of our finance, risk, audit, compliance, operations and technology functions. New organizational structures and frameworks for each of these areas were implemented in 2005.

We also initiated a comprehensive plan to transform our corporate culture into one focused on service, open and honest engagement, accountability and effective management practices. Additionally, based on the recommendations of our independent consultants, we modified our compensation practices to include metrics in addition to earnings per share, including non-financial metrics relating to our controls, culture and mission goals.

In addition to these personnel, organizational and compensation changes, our new management team encourages an environment that fosters frequent, open and direct communications. This environment includes weekly CEO newsletters, open question lines to executive management, frequent company-wide town hall meetings, training on how to further foster open communication, and open feedback solicitation through management forums, surveys and roundtables. Management continuously supports enhancement of the understanding and execution of internal control over financial reporting as a top priority for the company.

Board of Directors and Executive Roles

We made significant changes to the Board of Directors including:

- amending our bylaws to separate the functions of the Chief Executive Officer and Chairman of the Board;
- appointing a non-executive Chairman of the Board;
- creating a Risk Policy and Capital Committee of the Board in February 2005, which replaced the role of the former Assets & Liabilities Policy Committee in assisting the Board in overseeing capital management and risk management;

creating a Technology and Operations Committee of the Board with responsibility for assisting the Board in overseeing these functions;

re-designating a new Compliance Committee of the Board, composed entirely of independent directors, in October 2004, that now has responsibility for monitoring compliance with our May 2006 consent order with OFHEO. In November 2005, the Board of Directors established the Compliance Committee as a permanent committee of the Board with responsibility for providing legal and regulatory oversight;

revising the charters of six standing committees of our Board of Directors (Audit Committee, Nominating and Corporate Governance Committee, Compensation Committee, Compliance Committee, Risk Policy and Capital Committee, and Housing and Community Finance Committee);

changing the composition of the Board by eliminating two of the three management Board seats;

adding six new Board members, three of whom joined in 2006, who are intended to enhance the substantive business operations, accounting and finance knowledge of the Board; and

naming a new Chairman of the Audit Committee in 2006 and appointing three other new members to the Audit Committee, two of whom joined the Board in 2006.

In addition, the Board of Directors appointed a new Chief Executive Officer.

Whistleblower Program

We enhanced our whistleblower program with a new corporate ethics line that offers full anonymity to callers, if desired, regular reporting of cases to the Chief Compliance Officer, and regular formal reporting of cases to the Compliance and Audit Committees of the Board of Directors.

Fraud Risk Management Program

We implemented a fraud risk and control identification program and assessed the operating effectiveness of the identified controls. In addition, the Audit Committee of the Board of Directors periodically reviews the status and effectiveness of the fraud risk management program. We believe that these initial actions remediated this material weakness. Subsequently, we have further enhanced this area by adopting a fraud risk management policy and developing a formal fraud assessment process, which has been implemented for those business areas identified as having high potential for fraud risk. A fraud risk management training program has been designed and rolled out to risk-prioritized business units.

Accounting/Finance Staffing Levels

As part of our organizational redesign, we performed a thorough staffing assessment of our accounting and finance organizations. We replaced substantially all senior finance and accounting employees, including hiring a new Controller and appointing a new Chief Financial Officer. Additionally, we increased the number of full-time employees with the appropriate level of accounting experience in our accounting function and supplemented the function with outside contractors having the appropriate level of accounting experience and expertise to assist us in our restatement efforts.

Actions Relating to Material Weaknesses Remediated as of the Date of this Filing

The discussion below describes the actions that management took during 2004, 2005, 2006 and 2007 through the date of this filing to remediate the material weaknesses in internal control over financial reporting that were remediated as of the date of this filing.

Control Environment

Accounting Policy

We have completed a full assessment of all our accounting policies designed to ensure their compliance with GAAP, which required us to revise substantially all of these accounting policies. As part of this process, we engaged accounting experts to advise on our accounting policies. We currently maintain a written, comprehensive set of GAAP-compliant financial accounting policies. All of these accounting policies have been communicated to the appropriate accounting functions.

Staff in the accounting policy function has worked closely with each of the business units and financial reporting designed to ensure accurate accounting policy interpretation and to address new or emerging accounting policy issues. Accounting standard-setting developments are actively monitored, with implementation impacts researched in coordination with the Controller s department, business unit personnel and other divisions that would be impacted. Additionally, accounting policy is actively engaged in new product and process approval designed to ensure that the correct accounting policy decisions are reached and implemented.

In addition, in order to provide a segregation of duties between those who develop our accounting policies and those who implement them, as part of our organizational redesign, reporting responsibility for the accounting policy function was moved from the Controller to the CFO. In May 2005, we announced the hiring of a new senior officer to oversee the accounting policy function.

Enterprise-Wide Risk Oversight

We have established an enterprise-wide risk organization with oversight of credit risk, market risk and operational risk, as well as model review. In May 2006, we announced the hiring of a Chief Risk Officer, and new senior officers responsible for credit risk oversight and operational risk oversight reporting to the new Chief Risk Officer. In 2006, we also hired a senior officer responsible for market risk oversight, capital methodology and model review. We have developed and communicated corporate-wide risk policies and enhanced our business unit risk management processes. We have implemented a new organizational risk structure that includes risk management personnel within each business unit. Those individuals report to business unit leadership and have responsibility for implementing the corporate-wide risk policies in their respective business units. We have enhanced Board monitoring and communication regarding credit risk and market risk by establishing the Risk Policy and Capital Committee of the Board of Directors. The Chief Risk Officer reports independently to the Risk Policy and Capital Committee, and also reports directly to the Chief Executive Officer.

Internal Audit

In July 2005, management and the Audit Committee of the Board appointed a new Chief Audit Executive from outside the company. The Chief Audit Executive reports directly to the Audit Committee with indirect reporting to the Chief Executive Officer. The Chief Audit Executive has enhanced the level of communication with the Audit Committee, which includes increased communication with the Chairman of the Audit Committee and enhanced detail within the formal reports to the Audit Committee. Additionally, the Internal Audit function has completed a comprehensive review and analysis of its organizational design and audit processes, including organizational structure, staffing levels, skill assessments, audit planning, audit execution and reporting. Internal Audit has filled its key management positions and continues to reassess and enhance its staffing. The Internal Audit management team was expanded from one officer to four, three of whom were external hires. All officers in the Internal Audit department hold one or more of the following professional credentials: certified public accountant, certified internal auditor, certified fraud examiner, certified information systems auditor or certified bank auditor. Internal Audit has developed and communicated a risk-based audit plan, which it reports upon regularly to the Audit Committee.

Human Resources

As part of our organizational redesign, we have repositioned and redefined the role of our human resources function. This has included adoption and implementation of a new performance assessment process, enhancement of job descriptions, and clearly communicated policies and procedures regarding human resources. We have also hired additional personnel into HR functions to assist in strengthening the role of human resources within the company. Additionally, we have completed a comprehensive corporate review of delegations of authority and developed and communicated a corporate-wide policy.

Information Technology Policy

We have implemented an information technology standard setting board that governs the development and communication of information technology policies, corporate technology standards and detailed technology operating procedures throughout the company.

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Policies and Procedures

We have developed and communicated corporate-wide standards for policies and procedures for use throughout our business to support a uniform approach to the documentation of current policies, procedures and delegated authority in most areas of the company. Concurrent with our corporate policy and procedures initiative, each of our business units has identified and corrected deficient policies and procedures documentation for processes relevant to internal control over financial reporting. As noted above, we have also completed a comprehensive corporate review of delegations of authority and developed and communicated a corporate-wide policy.

Application of GAAP

For each misapplication of GAAP, we have assessed the applicable accounting policy and implemented new processes and technology designed to ensure the appropriate application of GAAP. In addition, as described above in our discussion of remediation activities relating to our accounting policy function under Control Environment Accounting Policy, we have completed a full assessment of all of our accounting policies and have revised these accounting policies in an effort designed to ensure their compliance with GAAP. We now maintain a written set of GAAP-compliant financial accounting policies. All of these accounting policies have been communicated to the appropriate accounting functions. Staff in the accounting policy function work closely with each of the business units and financial reporting in an effort designed to ensure accurate accounting policy interpretation and to address new or emerging accounting policy issues. Accounting standard-setting developments are actively monitored, with implementation impacts researched in coordination with the Controller s department, business unit personnel and other divisions that would be impacted. Additionally, accounting policy is actively engaged in new product and process approval designed to ensure that the correct accounting policy decisions are reached and implemented.

Further, as described above in our discussion of remediation activities relating to our accounting/finance staffing levels under Control Environment Accounting/Finance Staffing Levels, we have increased the number of full time employees in our accounting function. This staffing increase and the related separation of duties have improved the controls relating to our process for determining, monitoring, disseminating, implementing and updating GAAP. We have also enhanced our technology processes in an effort designed to ensure that our systems are operating in a manner consistent with our accounting policies. Additionally, we have designed and implemented new systems which have resulted in generating the consolidated financial statements included in this Annual Report on Form 10-K.

Financial Reporting Process

General Ledger Controls

We have implemented review and approval controls to manage the addition and deletion of general ledger accounts. We have strengthened supervisory review controls over account management and the periodic close process.

Information Technology Applications and Infrastructure

Change Management

We have designed and implemented procedures to control changes to all of the applications that are material to our financial reporting process. Such procedures include standard request, approval and review controls over any system or data change. Significant changes are managed through a governance committee of corporate representatives from technology and business unit management. In addition, we have implemented reconciliation or user controls designed to ensure that the desired change was implemented as intended.

End User Computing

We have designed and implemented procedures to control changes to our EUCs. These procedures have included:

- identification of EUCs used in all significant financial reporting processes;
- protecting EUCs through maintenance on a controlled platform within our IT infrastructure where EUC access can be controlled using a process similar to the corporate application access process;
- version control for a significant portion of EUCs; and
- data change control for a significant portion of EUCs.

Independent Model Review Process

A corporate model policy approved in September 2005 established an independent model review process that assesses and validates on a regular basis whether the models and assumptions are reasonable for their intended use. We have established an independent model review function under the Chief Risk Officer. As of the date of this filing, we have applied this process to our most critical financial models pursuant to our new independent model review process.

Treasury and Trading Operations

We have redesigned our process for authorizing, approving, validating and settling trades, including segregating duties among trading, settlement and valuation activities within both our treasury and trading operations. In addition, with the assistance of an independent consulting firm, we have assessed the organizational design of our treasury and trading operations, and have implemented changes in those functions.

Pricing and Independent Price Verification

Management believes that we have remediated part of this material weakness as of the date of this filing. We have implemented independent validation controls to provide verification of fair value prices through comparisons with external market sources and analytical procedures. As discussed below, we continue to implement remedial actions to improve our pricing processes.

Wire Transfer Controls

We have redesigned our internal control over financial reporting related to our wire transfer activity. Specifically, we implemented system changes, developed multiple department policies and created a cross functional team to develop enhancements to our wire transfer process and controls. As a result, we have enhanced our access controls by segregating the wire initiation and wire system access functions, implemented a periodic access review process and strengthened our access approval procedures. Additionally, we have eliminated the use of paper manual wire transfers from our standard processes and have reduced our list of inactive counterparty wire instructions in our database. Lastly, we have also increased business unit staffing levels and hired an external consultant to provide best practice and industry standards guidance.

Remediation Actions Relating to Remaining Material Weaknesses

The discussion below describes the actions that management has taken and is in the process of taking to remediate our remaining material weaknesses in internal control over financial reporting.

Financial Reporting Process

Financial Statement Preparation and Reporting

Although we have not yet remediated this material weakness, as of the date of this filing, we have redesigned our financial reporting processes and implemented technological changes which have resulted in generating the consolidated financial statements included in this Annual Report on Form 10-K. This

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redesigned process also includes requirements for appropriate review and approval of the consolidated financial statements by qualified accounting personnel.

To further enhance our internal control over financial reporting relating to financial statement preparation and reporting, we created a new financial controls and systems group within our Controller s department which is focused solely on improving our accounting systems and internal control framework in an effort designed to ensure that our accounting function properly supports our internal control over financial reporting. The financial controls and systems group has responsibility for designing, implementing and monitoring controls within the Controller s department. Additionally, the group is responsible for managing the development, testing and deployment of new accounting systems and ensuring those systems have adequate controls and documentation.

Further, we continue to enhance the financial statement preparation and reporting process by identifying and communicating requirements earlier, providing detailed training on cash flow statement preparation, and improving data sourcing processes. These process and system design changes should enable us to develop a sustainable, repeatable financial reporting process. We continue to implement additional analytics to facilitate a more thorough and timely review of the results of operations.

Journal Entry Controls

Although we have not yet remediated this material weakness, as of the date of this filing, we have redesigned our journal entry creation and approval process. The new process includes additional training on the creation of journal entries, required journal entry support and the requirements for the review and approval of journal entries. Additional controls were added to specify thresholds for journal entry approval and ongoing monitoring of journal entry generation and compliance. However, we continue to refine and enhance these processes.

Reconciliation Controls

Although we have not yet remediated this material weakness, as of the date of this filing, we have implemented a redesigned process to ensure that all of our general ledger accounts are reconciled on a timely basis. We have assigned primary and supervisory account management responsibility for all of our general ledger accounts. We have also provided detailed training on account reconciliations. Reconciliation completion, review and issue management is monitored each month to ensure compliance with our policies. However, we continue to refine and enhance these processes.

Disclosure Controls and Procedures

While we have made progress in improving our disclosure controls and procedures, as discussed under Evaluation of Disclosure Controls and Procedures above, management believes that this material weakness will not be remediated until we are able to file required reports with the SEC and the NYSE on a timely basis.

Access Controls for Information Technology Applications and Infrastructure

Although we have not yet remediated this material weakness, as of the date of this filing, we have designed and implemented procedures and technology to control access to all of the applications that are within all significant financial reporting processes. Such procedures include standard request, review and approval controls over any addition or deletion to system access. In addition, we perform regular, periodic monitoring of authorized users designed to ensure that only authorized users have access to systems and that such access is commensurate with current job responsibilities.

To remediate this material weakness, we are further standardizing and automating the process to add or remove a user s access to applications that are material to our financial reporting process. In addition, we are improving automation of the workflow for requesting, approving, granting, revoking and reviewing access privileges on technology platforms that support applications that are material to our financial reporting process.

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Pricing Controls

Although we have not yet remediated this material weakness, as of the date of this filing, we have redesigned our process for pricing our financial instruments. The process includes supervisory review over data inputs, model outputs and computational accuracy. However, we continue to refine and enhance these processes.

Multifamily Lender Loss Sharing Modifications

We have implemented review and approval controls for the initial contract data entry for credit facilities in our information systems. Further, we are in the process of redesigning our processes and controls for monitoring all changes to contractual arrangements, and updating and validating such changes in our systems.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Fannie Mae:

We have audited management s assessment, included in the accompanying *Management s Report on Internal Control over Financial Reporting*, that Fannie Mae (the Company) did not maintain effective internal control over financial reporting as of December 31, 2005, because of the effect of the material weaknesses identified in management s assessment based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company 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. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of 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, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s board of directors, management, and other personnel 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 the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Numerous pervasive material weaknesses have been identified and included in the accompanying *Management s Report on Internal Control over Financial Reporting*. The nature of these weaknesses is described below:

Control Environment The Company did not maintain an effective control environment related to internal control over financial reporting. Specifically, the control environment lacked the following controls which represent material weaknesses: a comprehensive set of financial accounting policies, a comprehensive and independent risk oversight function, an effective and independent Internal Audit function, a human resources function with clear enterprise-wide coordination, clearly communicated information technology policies and procedures, and adequate transactional policies and procedures.

Application of Accounting Principles Generally Accepted in the United States of America The Company did not maintain effective internal control relating to designing its process and information technology applications to comply with accounting principles generally accepted in the United States of America.

Financial Reporting Process The Company did not maintain an effective, timely and accurate financial reporting process, including a lack of timely and complete financial statement reviews, effective disclosure controls and procedures, general ledger and journal entry controls, and appropriate reconciliation processes.

Information Technology Applications and Infrastructure The Company did not maintain effective internal control related to information technology applications and infrastructure, including access controls, change management controls, and controls over end user computing including spreadsheets.

Independent Model Review Process The design of internal control did not provide for independent review that accounting related models and assumptions were appropriate and that outputs were calculated accurately according to model specifications.

Treasury and Trading Operations The design of internal control was inadequate with respect to the process of authorizing, approving, validating, and settling trades, including inadequate segregation of duties among trading, settlement, and valuation activities within both the treasury and trading operations.

Pricing and Independent Price Verification Processes The design of internal control was inadequate with respect to the process used to price assets and liabilities, and did not maintain appropriate segregation of duties between the pricing function and the function responsible for independently verifying such prices.

Wire Transfer Controls The design of internal control was insufficient with respect to the initiation, authorization, segregation of duties and anti-fraud measures related to wire transfer transactions and with respect to the reconciliation of cash balances and wire transfer activity.

Multifamily Lender Loss Sharing Modifications The design of internal control was inadequate with respect to accurate loss sharing information in the information systems as there was no control in place to ensure that loss sharing amendments related to credit facilities with the multifamily lenders were appropriately recorded in the information systems.

Due to the nature and extent of these weaknesses, annual and quarterly consolidated financial statements have not been filed timely since the quarter ended June 30, 2004, and there is more than a remote likelihood that a material misstatement in the Company s financial statements might not be detected and prevented by the Company s internal controls over financial reporting. These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended December 31, 2005, of the Company and this report does not affect our report on such financial statements.

In our opinion, management s assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2005, of the Company and our report dated May 1, 2007 expressed an unqualified opinion on those financial statements.

/s/ Deloitte & Touche LLP

May 1, 2007

Item 9B. Other Information

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

Directors

Our current directors are listed below. They have provided the following information about their principal occupation, business experience and other matters.

Stephen B. Ashley, 67, has been Chairman and Chief Executive Officer of The Ashley Group, a group of commercial and multifamily real estate, brokerage and investment companies, since 1995. The Ashley Group is comprised of S.B. Ashley Management Corporation, S.B. Ashley Brokerage Corporation and S.B. Ashley & Associates Venture Company, LLC. From 1991 to 1995, Mr. Ashley served as Chairman and Chief Executive Officer of Sibley Mortgage Corporation, a commercial, multifamily and single-family mortgage banking firm, and Sibley Real Estate Services, Inc. Mr. Ashley is a past President of the Mortgage Bankers Association of America and has over 40 years of experience in the real estate and real estate financing industries. Mr. Ashley also serves as a director of Manning & Napier Fund, Inc. In addition, Mr. Ashley serves as a trustee of Cornell University. Mr. Ashley has been a Fannie Mae director since May 1995 and Chairman of Fannie Mae s Board since December 2004.

Dennis R. Beresford, 68, has served as Ernst & Young Executive Professor of Accounting at the J.M. Tull School of Accounting, Terry College of Business, University of Georgia since 1997. From 1987 to 1997, Mr. Beresford served as Chairman of the Financial Accounting Standards Board, or FASB, the designated organization in the private sector for establishing standards of financial accounting and reporting in the United States. From 1961 to 1986, Mr. Beresford was with Ernst & Young LLP, including ten years as a Senior Partner and National Director of Accounting. Mr. Beresford is a member of the Board of Directors and Chairman of the Audit Committee of Kimberly-Clark Corporation and Legg Mason, Inc. Mr. Beresford is a certified public accountant. Mr. Beresford has been a Fannie Mae director since May 2006.

Brenda J. Gaines, 57, served as President and Chief Executive Officer of Diners Club North America, a subsidiary of Citigroup, from October 2002 until her retirement in April 2004. She served as President, Diners Club North America, from February 1999 to September 2002. From 1988 until her appointment as President, she held various positions within Diners Club North America, Citigroup and Citigroup s predecessor corporations. She also served as Deputy Chief of Staff for the Mayor of the City of Chicago from 1985 to 1987 and as Chicago Commissioner of Housing from 1983 to 1985. In addition, Ms. Gaines serves as a director of Office Depot, NICOR, Inc. and Tenet Healthcare Corporation. Ms. Gaines has been a Fannie Mae director since September 2006.

Karen N. Horn, Ph.D., 63, is a Senior Managing Director of Brock Capital Group LLC, an advisory and investment firm, a position she has held since 2003. She served as Managing Director, Private Client Services of Marsh Inc., a subsidiary of Marsh & McLennan Companies, Inc., from 1999 until her retirement in 2003. She served as Senior Managing Director and Head of International Private Banking at Bankers Trust Company from 1996 to 1999, as Chairman and Chief Executive Officer, Bank One, Cleveland, from 1987 to 1996 and as President of the Federal Reserve Bank of Cleveland from 1982 to 1987. Ms. Horn is a director of Eli Lilly and Company and Simon Property Group, Inc. and a director or trustee of all T. Rowe Price funds and trusts. She also serves as a vice-chairman of the U.S. Russia Investment Fund, a presidential appointment. Ms. Horn has been a Fannie Mae director since September 2006.

Bridget A. Macaskill, 58, is the Principal of BAM Consulting LLC, an independent financial services consulting firm, which she founded in 2003. Ms. Macaskill has been providing consulting services to the financial services industry since 2001. Ms. Macaskill previously held several positions at Oppenheimer Funds, Inc. including serving as Chairman of the Board from 2000 to 2001, Chief Executive Officer from 1995 to 2001 and President from 1991 to 2000. Ms. Macaskill is a director of Prudential plc and Scottish & Newcastle plc. She also serves on the Board of Trustees of the College Retirement Equities Fund (CREF) and the TIAA-CREF Funds. Ms. Macaskill has been a Fannie Mae director since December 2005.

Daniel H. Mudd, 48, has served as President and Chief Executive Officer of Fannie Mae since June 2005. Mr. Mudd previously served as Vice Chairman of Fannie Mae s Board of Directors and interim Chief Executive Officer, from December 2004 to June 2005, and as Vice Chairman and Chief Operating Officer from February 2000 to December 2004. Prior to his employment with Fannie Mae, Mr. Mudd was President and Chief Executive Officer of GE Capital, Japan, a diversified financial services company and a wholly-owned subsidiary of the General Electric Company, from April 1999 to February 2000. He also served as President of GE Capital, Asia Pacific, from May 1996 to June 1999. Mr. Mudd has served as a director of the Fannie Mae Foundation since March 2000, serving as Vice Chairman from September 2003 to December 2004, interim Chairman from December 2004 to June 2005, and Chairman since June 2005. Mr. Mudd also serves as a director of Fortress Investment Group LLC and Ryder System, Inc., although he has resigned as a director of Ryder effective May 4, 2007. Mr. Mudd has been a Fannie Mae director since February 2000.

Joe K. Pickett, 61, retired from HomeSide International, Inc. in 2001, where he had served as Chairman since 1996. He also served as Chief Executive Officer of HomeSide International, Inc. from 1996 to 2001. HomeSide International was the parent of HomeSide Lending, Inc., a mortgage banking company that was previously known as BancBoston Mortgage Corporation. Mr. Pickett also served as Chairman and Chief Executive Officer of HomeSide Lending from 1990 to 1999. Mr. Pickett is a past President of the Mortgage Bankers Association of America. Mr. Pickett has been a Fannie Mae director since May 1996.

Leslie Rahl, 56, is the founder of and has been President of Capital Market Risk Advisors, Inc., a financial advisory firm specializing in risk management, hedge funds and capital market strategy, since 1994. Previously, Ms. Rahl spent 19 years at Citibank, including nine years as Vice President and Division Head, Derivatives Group North America. She is currently a director of the International Association of Financial Engineers and the Fischer Black Memorial Foundation. She is a former director of the International Swaps Dealers Association. Ms. Rahl has been a Fannie Mae director since February 2004.

Greg C. Smith, 55, retired in March 2006 from Ford Motor Company, or Ford, where he had served as Vice Chairman since October 2005. Mr. Smith held several positions at Ford including serving as the Executive Vice President and President, The Americas, from 2004 to 2005. He was Group Vice President of Ford and Chairman and Chief Executive Officer of Ford Motor Credit Company, or Ford Credit, an indirect, wholly-owned subsidiary of Ford, from 2002 to 2004. He also served as the Chief Operating Officer of Ford Credit from 2001 to 2002, and President, Ford Credit North America from 1997 to 2001. Mr. Smith is a former Chairman of the American Financial Services Association. He has been a Fannie Mae director since April 2005.

H. Patrick Swygert, 64, has been President of Howard University since 1995. He also serves as a director of Hartford Financial Services Group, Inc. and United Technologies Corporation. In addition, Mr. Swygert is a member of the Central Intelligence Agency External Advisory Board. Mr. Swygert has been a Fannie Mae director since January 2000.

John K. Wulff, 58, has been the non-executive Chairman of the Board of Hercules Incorporated, a manufacturer and supplier of specialty chemical products, since December 2003. Mr. Wulff was first elected as a director of Hercules in July 2003, and served as interim Chairman from October 2003 to December 2003. Mr. Wulff also served as a member of the FASB from July 2001 until June 2003. From 1996 until 2001, Mr. Wulff was Chief Financial Officer of Union Carbide Corporation, a chemicals and polymers company. In addition to serving as a director of Hercules Incorporated, Mr. Wulff is a director of Sunoco, Inc., Celanese Corporation and Moody s Corporation. Mr. Wulff has been a Fannie Mae director since December 2004.

Corporate Governance

Under the Charter Act, our Board of Directors consists of 18 directors, 5 of whom are appointed by the President of the United States. The terms of the most recent Presidential appointees to Fannie Mae s Board expired on May 25, 2004 and the President declined to reappoint or replace them. Pursuant to the Charter Act, those five Board positions will remain open unless and until the President names new appointees. There are currently two additional vacancies on our Board.

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Fannie Mae s bylaws provide that each director holds office for the term to which he or she was elected or appointed and until his or her successor is chosen and qualified or until he or she dies, resigns, retires or is removed from office in accordance with the law, whichever occurs first. Under the Charter Act, each director is elected or appointed for a term ending on the date of our next stockholders meeting.

Director Independence

Our Board of Directors, with the assistance of the Nominating and Corporate Governance Committee, has reviewed the independence of all current Board members under the listing standards of the NYSE, and the standards of independence adopted by the Board, as set forth in our Corporate Governance Guidelines and outlined below. It is the policy of our Board of Directors that a substantial majority of our seated directors will be independent in accordance with these standards.

Our Board of Directors has affirmatively determined that the following Board members are independent: Stephen Ashley, the non-executive Chairman, Dennis Beresford, Brenda Gaines, Karen Horn, Bridget Macaskill, Joe Pickett, Leslie Rahl, Greg Smith, Patrick Swygert and John Wulff. Board member Daniel Mudd, our President and Chief Executive Officer, is not independent.

Under the standards of independence adopted by our Board, which meet and in some respects exceed the definition of independence adopted by the NYSE, an independent director must be determined to have no material relationship with us, either directly or through an organization that has a material relationship with us. A relationship is material if, in the judgment of the Board, it would interfere with the director s independent judgment. In addition, under the NYSE s listing requirements for audit committees, members of a company s audit committee must meet additional, heightened independence criteria, although our own independence standards require all independent directors to meet these criteria.

To assist it in determining whether a director is independent, our Board has adopted the standards set forth below:

A director will not be considered independent if, within the preceding five years:

the director was our employee; or

an immediate family member of the director was employed by us as an executive officer.

A director will not be considered independent if:

the director is a current partner or employee of our outside auditor, or within the preceding five years, was (but is no longer) a partner or employee of our outside auditor and personally worked on our audit within that time; or

an immediate family member of the director is a current partner of our outside auditor, or is a current employee of our outside auditor participating in the firm s audit, assurance or tax compliance (but not tax planning) practice, or within the preceding five years, was (but is no longer) a partner or employee of our outside auditor and personally worked on our audit within that time.

A director will not be considered independent if, within the preceding five years:

the director was employed by a company at a time when one of our current executive officers sat on that company s compensation committee; or

an immediate family member of the director was employed as an officer by a company at a time when one of our current executive officers sat on that company s compensation committee.

A director will not be considered independent if, within the preceding five years:

the director received any compensation from us, directly or indirectly, other than fees for service as a director; or

an immediate family member of the director received any compensation from us, directly or indirectly, other than compensation received for service as our employee (other than an executive officer).

A director will not be considered independent if:

- the director is a current executive officer, employee, controlling stockholder or partner of a corporation or other entity that does or did business with us and to which we made, or from which we received, payments within the preceding five years that, in any single fiscal year, were in excess of $1 million or 2% of the entity s consolidated gross annual revenues, whichever is greater; or

- an immediate family member of the director is a current executive officer of a corporation or other entity that does or did business with us and to which we made, or from which we received, payments within the preceding five years that, in any single fiscal year, were in excess of $1 million or 2% of the entity s consolidated gross annual revenues, whichever is greater.

A director will not be considered independent if the director or the director s spouse is an executive officer, employee, director or trustee of a nonprofit organization to which we or the Fannie Mae Foundation makes contributions in any year in excess of 5% of the organization s consolidated gross annual revenues, or $100,000, whichever is less (amounts contributed under our Matching Gifts Program are not included in the contributions calculated for purposes of this standard). The Nominating and Corporate Governance Committee also will administer standards concerning any charitable contribution to organizations otherwise associated with a director or any spouse of a director. We are guided by our interests and that of our stockholders in determining whether and the extent to which we make charitable contributions.

After considering all the facts and circumstances, our Board may determine in its judgment that a director is independent (in other words, the director has no relationship with us that would interfere with the director s independent judgment), even though the director does not meet the standards listed above, so long as the determination of independence is consistent with the NYSE definition of independence.

Where the guidelines above do not address a particular relationship, the determination of whether the relationship is material, and whether a director is independent, will be made by our Board, based upon the recommendation of the Nominating and Corporate Governance Committee.

The Board has determined that all of our independent directors meet the director independence standards of our Corporate Governance Guidelines and the NYSE.

Our Board has an Audit Committee consisting of Dennis Beresford, who is the Chair, Stephen Ashley, Karen Horn, Greg Smith and John Wulff. The Board has determined that Mr. Beresford, Ms. Horn, Mr. Smith and Mr. Wulff have the requisite experience to qualify as audit committee financial experts under the rules and regulations of the SEC and has designated each of them as such.

Corporate Governance Information, Committee Charters and Codes of Conduct

Our Corporate Governance Guidelines, as well as the charters for standing Board committees, including our Board s Audit Committee, Compensation Committee, Compliance Committee and Nominating and Corporate Governance Committee, are posted on our Web site, www.fanniemae.com, under Corporate Governance.

We have a Code of Conduct that is applicable to all officers and employees and a Code of Conduct and Conflict of Interests Policy for Members of the Board of Directors. Our Code of Conduct also serves as the code of ethics for our Chief Executive Officer and senior financial officers required by the Sarbanes-Oxley Act of 2002 and implementing regulations of the SEC. These codes have been posted on our Web site, www.fanniemae.com, under Corporate Governance. We will make disclosures by posting on our Web site any change to or waiver from these codes for any of our executive officers or directors.

Copies of these documents also are available in print to any stockholder who requests them.

Annual Certifications

The NYSE listing standards require each listed company s chief executive officer to certify annually that he or she is not aware of any violation by the company of the NYSE s corporate governance listing standards, qualifying the certification to the extent necessary. Our Chief Executive Officer certification for 2005 contained qualifications relating to our failure to provide disclosure about our corporate governance in a proxy statement or annual report. We made these disclosures in a Form 8-K filed May 25, 2006, and with that filing came into compliance with the NYSE corporate governance listing standards. In December 2006, we submitted to the NYSE our Chief Executive Officer s certificate without qualification.

We have not yet filed annual consolidated financial statements for 2006, nor have we filed any related certifications by our Chief Executive Officer or Chief Financial Officer required by the Sarbanes-Oxley Act of 2002. With the filing of this Annual Report on Form 10-K for the year ended 2005, we are filing our annual consolidated financial statements for 2005 and related certifications by our Chief Executive Officer and Chief Financial Officer required by the Sarbanes-Oxley Act of 2002.

Executive Sessions

Our non-management directors meet regularly in executive session without management present. Time for an executive session is reserved at every regularly scheduled Board meeting. The non-executive Chairman of the Board, Mr. Ashley, typically presides over these sessions.

Communications with Directors

Interested parties wishing to communicate any concerns or questions about us to the non-executive Chairman of the Board or to our non-management directors as a group may do so by electronic mail addressed to board@fanniemae.com, or by U.S. mail addressed to Fannie Mae Directors, c/o Office of the Secretary, Fannie Mae, Mail Stop 1H-2S/05, 3900 Wisconsin Avenue NW, Washington, DC 20016-2892. Communications may be addressed to a specific director or directors, including Mr. Ashley, the Chairman of the Board, or to groups of directors, such as the independent or non-management directors.

The Office of the Secretary is responsible for processing all communications received through these procedures and for forwarding communications as appropriate.

Any stockholder who wishes to submit a candidate for director for consideration by the Nominating and Corporate Governance Committee should submit a written notice to Fannie Mae Director Nominees, c/o Office of the Secretary, Fannie Mae, Mail Stop 1H-2S/05, 3900 Wisconsin Avenue, NW, Washington, DC 20016-2892.

Executive Officers

Our current executive officers who are not also members of the Board of Directors are listed below. They have provided the following information about their principal occupation, business experience and other matters.

Kenneth J. Bacon, 52, has been Executive Vice President Housing and Community Development since July 2005. He was interim head of Housing and Community Development from January 2005 to July 2005. He was Senior Vice President Multifamily Lending and Investment from May 2000 to January 2005, and Senior Vice President American Communities Fund from October 1999 to May 2000. From August 1998 to October 1999 he was Senior Vice President of the Community Development Capital Corporation. He was Senior Vice President of Fannie Mae s Northeastern Regional Office in Philadelphia from May 1993 to August 1998. Mr. Bacon has served as a director of the Fannie Mae Foundation since January 1995 and as Vice Chairman since January 2005. Mr. Bacon is also a director of Comcast Corporation, Corporation for Supportive Housing and Maret School. He is a member of the Executive Leadership Council and the Real Estate Round Table.

Robert T. Blakely, 65, has been Executive Vice President and Chief Financial Officer since January 2006. Prior to joining Fannie Mae, Mr. Blakely was Executive Vice President, Chief Financial Officer and Chief Accounting Officer of MCI, Inc. since April 2005, and Executive Vice President and Chief Financial Officer of MCI from April 2003 to April 2005. Prior to that date, he was President of Performance Enhancement Group, Inc., a business development services firm, from July 2002 to April 2003; Executive Vice President and Chief Financial Officer of Lyondell Chemical Company from November 1999 to June 2002 and Executive Vice President of Tenneco, Inc. from 1996 to November 1999 and Chief Financial Officer from 1981 to November 1999. Mr. Blakely is also a Trustee of the Financial Accounting Foundation, which oversees the

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FASB. Mr. Blakely is a director of Natural Resources Partners L.P. and Westlake Chemicals Corporation. Mr. Blakely joined Fannie Mae in January 2006. Mr. Blakely has advised us of his intention to step down as Fannie Mae s Chief Financial Officer during 2007 following a transition period. Information about Fannie Mae s new Chief Financial Officer Designate appears below.

Enrico Dallavecchia, 45, has been Executive Vice President and Chief Risk Officer since June 2006. Prior to joining Fannie Mae, Mr. Dallavecchia was with JP Morgan Chase, where he served as Head of Market Risk for Retail Financial Services, Chief Investment Office and Asset Wealth Management from April 2005 to May 2006 and as Market Risk Officer for Global Treasury, Retail Financial Services, Credit Cards and Proprietary Positioning Division and Co-head of Market Risk Technology, the group responsible for developing, implementing and maintaining the firm-wide market risk measurement systems, from December 1998 to March 2005.

Linda K. Knight, 57, has been Executive Vice President Enterprise Operations since April 2007. Prior to her present appointment, Ms. Knight served as Executive Vice President Capital Markets from March 2006 to April 2007. Before that, Ms. Knight served as Senior Vice President and Treasurer from February 1993 to March 2006, and Vice President and Assistant Treasurer from November 1986 to February 1993. Ms. Knight held the position of Director, Treasurer s Office from November 1984 to November 1986. Ms. Knight joined Fannie Mae in August 1982 as a senior market analyst.

Robert J. Levin, 51, has been Executive Vice President and Chief Business Officer since November 2005. Mr. Levin was Fannie Mae s interim Chief Financial Officer from December 2004 to January 2006. Prior to that position, Mr. Levin was the Executive Vice President of Housing and Community Development from June 1998 to December 2004. From June 1990 to June 1998, he was Executive Vice President Marketing. Mr. Levin has previously served as a director and as treasurer of the Fannie Mae Foundation. Mr. Levin joined Fannie Mae in 1981.

Thomas A. Lund, 48, has been Executive Vice President Single-Family Mortgage Business since July 2005. He was interim head of Single-Family Mortgage Business from January 2005 to July 2005 and Senior Vice President Chief Acquisitions Office from January 2004 to January 2005. Mr. Lund has served as Senior Vice President Investor Channel from August 2000 to January 2004; Senior Vice President Southwestern Regional Office, Dallas, Texas from July 1996 to July 2000; and Vice President for marketing from January 1995 to July 1996.

Rahul N. Merchant, 50, has been Executive Vice President and Chief Information Officer since November 2006. Prior to joining Fannie Mae, Mr. Merchant was with Merrill Lynch & Co., where he served as Head of Technology from 2004 to 2006 and as Head of Global Business Technology for Merrill Lynch s Global Markets and Investment Banking division from 2000 to 2004. Before joining Merrill, he served as Executive Vice President at Dresdner, Kleinwort and Benson, a global investment bank, from 1998 to 2000. He also previously served as Senior Vice President at Sanwa Financial Products and First Vice President at Lehman Brothers, Inc. Mr. Merchant serves on the board of advisors of the American India Foundation.

Peter S. Niculescu, 47, has been Executive Vice President Capital Markets (previously Mortgage Portfolio) since November 2002. Mr. Niculescu joined Fannie Mae in March 1999 as Senior Vice President Portfolio Strategy and served in that position until November 2002.

William B. Senhauser, 44, has been Senior Vice President and Chief Compliance Officer since December 2005. Prior to his present appointment, Mr. Senhauser was Vice President for Regulatory Agreements and Restatement from October 2004 to December 2005 and Vice President for Operating Initiatives from January 2003 to September 2004. Mr. Senhauser joined Fannie Mae in 2000 as Vice President for Fair Lending.

Stephen M. Swad, 45, is beginning service as our Executive Vice President and Chief Financial Officer Designate on the date we file this annual report. We expect Mr. Swad initially to serve as Chief Financial Officer Designate and to become the Chief Financial Officer when Mr. Blakely steps down from that role. As Chief Financial Officer, Mr. Swad will be Fannie Mae s principal financial officer. Mr. Swad was previously Executive Vice President and Chief Financial Officer at AOL, LLC, from February 2003 to February 2007. Before joining AOL, Mr. Swad served as Executive Vice President of Finance and Administration at Turner

Broadcasting System Inc. s Turner Entertainment Group, from April 2002 to February 2003. From 1998 through 2002, he was with Time Warner, where he served in various corporate finance roles. Prior to that Mr. Swad was a partner in KPMG s national office and also worked as the Deputy Chief Accountant at the Securities and Exchange Commission.

Beth A. Wilkinson, 44, has been Executive Vice President General Counsel and Corporate Secretary since February 2006. Prior to joining Fannie Mae, Ms. Wilkinson was a partner and co-chair, White Collar Practice Group for Latham & Watkins LLP, from 1998 to 2006. Before joining Latham, she served as a prosecutor and special counsel for *U.S. v. McVeigh and Nichols* from 1996 to 1998. During her tenure at the Department of Justice, Ms. Wilkinson was appointed principal deputy of the Terrorism & Violent Crime Section in 1995, and served as Special Counsel to the Deputy Attorney General from 1995 to 1996. Ms. Wilkinson also served as an Assistant U.S. Attorney in the Eastern District of New York from 1991 to 1995. Prior to that time, Ms. Wilkinson was a Captain in the United States Army serving as an assistant to the general counsel of the Army for Intelligence & Special Operations from 1987 to 1991.

Michael J. Williams, 49, has been Executive Vice President and Chief Operating Officer since November 2005. Mr. Williams was Fannie Mae s Executive Vice President for Regulatory Agreements and Restatement from February 2005 to November 2005. He has been responsible for managing our overall effort to restate and reaudit Fannie Mae s financial statements since January 2005 and for fulfilling Fannie Mae s obligations under Fannie Mae s agreements with OFHEO since October 2004. Mr. Williams also served as President Fannie Mae eBusiness from July 2000 to February 2005 and as Senior Vice President e-commerce from July 1999 to July 2000. Prior to this, Mr. Williams served in various roles in the Single-Family and Corporate Information Systems divisions of the company. Mr. Williams joined Fannie Mae in 1991.

Under our bylaws, each executive officer holds office until his or her successor is chosen and qualified or until he or she resigns, retires or is removed from office.

Section 16(a) Beneficial Ownership Reporting Compliance

Our directors and officers file with the SEC reports on their ownership of our stock and on changes in their stock ownership. Based on a review of forms filed during 2005 or with respect to 2005 and on written representations from our directors and officers, we believe that all of our directors and officers filed all required reports and reported all transactions reportable during 2005 except that Mr. Williams did not timely report a transfer of shares held by his wife into their joint account.

Item 11. Executive Compensation

Below we provide information regarding compensation we pay to our executive officers and directors. We have previously filed Form 8-Ks containing much of this information. Additional executive compensation information can be found in other Form 8-Ks we have filed. Incorporated herein by reference is the Form 8-K information identified in the following table.

Information	Form 8-K Filing Date	Item Number and/or Heading
Compensation arrangements for our Chief Financial Officer	November 15, 2005	Item 5.01: Appointment of Robert T. Blakely as Chief Financial Officer
Table showing 2006 salaries for certain executive officers	February 10, 2006	General
	April 28, 2006	Item 1.01

2006 corporate performance goals and award targets for cash bonus awards for executive officers and other employees under the company s Annual Incentive Plan		
2007 salaries, the 2006 performance year cash bonuses and the 2006 performance year variable long-term incentive awards for certain executive officers	January 26, 2007	Item 5.02
2007 corporate performance goals; elimination of perquisites; and determination regarding performance share program awards	February 20, 2007	Item 5.02

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Executive Compensation

The compensation tables in this section provide, for the periods stated, compensation information for our Chief Executive Officer and our four other most highly compensated executive officers during 2005. We refer to these individuals below as the covered executives.

Summary Compensation Table

The following table shows summary compensation information for the covered executives for 2005, 2004 and 2003.

		Annual Compensation[1]			Long Term Compensation			
					Awards		Payouts	
Name and Principal Position	Year	Salary ($)	Bonus ($)[2]	Other Annual Compensation ($)[3]	Restricted Stock Awards ($)[4]	Securities Underlying Options/ SARs(#)	LTIP Payouts ($)[5]	All Other Compensation ($)[6]
Daniel Mudd	2005	908,121	2,591,875	107,971	9,487,221			66,150
President and	2004	743,895		20,615	5,524,381			43,200
Chief Executive Officer	2003	714,063	1,288,189	144,405		105,749	4,674,015	10,167
Robert Levin	2005	678,442	3,918,750	19,070	4,269,702			39,215
Executive Vice President	2004	590,923		17,288	3,125,480			39,015
Chief Business Officer	2003	567,706	801,237	851	227,789	100,613	2,706,381	10,024
Michael Williams	2005	532,624	3,014,770	14,050	3,361,496			30,804
Executive Vice President	2004	495,169		12,823	2,194,110			30,604
Chief Operating Officer	2003	471,415	663,129	717		73,880	1,274,349	8,302
Peter Niculescu	2005	512,130	1,795,154	10,586	1,797,643			25,601
Executive Vice President	2004	454,538		9,143	1,994,111			25,401
Capital Markets	2003	425,000	489,224	632		59,425	789,673	7,330
Thomas Lund[7] Executive Vice President Single-Family Mortgage Business	2005	411,336	1,791,900	7,911	1,724,476			18,348

(1) Our executive compensation program is designed to tie a large portion of each officer s total compensation to performance, including since 2005 our performance against non-financial metrics relating to our controls, culture and mission. An executive officer s bonus generally is designed to reflect corporate and individual performance for the previous year. See also footnote (5) for information about long-term compensation. Salary includes annual salary deferred to later years. Bonus includes amounts earned during the year under the Annual Incentive Plan. Bonus for 2005 also includes a $300,000 cash award for Mr. Lund that is payable 20% in 2005, 30% in 2006, and 50% in 2007. It also includes the cash portion of what we refer to as the variable long-term incentive award for the 2005 performance year for the covered executives in the following amounts: Mr. Mudd $0; Mr. Levin $2,103,750; Mr. Williams $1,656,270; Mr. Niculescu $885,720; and Mr. Lund $698,940. This cash portion is payable at a rate of 25% per year over four years. The restricted stock portion of this award is reported under Restricted Stock Awards.

(2) In January 2005, our Board of Directors and Compensation Committee determined that no cash bonuses would be paid to officers at the level of senior vice president or above for 2004. We disclosed this in our January 21, 2005 Form 8-K.

(3) Other Annual Compensation in 2005 includes $25,240 for tax counseling and financial planning services for Mr. Mudd and $27,752 for legal advice for Mr. Mudd in connection with entering into his employment agreement, and a gross-up for taxable income on insurance coverage provided by the company for the covered executives in the following amounts: Mr. Mudd $32,869; Mr. Levin $19,070; Mr. Williams $14,050; Mr. Niculescu $10,586; and Mr. Lund $7,911. Other Annual Compensation in 2004 includes a gross-up for taxable income on insurance coverage provided by the company for the covered executives in the following amounts: Mr. Mudd $20,615; Mr. Levin $17,288; Mr. Williams $12,823; and Mr. Niculescu $9,143. Other Annual Compensation in 2003 for Mr. Mudd includes $80,400 for club membership fees agreed to by us in connection with recruiting him from his prior employment and $32,093 for residential security services. It also includes a gross-up for taxable income on insurance coverage provided by the company for the covered executives in the following amounts: Mr. Mudd $1,066; Mr. Levin $851; Mr. Williams $717; and Mr. Niculescu $632.

(4) Restricted stock awards made in March of 2006 are reported as compensation for 2005 and vest over four years in equal annual installments. Mr. Mudd also received a restricted stock award of 31,766 shares in November 2005 in

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connection with entering into an employment agreement with us. These shares vest in three equal annual installments beginning in March 2006. Restricted stock awards and, in the case of Mr. Mudd, restricted stock unit awards made in March of 2005 are reported as compensation for 2004 and vest over three years in equal annual installments. Dividends are paid on restricted common stock and dividend equivalents are paid on restricted stock units at the same rate as dividends on unrestricted common stock. As of December 31, 2005, the covered executives held a number of shares of unvested restricted common stock and restricted stock units with an aggregate value based on the closing price on December 30, 2005 as follows: Mr. Mudd 127,476 shares and units, $6,222,104; Mr. Levin 56,339 shares, $2,749,907; Mr. Williams 38,013 shares, $1,855,415; Mr. Niculescu 35,548 shares, $1,735,098; and Mr. Lund 18,949 shares, $924,901.

(5) LTIP Payouts relate to annual awards entitling executives to receive shares of common stock based upon and subject to our meeting corporate performance objectives over three-year periods. Generally, the Compensation Committee of our Board of Directors determines in January our achievement against the goals for the performance share cycle that just ended. That achievement determines the payout of the performance shares and the shares are paid out to current executives in two annual installments. Because we did not have reliable financial data for years within the award cycles, the Compensation Committee and the Board decided to postpone the determination of the amount of the awards under the performance share program for the three-year performance share cycles that ended in 2004 and 2005 and to postpone payment of the second installment of shares for the three-year performance share cycle that ended in 2003, the first installment of which was paid in January 2004. In February 2007, the Board determined not to make any payouts for the three-year performance share cycle that ended in 2004 and not to pay the unpaid second installment of the award for the three-year performance share cycle that ended in 2003. In the future, the Compensation Committee and the Board of Directors will review the performance share program and determine the appropriate approach for settling our obligations with respect to the remaining unpaid performance share cycles.

(6) All Other Compensation for each covered executive in 2005 includes a $6,300 employer matching contribution under the Retirement Savings Plan for Employees and premiums of $1,200 paid on behalf of each covered executive in 2005 for excess liability insurance coverage. All Other Compensation for 2005 also includes premiums paid on behalf of each covered executive for universal life insurance coverage in the following amounts: Mr. Mudd $58,650; Mr. Levin $31,715; Mr. Williams $23,304; Mr. Niculescu $18,101; and Mr. Lund $10,848.

(7) Mr. Lund began serving as an executive officer in 2005.

Aggregated Option Exercises in Last Fiscal Year and Fiscal Year-End Option Values

The following table shows the aggregate number of shares underlying options exercised in 2005 and the value as of December 31, 2005 of outstanding in-the-money options, whether or not exercisable.

Name	Shares Acquired on Exercise (#)	Value Realized[1] ($)	Number of Securities Underlying Unexercised Options as of December 31, 2005 Exercisable/Unexercisable (#)	Value of Unexercised In-the-Money Options as of December 31, 2005 Exercisable/Unexercisable[2] ($)

Daniel Mudd		$	476,385/120,771	$ 0/$0
Robert Levin	53,520	1,026,514	373,852/111,683	287,548/0
Michael Williams	25,800	521,547	212,757/87,328	124,748/0
Peter Niculescu			125,166/67,178	0/0
Thomas Lund			75,116/25,842	20,807/0

(1) Value Realized is the difference between the exercise price and the market price on the exercise date, multiplied by the number of options exercised. Value Realized numbers do not necessarily reflect what the executive might receive when he or she sells the shares acquired by the option exercise, since the market price of the shares at the time of sale may be higher or lower than the price on the exercise date of the option.

(2) Value of Unexercised In-the-Money Options is the aggregate, calculated on a grant-by-grant basis, of the product of the number of unexercised options at the end of 2005 multiplied by the difference between the exercise price for the grant and the December 30, 2005 closing price per share of Fannie Mae common stock of $48.81, excluding grants for which the exercise price equaled or exceeded $48.81. As of April 23, 2007, the closing price per share of Fannie Mae common stock was $58.49.

Retirement Plans

Fannie Mae Retirement Plan

The Federal National Mortgage Association Retirement Plan for Employees Not Covered Under Civil Service Retirement Law, which we refer to as the Retirement Plan, provides benefits for those eligible employees who are not covered by the federal Civil Service retirement law. Normal retirement benefits are computed on a single life basis using a formula based on final average annual earnings and years of credited service. Participants are fully vested when they complete five years of credited service. Since 1989, provisions of the Internal Revenue Code of 1986, as amended, have limited the amount of annual compensation that may be used for calculating pension benefits and the annual benefit that may be paid. For 2005, the statutory compensation and benefit caps were $210,000 and $170,000, respectively. Before 1989, some employees accrued benefits based on higher income levels. For employees who retire before age 65, benefits are reduced by stated percentages for each year that they are younger than 65.

The covered executives had approximately the following years of credited service as of December 31, 2005: Mr. Levin, 25 years; Mr. Mudd, 6 years; Mr. Williams, 15 years; Mr. Niculescu, 7 years; Mr. Lund, 11 years.

Because the Retirement Plan is coordinated with Social Security Covered Compensation as defined in Internal Revenue Service regulations, the benefits under the Retirement Plan are not subject to deductions for social security benefits.

Supplemental Pension Plans

We adopted the Supplemental Pension Plan to provide supplemental retirement benefits to employees who do not participate in or are not fully vested in the Executive Pension Plan and whose salary exceeds the statutory compensation cap applicable to the Retirement Plan or whose benefit under the Retirement Plan is limited by the statutory benefit cap applicable to the Retirement Plan. Separately, we adopted the 2003 Supplemental Pension Plan to provide additional benefits to our officers based on the annual cash bonuses received by our officers. For purposes of determining benefits under the 2003 Supplemental Pension Plan, the amount of an officer s annual cash bonus taken into account is limited to 50% of the officer s salary.

The benefits under the Fannie Mae supplemental pension plans are not subject to deductions for social security benefits.

The following table shows the estimated annual benefits that would have been payable under the Retirement Plan and, if applicable, the supplemental pension plans to an employee who did not participate in or was not fully vested in the Executive Pension Plan and who turned 65 and retired on January 1, 2006, using years of service accrued through January 1, 2006.

Fannie Mae Retirement Plan and Supplemental Pension Plans

Final Average Annual Earnings	Estimated Annual Pension for Representative Years of Service 10	15	20	25	30	35
$ 50,000	$ 7,559	$ 11,339	$ 15,734	$ 20,539	$ 25,344	$ 30,149
100,000	17,559	26,339	35,734	45,539	55,344	65,149
150,000	27,559	41,339	55,734	70,539	85,344	100,149
200,000	37,559	56,339	75,734	95,539	115,344	135,149
250,000	47,559	71,339	95,734	120,539	145,344	170,149
300,000	57,559	86,339	115,734	145,539	175,344	205,149
350,000	67,559	101,339	135,734	170,539	205,344	240,149
400,000	77,559	116,339	155,734	195,539	235,344	275,149
450,000	87,559	131,339	175,734	220,539	265,344	310,149
500,000	97,559	146,339	195,734	245,539	295,344	345,149
550,000	107,559	161,339	215,734	270,539	325,344	380,149
600,000	117,559	176,339	235,734	295,539	355,344	415,149
650,000	127,559	191,339	255,734	320,539	385,344	450,149
700,000	137,559	206,339	275,734	345,539	415,344	485,149
1,387,400	275,039	412,559	550,694	689,239	827,784	966,329

Executive Pension Plan

We adopted the Executive Pension Plan to supplement the benefits payable to key officers under the Retirement Plan. The Compensation Committee selects the participants in the Executive Pension Plan. Active participants in the Executive Pension Plan are Executive Vice Presidents. The Board of Directors sets their pension goal, which is part of the formula that determines the pension benefits for each participant. Mr. Mudd is also an active participant in the Executive Pension Plan. His pension goal was approved by the independent members of the Board of Directors. Payments are reduced by any amounts payable under the Retirement Plan and any amounts payable under the Civil Service retirement system attributable to our contributions for service with it.

Participants pension benefits generally range from 30% to 60% of the average total compensation for the 36 consecutive months of the participant s last 120 months of employment when total compensation was the highest. Total compensation generally is a participant s average annual base salary, including deferred compensation, plus the participant s other taxable compensation (excluding income or gain in connection with the exercise of stock options) earned for the relevant year, in an amount up to 50% of annual base salary for that year. Effective for benefits earned on and after March 1, 2007, the only other taxable compensation considered for the purpose of calculating total compensation is a participant s annual cash bonus. Under his current employment agreement, Mr. Mudd s total compensation for a given year includes other taxable compensation up to 100%, not 50%, of his annual base salary for that year.

Participants who retire before age 60 generally receive a reduced benefit. Participants typically vest fully in their pension benefit after ten years of service as a participant in the Executive Pension Plan, with partial vesting usually beginning after five years. The benefit payment typically is a monthly amount equal to 1/12th of the participant s annual retirement benefit payable during the lives of the participant and the participant s surviving spouse. If a participant dies before receiving benefits under the Executive Pension Plan, generally his or her surviving spouse will be entitled to a death benefit that begins when the spouse reaches age 55, based on the participant s pension benefit at the date of death.

Estimated Annual Pension Benefits

Estimated annual benefits payable under our combined plans upon retirement for each of the covered executives, assuming full vesting at age 60 and that our corporate performance caused Mr. Mudd s other taxable compensation to equal or exceed 100% of his annual base salary and other participants other taxable compensation to equal or exceed 50% of annual base salary, were as follows as of December 31, 2005: Mr. Mudd (50% pension benefit), $950,000; Mr. Levin (40% pension benefit), $450,000; Mr. Williams (40% pension benefit), $390,000; Mr. Niculescu (40% pension benefit), $310,034; Mr. Lund (40% pension benefit), $283,200.

Employment Arrangements and Other Agreements with Our Covered Executives

The employment contracts, termination of employment and change-in-control arrangements that are currently in place for our covered executives are described below.

Severance Program

On March 10, 2005, our Board of Directors approved a severance program that provides guidelines regarding the severance benefits that management level employees, including executive officers, may receive if their employment with us is terminated as a result of corporate restructuring, reorganization, consolidation, staff reduction, or other similar circumstances, and only where there are no performance related issues, and the termination has not been for cause. The program, which we described in a Form 8-K filed with the SEC on March 11, 2005, expired on December 31, 2006 and was replaced with a program that does not apply to our executive officers. Eligible participants in the 2005-2006 program received a severance payment of one year s salary plus two to four weeks salary (three to four weeks salary in the case of executive officers) for each year of service with us up to a maximum of one and a half years salary. Participants terminated after the first quarter of the fiscal year received a pro rata payout of their annual cash incentive award target for that year, adjusted for corporate performance. Consistent with the terms of our stock compensation plans, the vesting of options scheduled to vest within 12 months of termination was accelerated and the post-termination exercise period of options was extended to the earlier of the option expiration date or 12 months following the termination of employment. Restricted stock and restricted stock unit awards granted under the Stock Compensation Plan of 2003 and vesting within 12 months of termination were subject to accelerated vesting, and unpaid performance shares for completed cycles were paid out. As provided under the terms of our stock compensation plans, participants in the severance program who attained a certain age and service received additional accelerated vesting of their restricted stock and restricted stock units and options, in addition to the full option exercise period. Participants were required to execute a separation agreement to receive these benefits containing, where permitted, a one-year non-compete clause. The program also provided for outplacement services and continued access to our medical and dental plans for up to five years, with the first 18 months premiums to remain at a level no higher than they would be if the participant were still an active employee. Employee eligibility for the program was determined by the Chairman of the Board, our Chief Executive Officer, or a designee of either. In addition, OFHEO s approval was required prior to the program being offered to any OFHEO-designated executive officer.

Employment Agreement with Daniel Mudd, President and Chief Executive Officer

On November 15, 2005, we entered into a new employment agreement with Mr. Mudd, effective June 1, 2005 when he was appointed our President and Chief Executive Officer. We described this agreement in a Form 8-K filed on November 15, 2005. The major terms of the agreement are as follows:

Employment Term. Through December 31, 2009.

Base Salary. Mr. Mudd s annual base salary will be no lower than $950,000. This base salary is subject to periodic review and possible increases, but not decreases, by the Board of Directors. Compensation arrangements for Mr. Mudd are determined annually by the Board of Directors (excluding Mr. Mudd and any other non-independent members of the Board) upon the recommendation of the Compensation Committee of the Board of Directors. Mr. Mudd s annual salary for 2007 is $990,000.

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Annual Bonus. Mr. Mudd will be considered for an annual cash bonus. The amount of any cash bonus Mr. Mudd receives is subject to prior approval from OFHEO while the company is subject to its capital restoration plan.

Executive Pension Plan. Mr. Mudd is entitled to participate in our Executive Pension Plan and our Supplemental Pension Plans described above. The Executive Pension Plan supplements the benefits payable to key officers under the Fannie Mae Retirement Plan. Mr. Mudd s employment agreement provides that his pension goal will be at least 50% of the average total compensation for the 36 consecutive months of his last 120 months of employment when total compensation was the highest. Mr. Mudd s pension goal is currently set at 50%. Mr. Mudd s total compensation for a given year includes other taxable compensation up to 100%, not 50%, of his annual base salary for that year. If he retires before reaching age 60, his pension goal will be reduced by 3 percentage points, rather than the 2 percentage points reduction generally applicable to participants in the plan, for each year in which he receives benefits prior to age 60. In addition, if his benefit payment is in the form of a joint and 100% survivor annuity, it will be actuarially reduced to reflect the joint life expectancy of Mr. Mudd and his spouse.

Equity and Incentive Awards. During the employment term, Mr. Mudd is eligible to be considered for awards under our stock option, restricted stock, annual incentive and performance share programs, all in accordance with our compensation philosophy and programs that are in effect from time to time. Under our capital restoration plan, we must obtain the approval of OFHEO prior to providing Mr. Mudd with any non-salary compensation awards.

Life Insurance. During the employment term, Mr. Mudd is eligible to receive life insurance benefits in accordance with our life insurance policies and programs that are in effect from time to time.

Fringe Benefits. Mr. Mudd is eligible to receive certain fringe benefits in accordance with our policies, including legal expenses incurred in negotiating his employment agreement and reimbursement for a complete annual physical examination. He is also eligible to participate generally in company benefit programs that are from time to time in effect and in which our other senior officers generally are entitled to participate.

Clawback. Mr. Mudd s bonus and other incentive-based or equity-based compensation will be subject to reimbursement to us if required by Section 304 of the Sarbanes-Oxley Act of 2002 or provisions of our compensation plans and arrangements, notwithstanding any provisions of the agreement to the contrary.

Mr. Mudd s employment agreement provides for certain benefits upon the termination of his employment with us depending on the reason for his termination:

Termination without Cause, for Good Reason or upon expiration of the agreement. Mr. Mudd s employment agreement provides that if we terminate him without Cause, or if Mr. Mudd terminates his employment for any of the specified Good Reason events described below, or if Mr. Mudd s employment is terminated due to the expiration of the agreement term on December 31, 2009, he would be entitled to receive his accrued but unpaid base salary, base salary for the period through the second anniversary of the termination of his employment (subject to offset for income from other employment or self-employment, other than board service), all amounts payable (but unpaid) under our annual incentive plan with respect to any year ended on or prior to the date of termination of his employment, a prorated annual incentive plan payment for the year of termination, all amounts payable (but unpaid) under any performance share award with respect to a performance cycle that had ended as of the date of termination of his employment, a prorated performance share program payment for any performance cycle as to which at least 18 months had elapsed as of the date of termination, full vesting of any unvested restricted stock and stock options, for his stock options granted on or after the date of the employment agreement an exercise period of three years (or if earlier, until the expiration date of the stock options), and, only in the cases of termination by us without Cause and termination by Mr. Mudd for a Good Reason, medical and dental coverage for Mr. Mudd and his spouse and coverage for his dependents (so long as they remain his dependents or, if later, until they reach the age of 21), at no cost to Mr. Mudd, until the earlier of the

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second anniversary of the termination of his employment and the date on which Mr. Mudd obtains comparable coverage through another employer.

Termination due to serious illness or disability. With the exception of the continued medical and dental coverage, the same benefits described above would be payable in the event Mr. Mudd s employment were to terminate by reason of serious illness or disability, subject to an offset against salary continuation for any employer-provided disability benefits.

Termination due to acceptance of senior position in U.S. federal government. If Mr. Mudd terminates his employment by reason of his acceptance of an appointment to a senior position in the U.S. federal government, he will receive his accrued but unpaid base salary, all amounts payable (but unpaid) under our annual incentive plan with respect to any year ended on or prior to the date of termination of his employment, a prorated annual incentive plan payment for the year of termination, all amounts payable (but unpaid) under any performance share award with respect to a performance cycle that had ended as of the date of termination of his employment, a prorated performance share program payment for any performance cycle as to which at least 18 months had elapsed as of the date of termination, and full vesting of any unvested restricted stock.

Termination due to death. In the event of Mr. Mudd s death during the employment term, his estate or beneficiary, as applicable, would be entitled to his accrued but unpaid base salary, all amounts payable (but unpaid) under the annual incentive plan for any year ended on or prior to his death, a prorated annual incentive plan payment for the year of death, all amounts payable (but unpaid) under any performance share award with respect to a performance cycle that had ended on or prior to the date of death, a prorated performance share program payment for any performance cycle as to which at least 18 months had elapsed prior to the date of death, full vesting of any unvested restricted stock and stock options, and for his stock options granted on or after the date of the employment agreement an exercise period of three years (or if earlier, until the expiration date of the stock options).

Termination due to retirement. In the event Mr. Mudd retires at or after age 65, or at an earlier age in certain situations, he would be entitled to receive his accrued but unpaid base salary, all amounts payable (but unpaid) under any performance share award with respect to a performance cycle that had ended as of the date of his retirement, a prorated performance share program payment for any performance cycle as to which at least 18 months had elapsed as of the date of his retirement, full vesting of any unvested stock options, for his stock options granted on or after the date of the employment agreement an exercise period of three years (or if earlier, until the expiration date of the stock options), and, in the case of retirement at or after age 65, full vesting of any unvested restricted stock and, in the case of retirement at an earlier age, the Board may, in its discretion, fully vest any unvested restricted stock.

Voluntary termination and termination for Cause. If Mr. Mudd is terminated for Cause or if Mr. Mudd terminates his employment voluntarily (other than a voluntary termination with Good Reason as defined in his agreement or a voluntary termination to accept an appointment to a senior position in the U.S. federal government), he would be entitled only to accrued but unpaid base salary plus such vested benefits or awards, if any, which have vested prior to such date; provided, however, that if he is terminated for Cause, he would not be entitled to any amounts payable (but unpaid) of any bonus or under any performance share award with respect to a performance cycle if the reason for such termination for Cause is substantially related to the earning of such bonus or to the performance over the performance cycle upon which the payment was based.

Mr. Mudd s employment agreement defines Good Reason as any of the following circumstances that remains uncured after 30 days notice: (a) a material reduction of his authority or a material change in his functions, duties or responsibilities that in any material way would cause his position to become less important, (b) a reduction in his base salary, (c) a requirement that he report to anyone other than the Chairman of the Board of Directors, (d) a requirement that he relocate his office outside of the Washington, D.C. area, or (e) our breach of any material obligation we have under the agreement. Under the agreement, we would have Cause if Mr. Mudd (A) materially harmed us by, in connection with his service under his employment agreement, engaging in dishonest or fraudulent actions or willful misconduct, or performing his duties in a grossly negligent manner, or (B) were convicted of, or pleaded *nolo contendere* with respect to, a felony. The agreement further provides that no act or failure to act will be considered willful unless it is done, or omitted to be done, in bad faith or without reasonable belief that the action or omission was in our best interests.

Mr. Mudd s employment agreement also obligates him not to compete with us in the United States, solicit any officer or employee of ours or our affiliates to terminate his or her relationship with us or to engage in prohibited competition, or to assist others to engage in activities in which Mr. Mudd would be prohibited from engaging, in each case for two years following termination. Mr. Mudd s employment agreement provides us with the right to seek and obtain injunctive relief from a court of competent jurisdiction to restrain Mr. Mudd from any actual or threatened breach of the obligations described in the preceding sentence. Disputes arising under the employment agreement are to be resolved through arbitration, and we bear Mr. Mudd s legal expenses unless he does not prevail.

Agreement with Robert Levin, Executive Vice President and Chief Business Officer

We have a letter agreement with Mr. Levin, dated June 19, 1990. That agreement provides that if he is terminated for reasons other than for cause, he will continue to receive his base salary for a period of 12 months from the date of termination and will continue to be covered by our life, medical, and long-term disability insurance plans for a 12-month period, or until re-employment that provides certain coverage for benefits, whichever occurs first. For the purpose of this agreement, cause means a termination based upon reasonable evidence that Mr. Levin has breached his duties as an officer by engaging in dishonest or fraudulent actions or willful misconduct. Any disability benefits that he receives during the 12-month period will reduce the amount otherwise payable by us, but only to the extent the benefits are attributable to payments made by us. A description of this letter agreement was included in a Form 8-K we filed on December 27, 2004.

Separation Agreement with Ann Kappler, Former Executive Vice President and General Counsel

On August 23, 2005, we entered into a separation agreement with Ann Kappler, our former Executive Vice President and General Counsel. Under the separation agreement and upon her separation from Fannie Mae on January 3, 2006, Ms. Kappler received accelerated vesting of all unvested options she held, options to purchase a total of 44,286 shares of our common stock at prices ranging from $69.43 to $78.315 per share. In addition, the exercise period of all 130,281 options held by Ms. Kappler at prices ranging from $62.50 to $80.95 per share was extended to the option expiration dates, which range from January 2009 to January 2014. Ms. Kappler also received accelerated vesting of all 32,813 shares of unvested restricted stock she held. The remaining terms of Ms. Kappler s separation agreement were generally in accordance with the provisions of our severance program for management level employees discussed under Employment Arrangements and Other Agreements with Our Covered Executives Severance Program.

Compensation Arrangements for Stephen Swad, Executive Vice President and Chief Financial Officer Designate

Except as described in this report, compensation arrangements for Mr. Swad will be determined annually by the Compensation Committee of Fannie Mae s Board of Directors, subject to approval by the Board. Under the terms of his employment arrangement with Fannie Mae, Mr. Swad will receive a base salary of $650,000 per year for the 2007 performance year. Upon joining the company, Mr. Swad will receive a signing bonus of $500,000, which will be subject to forfeiture if he leaves Fannie Mae before one full year of employment. He also will receive a grant of 80,000 shares of restricted stock, one-half of which will vest in equal annual installments over three years and the other one-half of which will vest in equal annual installments over four years. Pursuant to Fannie Mae s customary practice, Fannie Mae plans to enter into an indemnification agreement with Mr. Swad.

Mr. Swad also will be eligible to participate in Fannie Mae s annual incentive plan, to receive variable long-term incentive awards, and to participate in Fannie Mae s Executive Pension Plan and other compensation and benefits programs that are available to Fannie Mae executive vice presidents generally. Under the annual incentive plan, Mr. Swad s bonus target award for 2007 has been set at 210% of his base salary. Mr. Swad s 2007 bonus will be based on his full annual salary amount, rather than prorated based on his period of service during 2007. The amount Mr. Swad will receive for his bonus may be less than or greater than his target amount, depending on both corporate and individual performance. Mr. Swad s 2007 variable long-term incentive award for 2007 is targeted at approximately $3.2 million. The size of Mr. Swad s actual award may be greater than or less than this amount, depending on a number of factors, including individual performance. Mr. Swad s pension goal under Fannie Mae s Executive Pension Plan is 40% of average total compensation for the three consecutive years of his last ten years of employment when total compensation is the highest. In accordance with Fannie Mae s capital restoration plan, payment of Mr. Swad s bonus and non-salary compensation awards will be subject to prior approval from OFHEO.

Mr. Swad will also receive severance benefits if we terminate his employment prior to the end of 2008 for reasons other than cause. In that event, he would receive severance benefits that would include one year of salary, accelerated vesting of one cycle of any restricted stock or other stock-based award, and one year of subsidized medical and dental coverage. If we terminated his employment for a reason other than for cause before we pay him his 2007 annual incentive plan bonus award, he would receive 100% of his 2007 target award amount. If we terminated his employment during 2008 other than for cause, he would receive a 2008 annual incentive award, prorated based on the number of months he was employed during 2008.

Director Compensation Information

Below we describe our compensation arrangements with our directors. Mr. Mudd, who is our only director who is an employee of Fannie Mae, does not receive benefits under any of these arrangements except for the Matching Gifts Program, which is available to every Fannie Mae employee, and the Director s Charitable Award Program.

Cash Compensation

Our non-management directors, with the exception of the non-executive Chairman of our Board, are paid a retainer at an annual rate of $35,000, plus $1,500 for attending each Board or Board committee meeting in person or by telephone. Committee chairpersons received an additional retainer at an annual rate of $10,000, plus an additional $500 for each committee meeting chaired and $300 for each telephone committee meeting chaired. As we described in a Form 8-K filed on January 21, 2005, in January 2005, our Board approved a compensation arrangement for the non-executive Chairman of the Board, Mr. Ashley, in recognition of the substantial amount of time and effort necessary to fulfill the duties of the position. Under this arrangement, Mr. Ashley receives an annual fee of $500,000.

Restricted Stock Awards

We have a restricted stock award program for non-management directors established under the Fannie Mae Stock Compensation Plan of 2003 and the Fannie Mae Stock Compensation Plan of 1993. The award program provides for consecutive multi-year cycles of awards of restricted common stock. Under the 2003 plan, these award cycles are four years, and the first award was scheduled to be made at the time of the 2006 annual meeting. Under the 1993 plan, the cycles are five years and the most recent award was made at the time of the 2001 annual meeting. Awards vest in equal annual installments after each annual meeting during the cycle, provided the participant continues to serve on the Board of Directors. If a director joins the Board of Directors during a cycle, he or she receives a pro rata grant for the cycle, based on the time remaining in the cycle. Vesting generally accelerates upon departure from the Board due to death, disability, or for elected directors, not being renominated after reaching age 70. Under this program, in May 2001, we granted 871 shares of restricted common stock to each non-management director who was a member of the Board at that time. These shares vest over a five-year period at the rate of 20% per year. Each director who joined the Board prior to June 2006 received a pro rata grant for the cycle, based on the time remaining in the cycle.

In addition, in October 2003 we granted 2,600 shares of restricted common stock to each non-management director who was a member of the Board at that time, scheduled to vest in four equal annual installments beginning with the May 2004 annual meeting. We subsequently made pro rata grants to non-management directors who joined the Board after October 2003.

In December 2006, the Board approved the vesting of restricted stock that would have vested at the 2005 and 2006 annual meetings if such meetings had been held. No awards have yet been made for the cycle scheduled to begin with the 2006 annual meeting.

Stock Option Awards

Each non-management director is granted an annual nonqualified stock option to purchase 4,000 shares of common stock immediately following the annual meeting of stockholders at the fair market value on the date of grant. A non-management director appointed or elected as a mid-term replacement receives a nonqualified stock option to purchase at the fair market value on the date of grant a pro rata number of shares equal to the fraction of the remainder of the term. Each option will expire ten years after the date of grant and vests in four equal annual installments beginning on the first anniversary of the grant, subject to accelerated vesting upon the director s departure from the Board of Directors. Non-management directors will have one year to exercise the options when they leave the Board, except that options granted on or prior to May 20, 2003 must generally be exercised within three months after a director leaves the Board. No annual stock option awards have yet been made with respect to annual meetings that would have been held in 2005 or 2006.

Fannie Mae Director s Charitable Award Program

In 1992, we established our Director s Charitable Award Program. The purpose of the program is to acknowledge the service of our directors, recognize our own interest and that of our directors in supporting worthy institutions, and enhance our director benefit program to enable us to continue to attract and retain directors of the highest caliber. Under the program, we make donations upon the death of a director to up to five charitable organizations or educational institutions of the director s choice. We donate $100,000 for every year of service by a director up to a maximum of $1,000,000. To be eligible to receive a donation, a recommended organization must be an educational institution or charitable organization and must qualify to receive tax-deductible donations under the Internal Revenue Code of 1986. The program is generally funded by life insurance contracts on the lives of participating directors. The Board of Directors may elect to amend, suspend or terminate the program at any time.

Matching Gifts

To further our support for charitable giving, non-employee directors are able to participate in the Matching Gifts Program of the Fannie Mae Foundation on the same terms as our employees. Under this program, gifts made by employees and directors to 501(c)(3) charities are matched, up to an aggregate total of $10,000 in any calendar year, including up to $500 which may be matched on a 2-for-1 basis.

Deferred Compensation

We have a deferred compensation plan in which non-management directors can participate. Non-management directors may irrevocably elect to defer up to 100% of their annual retainer and all fees payable to them in their capacity as a member of the Board in any calendar year into the deferred compensation plan. Plan participants receive an investment return on the deferred funds as if the funds were invested in a hypothetical portfolio chosen by the participant from among the investment options our chief financial officer designates as available under the plan. Prior to the deferral, plan participants must elect to receive the deferred funds either in a lump sum, in approximately equal annual installments, or in an initial payment followed by approximately equal annual installments, with a maximum of 15 installments. Deferral elections generally must be made prior to the year in which the compensation otherwise would have been paid, and payments will be made as specified in the deferral election. Participants in the plan will be unsecured creditors of the company and will be paid from our general assets.

On November 16, 2004, our Board of Directors authorized a new deferred compensation plan to ensure that our plans comply with new requirements under the Internal Revenue Code of 1986, specifically Section 409A. We disclosed the plan in a Form 8-K filed on November 22, 2004. The new elective deferred compensation plan applies to compensation that is deferred after December 31, 2004. The terms described under the prior plan above are not expected to change. The prior deferred compensation plan will continue to operate for compensation deferred under that plan on or prior to December 31, 2004.

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Other Expenses

We also pay for or reimburse directors for out-of-pocket expenses incurred in connection with their service on the Board, including travel to and from our meetings, accommodations, and meals.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Equity Compensation Plan Information

The following table provides information as of December 31, 2005 with respect to shares of common stock that may be issued under our existing equity compensation plans.

	(As of December 31, 2005)		
Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights (#)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights ($)	Number of Securities Remaining Available for Future Issuance under Equity Compensation Plans (Excluding Securities Reflected in First Column) (#)
Equity compensation plans approved by stockholders	24,452,480(1)	$ 68.93(2)	45,962,333(3)
Equity compensation plans not approved by stockholders	N/A	N/A	N/A
Total	24,452,480	$ 68.93	45,962,333

(1) This amount includes outstanding stock options; restricted stock units; the maximum number of shares issuable to eligible employees pursuant to our stock-based performance award; shares issuable upon the payout of deferred stock balances; the maximum number of shares that may be issued pursuant to performance share awards made to members of senior management for which no determination had yet been made regarding the final number of shares payable; and the maximum number of shares that may be issued pursuant to performance share awards that have been made to members of senior management for which a payout determination has been made but for which the shares were not paid out as of December 31, 2005. Performance share awards entitle the recipient to receive shares of common stock based upon and subject to our meeting corporate performance objectives over three-year periods. Outstanding awards, options and rights include grants under the Fannie Mae

Stock Compensation Plan of 1993, the Stock Compensation Plan of 2003, and the payout of shares deferred upon the settlement of awards made under the 1993 plan and a prior plan.

(2) The weighted average exercise price is calculated for the outstanding options and does not take into account restricted stock units, stock-based performance awards, deferred shares or the performance shares described in footnote (1).

(3) This number of shares consists of 11,960,258 shares available under the 1985 Employee Stock Purchase Plan and 34,002,075 shares available under the Stock Compensation Plan of 2003 that may be issued as restricted stock, stock bonuses, stock options, or in settlement of restricted stock units, performance share awards, stock appreciation rights or other stock-based awards. No more than 1,682,431 of the shares issuable under the Stock Compensation Plan of 2003 may be issued as restricted stock or restricted stock units vesting in full in fewer than three years, performance shares with a performance period of less than one year, or bonus shares subject to similar vesting provisions or performance periods.

Stock Ownership

We encourage our directors, officers and employees to own our stock in order to align their interests with the interests of stockholders. Our compensation programs are structured so that a significant portion of the compensation paid to officers is in the form of common stock or rights to acquire common stock. Our employees also have the opportunity to own Fannie Mae common stock through bonus stock opportunities and our Employee Stock Ownership Plan.

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Stock Ownership Guidelines

In April 2003, the Board of Directors adopted formal stock ownership requirements for executive officers. In November 2005, the Board also adopted stock ownership guidelines for non-management members of the Board. These requirements and guidelines are contained in our Corporate Governance Guidelines.

Stock Ownership Guidelines for Non-Management Members of the Board:

Each non-management director is expected to own Fannie Mae common stock with a value equal to at least five times the director s annual cash retainer (currently, five times $35,000, or $175,000).

Each non-management director has three years from the time of election or appointment to reach the expected ownership level, excluding trading blackout periods imposed by the company.

Stock Ownership Requirements for Senior Executives :

Senior executives are officers holding positions at or above the level of Executive Vice President.

Each Fannie Mae senior executive is required to hold shares of Fannie Mae common stock with a value equal to a multiple of the executive s base salary, as follows:

Job Level	Multiple of Base Salary
Chief Executive Officer	five times
Executive Vice President	two times

Each senior executive has three years from the time of appointment to reach the expected ownership level.

In addition, on January 25, 2007, the Board awarded Mr. Mudd 176,506 shares of restricted stock as compensation for his performance in 2006 and determined that Mr. Mudd must retain one-fifth of these shares, net of any shares withheld to pay withholding tax liability due upon the shares vesting, until his employment with Fannie Mae is terminated. The portion of these shares that he is required to retain does not count toward the fulfillment of Mr. Mudd s stock ownership requirement.

Beneficial Ownership

The following table shows the beneficial ownership of Fannie Mae common stock by each of our current directors and the covered executives, and all current directors and executive officers as a group, as of March 31, 2007. As of that date, no director or covered executive, nor all directors and executive officers as a group, owned as much as 1% of our outstanding common stock.

	Amount and Nature of Beneficial Ownership[1]		
	Common Stock Beneficially Owned	Stock Options Exercisable or Other Shares	Total Common Stock

Name and Position	Excluding Stock Options	Obtainable Within 60 Days of March 31, 2007[(2)]	Beneficially Owned
Stephen Ashley[(3)] Chairman of the Board of Directors	20,747	24,000	44,747
Dennis Beresford[(4)] Director	719	0	719
Brenda Gaines[(5)] Director	487	0	487
Karen Horn[(6)] Director	487	0	487
Robert Levin[(7)] Executive Vice President and Chief Business Officer	448,853	429,701	878,554
Thomas Lund[(8)] Executive Vice President Single-Family Mortgage Business	87,391	93,160	180,551

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	Amount and Nature of Beneficial Ownership[1]		
Name and Position	Common Stock Beneficially Owned Excluding Stock Options	Stock Options Exercisable or Other Shares Obtainable Within 60 Days of March 31, 2007[2]	Total Common Stock Beneficially Owned
Bridget Macaskill[9] Director	1,062	0	1,062
Daniel Mudd[10] President and Chief Executive Officer	411,157	570,718	981,875
Peter Niculescu[11] Executive Vice President Capital Markets	146,945	177,487	324,432
Joe Pickett[12] Director	11,786	30,000	41,786
Leslie Rahl[13] Director	3,281	3,333	6,614
Greg Smith[14] Director	1,612	333	1,945
Patrick Swygert[15] Director	3,534	9,833	13,367
Michael Williams[16] Executive Vice President and Chief Operating Officer	230,088	269,589	499,677
John Wulff[17] Director	1,887	1,000	2,887
All directors and executive officers as a group (22 persons)[18]	1,752,208	1,939,245	3,691,453

(1) Beneficial ownership is determined in accordance with the rules of the SEC for computing the number of shares of common stock beneficially owned by each person and the percentage owned. Holders of restricted stock have no investment power but have sole voting power over the shares and, accordingly, these shares are included in this table. Holders of shares through our Employee Stock Ownership Plan, or ESOP, have sole voting power over the shares so these shares are also included in this table. Holders of shares through our ESOP generally have no investment power unless they are at least 55 years of age and have at least 10 years of participation in the ESOP. Additionally, although holders of shares through our ESOP have sole voting power through the power to direct the trustee of the plan to vote their shares, to the extent some holders do not provide any direction as to how to vote their shares, the plan trustee may vote those shares in the same proportion as the trustee votes the shares for which the trustee has received direction. Holders of stock options have no investment or voting power over the shares issuable upon the exercise of the options until the options are exercised.

(2) These shares are issuable upon the exercise of outstanding stock options, except for 1,284 shares of deferred stock held by Mr. Williams, which he could obtain within 60 days in certain circumstances.

(3) Mr. Ashley s shares include 1,200 shares held by his spouse and 650 shares of restricted stock.

(4) Mr. Beresford s shares consist of restricted stock.

(5) Ms. Gaines shares consist of restricted stock.

(6) Ms. Horn s shares consist of restricted stock.

(7) Mr. Levin s shares consist of 253,701 shares held jointly with his spouse and 195,152 shares of restricted stock.

(8) Mr. Lund s shares include 3,911 shares held jointly with his spouse, 661 shares held through our ESOP, and 68,999 shares of restricted stock.

(9) Ms. Macaskill s shares include 650 shares of restricted stock.

(10) Mr. Mudd s shares include 297,026 shares of restricted stock. Mr. Mudd must continue to hold 35,301 of these shares after vesting, net of any shares withheld to pay withholding tax liability upon vesting, until his employment with Fannie Mae is terminated. The reported amount does not include 31,901 restricted stock units held by Mr. Mudd.

(11) Mr. Niculescu s shares include 47,541 shares held jointly with his spouse, 232 shares held through our ESOP, and 86,354 shares of restricted stock.

(12) Mr. Pickett s shares include 650 shares of restricted stock.

(13) Ms. Rahl s shares include 200 shares held by her spouse and 650 shares of restricted stock.

(14) Mr. Smith s shares include 650 shares of restricted stock.

(15) Mr. Swygert s shares include 650 shares of restricted stock.

(16) Mr. Williams shares include 6,000 shares held jointly with his spouse, 700 shares held by his daughter, 863 shares held through our ESOP and 151,501 shares of restricted stock.

(17) Mr. Wulff s shares include 650 shares of restricted stock.

(18) The amount of shares held by all directors and executive officers as a group includes 1,108,394 shares of restricted stock held by our directors and executive officers, 4,428 held by them through our ESOP, 10,242 shares of stock held by their family members, 16,564 shares of restricted stock held by an executive officer s spouse and 701 shares held through our ESOP by an executive officer s spouse. The stock options or other shares column includes options to purchase 68,977 shares held by an executive officer s spouse. The beneficially owned total includes 1,284 shares of deferred stock. The shares in this table do not include 176,701 shares of restricted stock units over which the holders will not obtain voting rights or investment power until the restrictions lapse.

The following table shows the beneficial ownership of Fannie Mae common stock by each holder of more than 5% of our common stock as of December 31, 2006, or as otherwise noted, which is the most recent information provided.

5% Holders	Common Stock Beneficially Owned	Percent of Class
Capital Research and Management Company[1] 333 South Hope Street Los Angeles, CA 90071	167,555,250	17.2%
Citigroup Inc.[2] 399 Park Avenue New York, NY 10043	62,341,565	6.3%
AXA[3] 25 Avenue Matignon 75008 Paris, France	52,669,044	5.4%

(1) This information is based solely on information contained on a Schedule 13G/A filed with the SEC on February 12, 2007 by Capital Research and Management Company. According to the Schedule 13G/A, Capital Research and Management Company beneficially owned 167,555,250 shares of our common stock as of December 29, 2006, with sole voting power for 49,477,500 shares and sole dispositive power for all shares. Capital Research and Management Company s shares include 3,674,050 shares from the assumed conversion of 3,470 shares of our convertible preferred stock.

(2) This information is based solely on information contained in a Schedule 13G/A filed with the SEC on February 9, 2007 by Citigroup Inc. According to the Schedule 13G/A, Citigroup Inc. beneficially owns 62,341,565 shares of our common stock, with shared voting and dispositive power for all such shares.

(3) This information is based solely on information contained in a Schedule 13G/A filed with the SEC on February 13, 2007 by AXA, its subsidiary AXA Financial, Inc., and a group of entities that together as a group control AXA: AXA Assurances I.A.R.D. Mutuelle, AXA Assurances Vie Mutuelle, and AXA Courtage Assurance Mutuelle. According to the Schedule 13G/A, Alliance Capital Management L.P. and AllianceBernstein L.P., subsidiaries of AXA Financial, Inc., manage a majority of these shares as investment advisors. According to the Schedule 13G/A, each of these entities other than AXA Financial, Inc. beneficially owns 52,669,044 shares of our common stock, with sole voting power for 38,027,229 shares, shared voting power for 4,288,975 shares, sole dispositive power for 52,643,476 shares and shared dispositive power for 25,568 shares; while AXA Financial, Inc. beneficially owns 52,550,491 shares of our common stock, with sole voting power for 37,959,484 shares, shared voting power for 4,279,707 shares, sole dispositive power for 52,524,923 shares and shared dispositive power for 25,568 shares.

Item 13. Certain Relationships and Related Transactions

Described below are certain business transactions, employment and compensation arrangements and charitable donations that we have engaged in since January 1, 2005 with parties who are, or who are related in some way to, our executive officers, directors or holders of more than 5% of our common stock.

Transactions with 5% Shareholders

Citigroup Inc. (Citigroup) beneficially owned more than 5% of the outstanding shares of our common stock as of December 31, 2006 and Barclays PLC and its affiliates (Barclays) beneficially owned more than 5% of the outstanding shares of our common stock as of December 31, 2004. Since January 1, 2005, we have engaged in securities and other financial instrument transactions in the ordinary course of business with Citigroup and Barclays and their respective affiliates. We have extensive, multi-billion dollar relationships with Citigroup and Barclays. Citigroup, Barclays, and/or their affiliates have at times engaged in some or all of the following types of transactions: distributing our debt securities as dealers; committing to sell or buy mortgage-related securities or mortgage loans as dealers; delivering mortgage loans to us for purchase by our mortgage portfolio or for securitization into Fannie Mae MBS; issuing investments held in our liquid investment portfolio; and acting as derivatives counterparties and counterparties who have been involved in other financial instrument transactions with us. An affiliate of Citigroup has also provided strategic consulting services to us. These transactions were on substantially the same terms as those prevailing at the time for comparable transactions with unrelated third parties.

A majority of the assets in the Fannie Mae Retirement Plan are managed by Alliance Capital Management L.P. and AllianceBernstein L.P. Alliance Capital and AllianceBernstein may have beneficially owned more than 5% of the outstanding shares of our common stock as of December 31, 2006, through their management of shares beneficially owned by AXA and its related entities. In addition, an affiliate of AXA has engaged in financial instrument transactions with us. These transactions were on substantially the same terms as those prevailing at the time for comparable transactions with unrelated third parties.

Transactions with The Duberstein Group

Kenneth Duberstein, a former director of Fannie Mae, is Chairman and Chief Executive Officer of The Duberstein Group, Inc., an independent strategic planning and consulting company. The Duberstein Group previously provided us consulting services related to legislative and regulatory issues, and associated matters. We are entering into a new agreement with the Duberstein Group. They now provide us consulting services related to industry and trade issues. During 2005 and 2006 the firm provided services on an annual fixed-fee basis of $375,000. Under our new agreement, we will pay an annual fixed fee of $400,000. The firm has provided services to us since 1991.

Employment Relationships

Barbara Spector, the sister of our Chief Business Officer, Mr. Levin, is a non-officer employee in our Enterprise Systems Operations division. From January 1, 2005 through March 15, 2007, we paid or awarded Ms. Spector approximately $312,000 in salary and cash bonuses, including amounts that she will receive in full only if she remains employed by us until early 2010. For 2005 and 2006, she has also received an aggregate of 374 shares of our common stock in the form of restricted stock that vests over four years. Dividends are paid on restricted common stock at the same rate as dividends on unrestricted common stock. She also receives benefits under our compensation and benefit plans that are generally available to our employees, including our retirement plan and employee stock ownership plan. The Enterprise Systems Operations division does not report, nor has it ever reported, to Mr. Levin.

Rebecca Senhauser, the wife of William Senhauser, our Chief Compliance Officer, is a Senior Vice President in our Housing and Community Development division. From January 1, 2005 through March 15, 2007, we paid or awarded Ms. Senhauser approximately $1,958,000 in salary and cash bonuses, including some amounts that Ms. Senhauser will receive in full only if she remains employed by us until early 2010. For 2005 and 2006, she has also received an aggregate of 15,778 shares of our common stock in the form of restricted stock that vests over three or four years. Ms. Senhauser also receives benefits under our compensation and benefit plans that are generally available to our employees, including our retirement plan and our employee stock ownership plan. As a member of senior management, she also receives benefits under our compensation and benefit plans available to senior officers, including payment for tax and financial planning services, participation in the Supplemental Pension Plan and 2003 Supplemental Pension Plan, participation in the Performance

Share Program and participation in our elective deferred compensation plan. For the three-year performance cycle completed in 2003, it was determined in January 2004 that she was entitled to receive 5,730 shares, of which she received 2,865 shares in accordance with the program, with the balance scheduled to be received in January 2005. Our Board of Directors and Compensation Committee determined in February 2007 not to pay any unpaid performance shares for the performance share cycles completed in 2003 and 2004, as a result of which the balance of these shares will not be issued to Ms. Senhauser. The Housing and Community Development division does not report, nor has it ever reported, to Mr. Senhauser. Mr. and Ms. Senhauser recuse themselves from any matters that may directly and significantly affect the other, including matters that may affect each other s compensation and evaluation.

Charitable Contributions

We encourage our employees to volunteer their time to charitable organizations and actively support these volunteer activities. Our charitable activities generally focus on creating affordable homeownership and housing opportunities nationally and improving the quality of life for people of our hometown, Washington, D.C., through partnerships and initiatives and by funding and promoting research and education on housing-related issues. In February 2007, we announced the consolidation of our philanthropic initiatives into a new Office of Community and Charitable Giving.

In connection with our creation of the Office of Community and Charitable Giving, the Fannie Mae Foundation ceased its day-to-day operations in April 2007. We have been the sole provider of support for the Fannie Mae Foundation. In 2006, we made a contribution to the Foundation of $26.5 million. We have also agreed to provide funding if necessary to cover certain expenses relating to the winding down of the Foundation s operations, as well as other forms of support, including the services of Fannie Mae employees, to support the Foundation s orderly wind-down and termination and to support certain Foundation programs after April 2007. Our President and CEO, Daniel Mudd, is the Chairman of the Board of the Foundation. In addition, the Board of Directors of the Foundation includes four additional members who are current officers of Fannie Mae and two members who are former officers of Fannie Mae. Directors of the Foundation who are current Fannie Mae employees do not receive any additional compensation for serving on the Foundation s Board of Directors.

Under its Matching Gifts Program, the Fannie Mae Foundation matches gifts made by employees to 501(c)(3) public charities, up to an aggregate total of $10,000 per employee in any calendar year, including up to $500 which may be matched on a 2-for-1 basis. Directors and executive officers are eligible to participate in this matching program on the same terms as our other employees. This program will continue through 2007. Fannie Mae may undertake a matching gift program in 2008.

The Fannie Mae Foundation made charitable contributions to the University of Pennsylvania of $91,667 in 2005 and $20,000 in 2007 to support training for mid-career professionals in real estate financing and to support research on housing and housing policy. Mr. Gerrity, a former director of Fannie Mae, is a professor at the University of Pennsylvania. Mr. Gerrity had no involvement in the Foundation s grant-making decision.

Item 14. Principal Accounting Fees and Services

The Audit Committee of our Board of Directors is directly responsible for the appointment, oversight and evaluation of our independent registered public accounting firm. In accordance with the Audit Committee s charter, it must approve, in advance of the service, all audit and permissible non-audit services to be provided by our independent registered public accounting firm and establish policies and procedures for the engagement of the outside auditor to provide audit and permissible non-audit services. Our independent registered public accounting firm may not be retained to perform non-audit services specified in Section 10A(g) of the Exchange Act.

The Audit Committee appointed Deloitte & Touche LLP as our independent registered public accounting firm in January 2005. The Audit Committee dismissed KPMG LLP as our independent registered public accounting firm in December 2004, after concluding that Fannie Mae s previously filed interim and audited financial statements and the independent auditor s reports thereon for the periods from January 2001 through the second quarter of 2004 should no longer be relied upon because such financial statements were prepared applying accounting practices that did not comply with generally accepted accounting principles. Accordingly, we were required to

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restate our previously reported audited consolidated financial statements for the years ended December 31, 2003 and 2002. We also restated our previously reported December 31, 2001 consolidated balance sheet to reflect corrected items that relate to prior periods. Deloitte & Touche audited these restated consolidated financial statements, as well as our consolidated financial statements for the year ended December 31, 2004.

The following table sets forth the estimated or actual fees for services provided by our independent registered public accounting firm Deloitte & Touche for the 2005 and 2004 audits. During 2004, KPMG reviewed our interim financial statements for the quarters ended March 31, 2004 and June 30, 2004. KPMG did not report on our financial statements for the year ended December 31, 2004, but was in the process of auditing the 2004 information when the Audit Committee dismissed the firm. The fees for services provided by KPMG in 2004 are not reflected in the table below.

	For the Year Ended December 31,	
Description of Fees	**2005**	**2004[(1)]**
Audit fees[(2)]	$ 57,395,000	$ 203,375,000
Audit-related fees[(3)]		
Tax fees[(4)]		
All other fees		
Total fees	$ 57,395,000	$ 203,375,000

(1) Amount for 2004 has been updated from the previously estimated amount to reflect actual fees incurred for the 2004 audit.

(2) For 2004, excludes fees paid or accrued for services provided by KPMG totaling $6,010,604 for preliminary 2004 audit work. For 2004, amount includes fees paid to Deloitte & Touche for the audit of our consolidated financial statements for the years 2002 to 2004 as the audits occurred contemporaneously.

(3) For 2005, excludes $100,000 paid to Deloitte & Touche for an engagement by one of our counterparties to provide a comfort letter on a REMIC transaction. For 2004, excludes fees paid or accrued for services provided by KPMG totaling $4,721,399 related to the OFHEO special examination, $3,113,725 for REMIC pricing and closing letter fees, and $317,503 for REMIC payment data validation fees.

(4) For 2004, excludes fees paid or accrued for services provided by KPMG totaling $735,000 for review of tax accounts, $3,862,254 for REMIC tax return services, and $23,500 for reimbursable financial advisory fees paid directly to KPMG by Fannie Mae on behalf of certain of our officers.

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PART IV

Item 15. Exhibits, Financial Statement Schedules

(a) Documents filed as part of this report

1. *Consolidated Financial Statements*

2. *Financial Statement Schedules*

   None

3. *Exhibits*

   An index to exhibits has been filed as part of this report beginning on page E-1 and is incorporated herein by reference

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SIGNATURES

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.

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Stephen B. Ashley, Daniel H. Mudd and Robert T. Blakely, and each of them severally, his or her true and lawful attorney-in-fact with power of substitution and resubstitution to sign in his or her name, place and stead, in any and all capacities, to do any and all things and execute any and all instruments that such attorney may deem necessary or advisable under the Securities Exchange Act of 1934 and any rules, regulations and requirements of the U.S. Securities and Exchange Commission in connection with the Annual Report on Form 10-K and any and all amendments hereto, as fully for all intents and purposes as he or she might or could do in person, and hereby ratifies and confirms all said attorneys-in-fact and agents, each acting alone, and his or her substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Federal National Mortgage Association

By /s/ Daniel H. Mudd

Daniel H. Mudd
President and Chief Executive Officer

Date: May 2, 2007

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/ Stephen B. Ashley Stephen B. Ashley	Chairman of the Board of Directors	May 2, 2007
/s/ Daniel H. Mudd Daniel H. Mudd	President and Chief Executive Officer and Director	May 2, 2007
/s/ Robert T. Blakely Robert T. Blakely	Executive Vice President and Chief Financial Officer	May 2, 2007
/s/ David C. Hisey David C. Hisey	Senior Vice President and Controller	May 2, 2007
/s/ Dennis R. Beresford Dennis R. Beresford	Director	May 2, 2007

/s/ Brenda J. Gaines	Director	May 2, 2007
Brenda J. Gaines		
/s/ Karen N. Horn	Director	May 2, 2007
Karen N. Horn		
/s/ Bridget A. Macaskill	Director	May 2, 2007
Bridget A. Macaskill		
/s/ Joe K. Pickett	Director	May 2, 2007
Joe K. Pickett		

Signature	Title	Date
/s/ Leslie Rahl	Director	May 2, 2007
Leslie Rahl		
/s/ Greg C. Smith	Director	May 2, 2007
Greg C. Smith		
/s/ H. Patrick Swygert	Director	May 2, 2007
H. Patrick Swygert		
/s/ John K. Wulff	Director	May 2, 2007
John K. Wulff		

INDEX TO EXHIBITS

Item	Description
3.1	Fannie Mae Charter Act (12 U.S.C. § 1716 et seq.) (Incorporated by reference to Exhibit 3.1 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
3.2	Fannie Mae Bylaws, as amended on September 19, 2006 (Incorporated by reference to Exhibit 3.1 to Fannie Mae s Current Report on Form 8-K, filed September 25, 2006.)
4.1	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series D (Incorporated by reference to Exhibit 4.1 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
4.2	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series E (Incorporated by reference to Exhibit 4.2 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
4.3	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series F (Incorporated by reference to Exhibit 4.3 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
4.4	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series G (Incorporated by reference to Exhibit 4.4 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
4.5	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series H (Incorporated by reference to Exhibit 4.5 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
4.6	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series I (Incorporated by reference to Exhibit 4.6 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
4.7	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series L (Incorporated by reference to Exhibit 4.2 to Fannie Mae s Quarterly Report on Form 10-Q for the quarter ended March 31, 2003.)
4.8	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series M (Incorporated by reference to Exhibit 4.2 to Fannie Mae s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.)
4.9	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series N (Incorporated by reference to Exhibit 4.1 to Fannie Mae s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003.)
4.10	Certificate of Designation of Terms of Fannie Mae Non-Cumulative Convertible Preferred Stock, Series 2004-1 (Incorporated by reference to Exhibit 4.1 to Fannie Mae s Current Report on Form 8-K, filed January 4, 2005.)
4.11	Certificate of Designation of Terms of Fannie Mae Preferred Stock, Series O (Incorporated by reference to Exhibit 4.2 to Fannie Mae s Current Report on Form 8-K, filed January 4, 2005.)
10.1	Employment Agreement between Fannie Mae and Franklin D. Raines, as amended on June 30, 2004 (Incorporated by reference to Exhibit 10.1 to Fannie Mae s Quarterly Report on Form 10-Q for the quarter ended June 30, 2004.)
10.2	Letter Agreement between Fannie Mae and Franklin D. Raines, dated September 17, 2004 (Incorporated by reference to Exhibit 10.1 to Fannie Mae s Current Report on Form 8-K, filed September 23, 2004.)
10.3	Employment Agreement between Fannie Mae and Daniel H. Mudd, as amended on June 30, 2004 (Incorporated by reference to Exhibit 10.2 to Fannie Mae s Quarterly Report on Form 10-Q for the quarter ended June 30, 2004.)
10.4	Letter Agreement between Fannie Mae and Daniel H. Mudd, dated September 18, 2004 (Incorporated by reference to Exhibit 10.2 to Fannie Mae s Current Report on Form 8-K, filed September 23, 2004.)
10.5	Letter Agreement between Fannie Mae and Daniel Mudd, dated March 10, 2005 (Incorporated by reference to Exhibit 10.2 to Fannie Mae s Current Report on Form 8-K, filed March 11, 2005.)
10.6	Employment Agreement, dated November 15, 2005, between Fannie Mae and Daniel H. Mudd (Incorporated by reference to Exhibit 10.1 to Fannie Mae s Current Report on Form 8-K, filed November 15, 2005.)

10.7	Employment Agreement between Fannie Mae and J. Timothy Howard, as amended on June 30, 2004 (Incorporated by reference to Exhibit 10.3 to Fannie Mae s Quarterly Report on Form 10-Q for the quarter ended June 30, 2004.)
10.8	Letter Agreement between Fannie Mae and Timothy Howard, dated September 20, 2004 (Incorporated by reference to Exhibit 10.3 to Fannie Mae s Current Report on Form 8-K, filed September 23, 2004.)
10.9	Letter Agreement between Fannie Mae and Robert J. Levin, dated June 19, 1990 (Incorporated by reference to Exhibit 10.5 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)

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Item	Description
10.10	Separation Letter Agreement between Fannie Mae and Ann Kappler, dated August 23, 2005 (Incorporated by reference to Exhibit 99.3 to Fannie Mae s Annual Report on Form 10-K for the year ended December 31, 2004, filed December 6, 2006.)
10.11	Description of Fannie Mae s Elective Deferred Compensation Plan II (Incorporated by reference to Exhibit 10.9 to Fannie Mae s Annual Report on Form 10-K for the year ended December 31, 2004, filed December 6, 2006.)
10.12	Description of Fannie Mae s compensatory arrangements with its named executive officers for the year ended December 31, 2005 (Incorporated by reference to Executive Compensation Information in Item 11 of Fannie Mae s Annual Report on Form 10-K for the year ended December 31, 2005.)
10.13	Description of Fannie Mae s compensatory arrangements with its non-employee directors for the year ended December 31, 2005 (Incorporated by reference to Director Compensation Information in Item 11 of Fannie Mae s Annual Report on Form 10-K for the year ended December 31, 2005.)
10.14	Description of Fannie Mae s Severance Program for 2005 and 2006 (Incorporated by reference to Executive Compensation Information in Item 11 of Fannie Mae s Annual Report on Form 10-K for the year ended December 31, 2005.)
10.15	Form of Indemnification Agreement for Non-Management Directors of Fannie Mae (Incorporated by reference to Exhibit 10.7 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
10.16	Form of Indemnification Agreement for Officers of Fannie Mae (Incorporated by reference to Exhibit 10.7 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
10.17	Federal National Mortgage Association Supplemental Pension Plan (Incorporated by reference to Exhibit 10.9 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
10.18	Fannie Mae Supplemental Pension Plan of 2003 (Incorporated by reference to Exhibit 10.1 to Fannie Mae s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003.)
10.19	Executive Pension Plan of the Federal National Mortgage Association as amended and restated (Incorporated by reference to Exhibit 10.10 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
10.20	Amendment to the Executive Pension Plan of the Federal National Mortgage Association, as amended and restated, effective March 1, 2007
10.21	Fannie Mae Annual Incentive Plan, as Amended and Restated January 1, 2007
10.22	Fannie Mae Stock Compensation Plan of 2003 (Incorporated by reference to Exhibit 10.12 to Fannie Mae s Annual Report on Form 10-K for the year ended December 31, 2003.)
10.23	Fannie Mae Stock Compensation Plan of 1993 (Incorporated by reference to Exhibit 10.18 to Fannie Mae s Annual Report on Form 10-K for the year ended December 31, 2004, filed December 6, 2006.)
10.24	Fannie Mae Procedures for Deferral and Diversification of Awards (Incorporated by reference to Exhibit 10.14 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
10.25	Fannie Mae Stock Option Gain Deferral Plan (Incorporated by reference to Exhibit 10.15 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
10.26	Form of Election under Fannie Mae s Elective Deferred Compensation Plan II (Incorporated by reference to Exhibit 10.1 to Fannie Mae s Current Report on Form 8-K, filed November 22, 2004.)
10.27	Fannie Mae s Elective Deferred Compensation Plan (Incorporated by reference to Exhibit 10.13 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
10.28	Director s Charitable Award Program (Incorporated by reference to Exhibit 10.17 to Fannie Mae s registration statement on Form 10, filed March 31, 2003.)
10.29	Form of Nonqualified Stock Option Grant Award Document (Incorporated by reference to Exhibit 10.3 to Fannie Mae s Current Report on Form 8-K, filed December 9, 2004.)
10.30	

	Form of Restricted Stock Award Document (Incorporated by reference to Exhibit 99.1 to Fannie Mae s Current Report on Form 8-K, filed January 26, 2007.)
10.31	Form of Restricted Stock Units Award Document (Incorporated by reference to Exhibit 99.2 to Fannie Mae s Current Report on Form 8-K, filed January 26, 2007.)

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Item	Description
10.32	Form of Performance Share Plan Information Sheet (Incorporated by reference to Exhibit 10.6 to Fannie Mae s Current Report on Form 8-K, filed December 9, 2004.)
10.33	Form of Nonqualified Stock Option Grant Award Document for Non-Management Directors (Incorporated by reference to Exhibit 10.7 to Fannie Mae s Current Report on Form 8-K, filed December 9, 2004.)
10.34	Form of Restricted Stock Award Document under Fannie Mae Stock Compensation Plan of 2003 for Non-Management Directors (Incorporated by reference to Exhibit 10.8 to Fannie Mae s Current Report on Form 8-K, filed December 9, 2004.)
10.35	Form of Restricted Stock Award Document under Fannie Mae Stock Compensation Plan of 1993 for Non-Management Directors (Incorporated by reference to Exhibit 10.9 to Fannie Mae s Current Report on Form 8-K, filed December 9, 2004.)
10.36	Letter Agreement between The Duberstein Group and Fannie Mae, dated as of March 28, 2001, with Modification #1, dated February 3, 2002; Modification #2, dated March 1, 2003; and Modification #3, dated April 27, 2005 (Incorporated by reference to Exhibit 10.25 to Fannie Mae s Annual Report on Form 10-K for the year ended December 31, 2004, filed December 6, 2006.)
10.37	Agreement between OFHEO and Fannie Mae, September 27, 2004 (Incorporated by reference to Exhibit 10.1 to Fannie Mae s Current Report on Form 8-K, filed September 29, 2004.)
10.38	Supplement to the Agreement of September 27, 2004 between Fannie Mae and OFHEO, dated March 7, 2005 (Incorporated by reference to Exhibit 10.1 to Fannie Mae s Current Report on Form 8-K, filed March 11, 2005.)
10.39	Letters, dated September 1, 2005, setting forth an agreement between Fannie Mae and Office of Federal Housing Enterprise Oversight (OFHEO) (Incorporated by reference to Exhibit 10.1 to Fannie Mae s Current Report on Form 8-K, filed September 8, 2005.)
12.1	Statement re: computation of ratios of earnings to fixed charges
12.2	Statement re: computation of ratios of earnings to combined fixed charges and preferred stock dividends
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a)
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14(a)
32.1	Certipx;padding-bottom:2px;">

		45,890			43,3493%	
New Star Metals, Inc.	Indiana / Metal Services &	Senior Subordinated Term Loan (11.50% (LIBOR + 8.50% with 3.00% LIBOR floor) plus 1.00% PIK, due 2/2/2018)(4)	50,534	50,534	49,5186%	

Minerals	50,534	49,5185%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULES OF INVESTMENTS-(CONTINUED)
December 31, 2013 (Unaudited) and June 30, 2013 (Audited)
(in thousands, except share data)

			December 31, 2013 (Unaudited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Nixon, Inc.	California / Durable Consumer Products	Senior Secured Term Loan (8.75% plus 2.75% PIK, due 4/16/2018)(16)	13,862	13,625	13,625	0.4%
				13,625	13,625	0.4%
NRG Manufacturing, Inc.	Texas / Manufacturing	Escrow Receivable		—	1,068	—%
				—	1,068	—%
Octagon Investment Partners XV, Ltd. (22)	Cayman Islands / Diversified Financial Services	Income Notes (Residual Interest)	26,901	25,153	26,162	0.8%
				25,153	26,162	0.8%
Onyx Payments, Inc. (f/k/a Pegasus Business Intelligence, LP)(4)	Texas / Diversified Financial Services	Revolving Line of Credit — $2,500 Commitment (9.00% (LIBOR + 7.75% with 1.25% LIBOR floor), due 4/18/2014)(25)	—	—	—	—%
		Senior Secured Term Loan A (6.75% (LIBOR + 5.50% with 1.25% LIBOR floor), due 4/18/2018)	15,531	15,531	15,531	0.5%
		Senior Secured Term Loan B (13.75% (LIBOR + 12.50% with 1.25% LIBOR floor), due 4/18/2018)	15,938	15,938	15,938	0.5%
				31,469	31,469	1.0%
Pelican Products, Inc.(16)	California / Durable Consumer Products	Subordinated Secured (11.50% (LIBOR + 10.00% with 1.50% LIBOR floor), due 6/14/2019)(3),(4)	15,000	14,745	15,000	0.5%
				14,745	15,000	0.5%
Photonis Technologies SAS(22)	France / Aerospace & Defense	First Lien Term Loan (8.50% (LIBOR + 7.50% with 1.00% LIBOR floor), due 9/18/2019) (4), (16)	10,500	10,198	10,203	0.3%
				10,198	10,203	0.3%
			10,000	9,824	10,000	0.3%

Pinnacle (US) Acquisition Co Limited(16)	Texas / Software & Computer Services	Second Lien Term Loan (10.50% (LIBOR + 9.25% with 1.25% LIBOR floor), due 8/3/2020)(4)				
				9,824	10,000	0.3%
PrimeSport, Inc.(4)	Georgia/ Hotels, Restaurants & Leisure	Revolving Line of Credit — $15,000 Commitment (10.00% (LIBOR + 9.50% with 0.50% LIBOR floor), due 6/23/2014)(25)	$ —	$ —	$ —	—%
		Senior Secured Term Loan A (7.50% (LIBOR + 6.50% with 1.00% LIBOR floor), due 12/23/2019)	43,700	43,700	43,700	1.4%
		Senior Secured Term Loan B (11.50% (LIBOR + 10.50% with 1.00% LIBOR floor) plus 1.00% PIK, due 12/23/2019)	43,700	43,700	43,700	1.4%
				87,400	87,400	2.8%
Prince Mineral Holding Corp.	New York / Metal Services & Minerals	Senior Secured Term Loan (11.50%, due 12/15/2019)	10,000	9,895	9,895	0.3%
				9,895	9,895	0.3%
Progrexion Holdings, Inc.(4),(28)	Utah / Consumer Services	Senior Secured Term Loan (10.50% (LIBOR + 8.50% with 2.00% LIBOR floor), due 9/14/2017)(3)	284,521	284,521	284,521	8.8%
				284,521	284,521	8.8%
Rocket Software, Inc.(3), (4)	Massachusetts / Software & Computer Services	Second Lien Term Loan (10.25% (LIBOR + 8.75% with 1.50% LIBOR floor), due 2/8/2019)	20,000	19,738	19,967	0.6%
				19,738	19,967	0.6%
Royal Adhesives & Sealants, LLC	Indiana / Chemicals	Second Lien Term Loan (9.75% (LIBOR + 8.50% with 1.25% LIBOR floor), due 1/31/2019) (4), (16)	20,000	19,619	19,619	0.6%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULES OF INVESTMENTS-(CONTINUED)
December 31, 2013 (Unaudited) and June 30, 2013 (Audited)
(in thousands, except share data)

			December 31, 2013 (Unaudited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
				19,619	19,619	0.6%
Ryan, LLC(4)	Texas / Business Services	Subordinated Unsecured (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor) plus 3.00% PIK, due 6/30/2018)	70,000	70,000	70,000	2.2%
				70,000	70,000	2.2%
Sandow Media, LLC	Florida / Media	Senior Secured Term Loan (12.00%, due 5/8/2018) (3)	25,143	25,143	24,403	0.8%
				25,143	24,403	0.8%
SESAC Holdco II LLC(3)	Tennessee / Media	Second Lien Term Loan (10.00% (LIBOR + 8.75% with 1.25% LIBOR floor), due 7/12/2019)(4), (16)	6,000	5,919	6,000	0.2%
				5,919	6,000	0.2%
Skillsoft Public Limited Company (22)	Ireland / Software & Computer Services	Senior Unsecured (11.125%, due 6/1/2018)	15,000	14,933	15,000	0.5%
				14,933	15,000	0.5%
Snacks Holding Corporation	Minnesota / Food Products	Series A Preferred Stock (4,021.45 shares)		56	56	—%
		Series B Preferred Stock (1,866.10 shares)		56	56	—%
		Warrant (to purchase 31,196.52 voting common shares, expires 11/12/2020)		479	484	—%
				591	596	—%
Spartan Energy Services, Inc. (3)	Louisiana / Energy	Senior Secured Term Loan (10.50% (LIBOR + 9.00% with 1.50% LIBOR floor), due 12/28/2017) (4)	$36,225	$36,225	$36,225	1.1%
				36,225	36,225	1.1%
Speedy Group Holdings Corp.	Canada / Consumer Finance	Senior Unsecured (12.00%, due 11/15/2017)(22)	15,000	15,000	15,000	0.5%
				15,000	15,000	0.5%
		Escrow Receivable		—	401	—%

Sport Helmets Holdings, LLC(14)	New York / Personal & Nondurable Consumer Products					
				—	401	—%
Stauber Performance Ingredients, Inc. (3), (4)	California / Food Products	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 1/21/2016)	13,451	13,451	13,451	0.4%
		Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 5/21/2017)	10,106	10,106	10,106	0.3%
				23,557	23,557	0.7%
Stryker Energy, LLC	Ohio / Oil & Gas Production	Subordinated Secured Revolving Credit Facility — $50,300 Commitment (12.25% (LIBOR + 10.75% with 1.50% LIBOR floor) plus 3.75% PIK, in non-accrual status effective 12/1/2011, due 12/1/2015)(4), (25)	35,409	32,711	—	—%
		Overriding Royalty Interests(18)		—	—	—%
				32,711	—	—%
Sudbury Mill CLO Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	28,200	26,173	25,978	0.8%
				26,173	25,978	0.8%
Symphony CLO IX Ltd.(22)	Cayman Islands / Diversified Financial Services	LP Certificates (Residual Interest)	45,500	39,449	46,012	1.4%
				39,449	46,012	1.4%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULES OF INVESTMENTS-(CONTINUED)
December 31, 2013 (Unaudited) and June 30, 2013 (Audited)
(in thousands, except share data)

			December 31, 2013 (Unaudited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
System One Holdings, LLC (3),(4)	Pennsylvania / Business Services	Senior Secured Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 12/31/2018)	48,000	48,000	48,000	1.5%
				48,000	48,000	1.5%
TB Corp. (3)	Texas / Consumer Service	Senior Subordinated Note (12.00% plus 1.50% PIK, due 12/18/2018)	23,539	23,539	23,539	0.7%
				23,539	23,539	0.7%
Targus Group International, Inc. (16)	California / Durable Consumer Products	First Lien Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor) plus 1.0% PIK, due 5/24/2016)(3),(4)	22,374	22,110	22,110	0.7%
				22,110	22,110	0.7%
TGG Medical Transitory, Inc.	New Jersey / Healthcare	Second Lien Term Loan (11.25% (LIBOR + 10.00% with 1.25% LIBOR floor), due 6/27/2018)(4), (16)	13,000	12,741	13,000	0.4%
				12,741	13,000	0.4%
Totes Isotoner Corporation	Ohio / Personal & Nondurable Consumer Products	Second Lien Term Loan (10.75%, (LIBOR + 9.25% with 1.50% LIBOR floor), due 1/8/2018)(3), (4)	$53,000	$52,836	$52,836	1.6%
				52,836	52,836	1.6%
Traeger Pellet Grills LLC(4)	Oregon / Durable Consumer Products	Senior Secured Term Loan A (6.50% (LIBOR + 4.50% with 2.00% LIBOR floor), due 6/18/2018)	29,550	29,550	29,550	0.9%
		Senior Secured Term Loan B (11.50% (LIBOR + 9.50% with 2.00% LIBOR floor), due 6/18/2018) (3)	29,850	29,850	29,850	0.9%
				59,400	59,400	1.8%
TransFirst Holdings, Inc.(4)	New York / Software & Computer	Second Lien Term Loan (11.00%, (LIBOR + 9.75% with 1.25% LIBOR floor),	5,000	4,872	5,000	0.2%

	Services	due 6/27/2018)				
				4,872	5,000	0.2%
United Bank Card, Inc. (d/b/a Harbortouch)	Pennsylvania / Business Services	Senior Secured Term Loan (11.50% (LIBOR + 9.50% with 2.00% LIBOR floor), due 9/5/2018) (3), (4)	25,371	25,371	25,371	0.8%
				25,371	25,371	0.8%
United Sporting Companies, Inc.(5)	South Carolina / Durable Consumer Products	Second Lien Term Loan (12.75% (LIBOR + 11.00% with 1.75% LIBOR floor), due 5/16/2018) (3) ,(4)	160,000	160,000	160,000	5.0%
				160,000	160,000	5.0%
Water Pik, Inc. (16)	Colorado / Personal & Nondurable Consumer Products	Second Lien Term Loan (9.75% (LIBOR + 8.75% with 1.00% LIBOR floor), due 1/8/2021) (4)	11,000	10,584	10,584	0.3%
				10,584	10,584	0.3%
Wind River Resources Corporation(39)	Utah / Oil & Gas Production	Senior Secured Note (13.00% (LIBOR + 7.50% with 5.50% LIBOR floor) plus 3.00% default interest on principal, 16.00% default interest on past due interest, in non-accrual status effective 12/1/2008, past due)(4)	15,000	14,750	—	—%
		Net Profits Interest (5.00% payable on Equity distributions)(7)		—	—	—%
				14,750	—	—%
	Total Non-control/Non-affiliate Investments (Level 3 Investments)			3,690,727	3,683,674	114.0%
	Total Level 3 Portfolio Investments			4,976,291	4,885,854	151.2%

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CONSOLIDATED SCHEDULES OF INVESTMENTS-(CONTINUED)
December 31, 2013 (Unaudited) and June 30, 2013 (Audited)
(in thousands, except share data)

			December 31, 2013 (Unaudited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 1 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Dover Saddlery, Inc.	Massachusetts / Retail	Common Stock (30,974 shares)		$63	$166	—%
				63	166	—%
	Total Non-control/Non-affiliate Investments (Level 1 Investments)			63	166	—%
	Total Portfolio Investments			4,976,354	4,886,020	151.2%
SHORT TERM INVESTMENTS: Money Market Funds (Level 2 Investments)						
Fidelity Institutional Money Market Funds — Government Portfolio (Class I)				179,468	179,468	5.6%
Fidelity Institutional Money Market Funds — Government Portfolio (Class I)(3)				41,382	41,382	1.3%
Victory Government Money Market Funds				—	—	—%
		Total Money Market Funds		220,850	220,850	6.9%
		Total Investments		$5,197,204	$5,106,870	158.1%

See notes to consolidated financial statements.

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULES OF INVESTMENTS-(CONTINUED)
December 31, 2013 (Unaudited) and June 30, 2013 (Audited)
(in thousands, except share data)

			June 30, 2013 (Audited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Control Investments (greater than 25.00% voting control)(44)						
AIRMALL USA, Inc.(27)	Pennsylvania / Property Management	Senior Secured Term Loan (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor), due 6/30/2015)(3), (4)	$28,750	$28,750	$28,750	1.1%
		Senior Subordinated Term Loan (12.00% plus 6.00% PIK, due 12/31/2015)	12,500	12,500	12,500	0.5%
		Convertible Preferred Stock (9,919.684 shares)		9,920	9,920	0.4%
		Common Stock (100 shares)		—	3,478	0.1%
				51,170	54,648	2.1%
Ajax Rolled Ring & Machine, Inc.	South Carolina / Manufacturing	Senior Secured Note — Tranche A (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 3/30/2018)(3), (4)	19,737	19,737	19,737	0.7%
		Subordinated Unsecured Term Loan (11.50% (LIBOR + 8.50% with 3.00% LIBOR floor) plus 6.00% PIK, due 3/30/2018)(4)	19,700	19,700	19,700	0.7%
		Convertible Preferred Stock — Series A (6,142.6 shares)		6,057	—	—%
		Unrestricted Common Stock (6 shares)		—	—	—%
				45,494	39,437	1.4%
APH Property Holdings, LLC(32)	Georgia / Real Estate	Senior Secured Note (6.00% (LIBOR + 4.00% with 2.00% LIBOR floor) plus 5.50% PIK, due 10/24/2020)(4)	125,892	125,892	125,892	4.8%
		Common Stock (148,951 shares)		26,648	26,648	1.0%
				152,540	152,540	5.8%
AWCNC, LLC(19)	North Carolina / Machinery	Members Units — Class A (1,800,000 units)		—	—	—%
		Members Units — Class B-1 (1 unit)		—	—	—%
		Members Units — Class B-2 (7,999,999 units)		—	—	—%
				—	—	—%

Borga, Inc.	California / Manufacturing	Revolving Line of Credit — $1,150 Commitment (5.00% (PRIME + 1.75%) plus 3.00% default interest, in non-accrual status effective 03/02/2010, past due)(4), (25)	1,150	1,095	586	—%
		Senior Secured Term Loan B (8.50% (PRIME + 5.25%) plus 3.00% default interest, in non-accrual status effective 03/02/2010, past due)(4)	1,611	1,501	—	—%
		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)	9,738	706	—	—%
		Common Stock (100 shares)(21)		—	—	—%
		Warrants (33,750 warrants)(21)		—	—	—%
				3,302	586	—%
CCPI Holdings, Inc.(33)	Ohio / Manufacturing	Senior Secured Note (10.00%, due 12/31/2017)(3)	17,663	17,663	17,663	0.7%
		Senior Secured Note (12.00% plus 7.00% PIK, due 6/30/2018)	7,659	7,659	7,659	0.3%
		Common Stock (100 shares)		8,581	7,977	0.3%
		Net Revenue Interest (4% of Net Revenue)		—	604	—%
				33,903	33,903	1.3%

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Portfolio Company	Locale / Industry	Investments(1)	June 30, 2013 (Audited) Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Control Investments (greater than 25.00% voting control)(44)						
Credit Central Holdings of Delaware, LLC (22), (34)	Ohio / Consumer Finance	Senior Secured Revolving Credit Facility — $60,000 Commitment (20.00% (LIBOR + 18.50% with 1.50% LIBOR floor), due 12/31/2022)(4), (25)	$38,082	$38,082	$38,082	1.4%
		Common Stock (100 shares)		9,581	8,361	0.3%
		Net Revenue Interest (5% of Net Revenue)		—	4,019	0.2%
				47,663	50,462	1.9%
Energy Solutions Holdings, Inc.(8)	Texas / Gas Gathering and Processing	Junior Secured Note (18.00%, due 12/12/2016)	8,500	8,500	8,500	0.3%
		Senior Secured Note to Vessel Holdings LLC (18.00%, due 12/12/2016)	3,500	3,500	3,500	0.1%
		Subordinated Secured Note to Jettco Marine Services, LLC (12.00% (LIBOR + 6.11% with 5.89% LIBOR floor) plus 4.00% PIK, in non-accrual status effective 10/1/2010, past due) (4)	13,906	12,503	8,449	0.3%
		Senior Secured Debt to Yatesville Coal Holdings, Inc. (Non-accrual status effective 1/1/2009, past due)	1,449	1,449	—	—%
		Escrow Receivable		—	—	—%
		Common Stock (100 shares)		8,318	6,247	0.2%
				34,270	26,696	0.9%
First Tower Holdings of Delaware, LLC (22), (29)	Mississippi / Consumer Finance	Senior Secured Revolving Credit Facility — $400,000 Commitment (20.00% (LIBOR + 18.50% with 1.50% LIBOR floor), due 6/30/2022)(4), (25)	264,760	264,760	264,760	10.0%
		Common Stock (83,729,323 shares)		43,193	20,447	0.8%
				—	12,877	0.5%

		Net Revenue Interest (5% of Net Revenue & Distributions)				
				307,953	298,084	11.3%
Manx Energy, Inc.(12)	Kansas / Oil & Gas Production	Senior Secured Note (13.00%, in non-accrual status effective 1/19/2010, past due)	500	500	346	—%
		Preferred Stock (6,635 shares)		—	—	—%
		Common Stock (17,082 shares)		—	—	—%
				500	346	—%
Nationwide Acceptance Holdings, LLC (22), (36)	Chicago / Consumer Finance	Senior Secured Revolving Credit Facility — $30,000 Commitment (20.00% (LIBOR + 18.50% with 1.50% LIBOR floor), due 1/31/2023)(4), (25)	21,308	21,308	21,308	0.8%
		Membership Units (100 shares)		3,843	2,142	0.1%
		Net Revenue Interest (5% of Net Revenue)		—	1,701	0.1%
				25,151	25,151	1.0%
NMMB Holdings, Inc. (24)	New York / Media	Senior Term Loan (14.00%, due 5/6/2016)	16,000	16,000	13,149	0.5%
		Senior Subordinated Term Loan (15.00%, due 5/6/2016)	2,800	2,800	—	—%
		Series A Preferred Stock (4,400 shares)		4,400	—	—%
				23,200	13,149	0.5%

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Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Control Investments (greater than 25.00% voting control)(44)						
R-V Industries, Inc.	Pennsylvania / Manufacturing	Senior Subordinated Note (10.00% (LIBOR + 9.00% with 1.00% LIBOR floor), due 6/12/2018)(4)	$32,750	$32,750	$32,750	1.2%
		Warrants (200,000 warrants, expiring 6/30/2017)		1,682	6,796	0.3%
		Common Stock (545,107 shares)		5,087	18,522	0.7%
				39,519	58,068	2.2%
The Healing Staff, Inc.(9)	North Carolina / Contracting	Secured Promissory Notes (15.00%, in non-accrual status effective 12/22/2010, past due)	1,688	1,686	—	—%
		Senior Demand Note (15.00%, in non-accrual status effective 11/1/2010, past due)	1,170	1,170	—	—%
		Common Stock (1,000 shares)		975	—	—%
				3,831	—	—%
Valley Electric Holdings I, Inc. (35)	Washington / Construction & Engineering	Senior Secured Note (9.00% (LIBOR + 6.00%, with 3.00% LIBOR floor) plus 9.00% PIK, due 12/31/2018)(4)	34,063	34,063	34,063	1.3%
		Senior Secured Note (8.00% (LIBOR + 5.00% with 3.00% LIBOR floor) plus 2.50% PIK, due 12/31/2017)(3),(4)	10,026	10,026	10,026	0.4%
		Common Stock (50,000 shares)		9,526	8,288	0.3%
		Net Revenue Interest (5% of Net Revenue)		—	1,238	0.1%
				53,615	53,615	2.1%
Wolf Energy Holdings, Inc.(12), (37)	Kansas / Oil & Gas Production	Senior Secured Promissory Note secured by assets formerly owned by H&M	22,000	—	3,832	0.1%

		(18.00%, in non-accrual status effective 4/15/2013, due 4/15/2018)				
		Appalachian Energy Holdings, LLC ("AEH") — Senior Secured First Lien Note (8.00%, in non-accrual status effective 1/19/2010, past due)	2,642	2,000	546	—%
		Appalachian Energy Holdings, LLC ("AEH") — Senior Secured First Lien Note (8.00%, in non-accrual status, past due)	51	50	51	—%
		Coalbed, LLC — Senior Secured Note (8.00%, in non-accrual status effective 1/19/2010, past due)(6)	7,930	5,990	—	—%
		Common Stock (100 shares)		—	—	—%
		Net Profits Interest (8.00% payable on Equity distributions)(7)		—	520	—%
				8,040	4,949	0.1%
Total Control Investments				830,151	811,634	30.6%
Affiliate Investments (5.00% to 24.99% voting control)(45)						
BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork)	Michigan / Healthcare	Senior Secured Note (10.00% (LIBOR + 8.00% with 2.00% LIBOR floor), due 12/17/2017)(3),(4)	29,550	29,550	29,550	1.1%
		Preferred Stock Series A (9,925.455 shares)(13)		2,300	2,832	0.1%
		Preferred Stock Series B (1,753.64 shares)(13)		579	533	—%
				32,429	32,915	1.2%

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Portfolio Company	Locale / Industry	Investments(1)	June 30, 2013 (Audited) Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Affiliate Investments (5.00% to 24.99% voting control)(45)						
Boxercraft Incorporated(20)	Georgia / Textiles & Leather	Senior Secured Term Loan A (10.00% plus 1.00% PIK, due 9/15/2015)	$1,712	$1,702	$1,712	0.1%
		Senior Secured Term Loan B (10.00% plus 1.00% PIK, due 9/15/2015)	4,892	4,809	4,892	0.2%
		Senior Secured Term Loan C (10.00% plus 1.00% PIK, due 9/15/2015)	2,371	2,371	2,371	0.1%
		Senior Secured Term Loan (10.00% plus 1.00% PIK, due 9/15/2015)	8,325	7,878	410	—%
		Preferred Stock (1,000,000 shares)		—	—	—%
		Common Stock (10,000 shares)		—	—	—%
		Warrants (1 warrant, expiring 8/31/2022)		—	—	—%
				16,760	9,385	0.4%
Smart, LLC(14)	New York / Diversified / Conglomerate Service	Membership Interest		—	143	—%
				—	143	—%
Total Affiliate Investments				49,189	42,443	1.6%
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
ADAPCO, Inc.	Florida / Ecological	Common Stock (5,000 shares)		141	335	—%
				141	335	—%
Aderant North America, Inc.	Georgia / Software & Computer Services	Second Lien Term Loan (10.00% (LIBOR + 8.75% with 1.25% LIBOR floor), due 6/20/2019)(4)	7,000	6,900	7,000	0.3%

				6,900	7,000	0.3%
Aircraft Fasteners International, LLC	California / Machinery	Convertible Preferred Stock (32,500 units)		396	565	—%
				396	565	—%
ALG USA Holdings, LLC	Pennsylvania / Hotels, Restaurants & Leisure	Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 2/28/2020)(4)	12,000	11,764	12,000	0.4%
				11,764	12,000	0.4%
Allied Defense Group, Inc.	Virginia / Aerospace & Defense	Common Stock (10,000 shares)		56	—	—%
				56	—	—%
American Gilsonite Company	Utah / Specialty Minerals	Second Lien Term Loan (11.50%, due 9/1/2017)	38,500	38,500	38,500	1.4%
		Membership Interest in AGC/PEP, LLC (99.9999%)(15)		—	4,058	0.2%
				38,500	42,558	1.6%
Apidos CLO VIII, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	19,730	19,931	19,718	0.7%
				19,931	19,718	0.7%

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LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Apidos CLO IX, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	$20,525	$19,609	$19,294	0.7%
				19,609	19,294	0.7%
Apidos CLO XI, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	38,340	39,239	37,972	1.4%
				39,239	37,972	1.4%
Apidos CLO XII, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	44,063	43,480	40,294	1.5%
				43,480	40,294	1.5%
Arctic Glacier U.S.A, Inc.(4)	Canada / Food Products	Second Lien Term Loan (11.25% (LIBOR + 10.00% with 1.25% LIBOR floor), due 11/10/2019)	150,000	150,000	150,000	5.6%
				150,000	150,000	5.6%
Armor Holding II LLC(4), (16)	New York / Diversified Financial Services	Second Lien Term Loan (9.25% (LIBOR + 8.00% with 1.25% LIBOR floor), due 12/26/2020)	7,000	6,860	7,000	0.3%
				6,860	7,000	0.3%
Atlantis Healthcare Group (Puerto Rico), Inc.(4)	Puerto Rico / Healthcare	Revolving Line of Credit — $7,000 Commitment (10.00% (LIBOR + 8.00% with 2.00% LIBOR floor), due 2/21/2014)(25),(26)	2,000	2,000	2,000	0.1%
		Senior Term Loan (10.00% (LIBOR + 8.00% with 2.00% LIBOR floor), due 2/21/2018)(3)	39,352	39,352	39,352	1.5%
				41,352	41,352	1.6%

Babson CLO Ltd 2011-I(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	35,000	34,499	34,450	1.3%
				34,499	34,450	1.3%
Babson CLO Ltd 2012-IA(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	29,075	25,917	27,269	1.0%
				25,917	27,269	1.0%
Babson CLO Ltd 2012-IIA(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	27,850	28,863	27,510	1.0%
				28,863	27,510	1.0%
Blue Coat Systems, Inc. (16)	Massachusetts / Software & Computer Services	Second Lien Term Loan (9.50% (LIBOR + 8.50% with 1.00% LIBOR floor), due 6/28/2020)(4)	11,000	10,890	11,000	0.4%
				10,890	11,000	0.4%
Broder Bros., Co.	Pennsylvania / Textiles, Apparel & Luxury Goods	Senior Secured Notes (10.75% (LIBOR + 9.00% with 1.75% LIBOR floor), due 6/27/2018)(3),(4)	99,500	99,500	99,323	3.7%
				99,500	99,323	3.7%

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LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Brookside Mill CLO Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	$26,000	$23,896	$23,743	0.9%
				23,896	23,743	0.9%
Byrider Systems Acquisition Corp (22)	Indiana / Auto Finance	Senior Subordinated Notes (12.00% plus 2.00% PIK, due 11/3/2016)(3)	10,914	10,914	10,417	0.4%
				10,914	10,417	0.4%
Caleel + Hayden, LLC (14), (31)	Colorado / Personal & Nondurable Consumer Products	Membership Units (13,220 shares)		—	104	—%
		Escrow Receivable		—	137	—%
				—	241	—%
Capstone Logistics, LLC(4)	Georgia / Commercial Services	Senior Secured Term Loan A (6.50% (LIBOR + 5.00% with 1.50% LIBOR floor), due 9/16/2016)	97,291	97,291	97,291	3.7%
		Senior Secured Term Loan B (11.50% (LIBOR + 10.00% with 1.50% LIBOR floor), due 9/16/2016)(3)	100,000	100,000	100,000	3.8%
				197,291	197,291	7.5%
Cargo Airport Services USA, LLC	New York / Transportation	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 3/31/2016) (3), (4)	43,977	43,977	44,417	1.7%
		Common Equity (1.6 units)		1,639	1,860	0.1%
				45,616	46,277	1.8%

Cent CLO 17 Limited(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	24,870	24,615	25,454	1.0%
				24,615	25,454	1.0%
CI Holdings(4)	Texas / Software & Computer Services	Senior Secured Term Loan (10.00% (LIBOR + 5.00% with 5.00% LIBOR floor), due 6/11/2019)	114,713	114,713	114,713	4.3%
				114,713	114,713	4.3%
CIFC Funding 2011-I, Ltd.(4), (22)	Cayman Islands / Diversified Financial Services	Secured Class D Notes (5.32% (LIBOR + 5.00%), due 1/19/2023)	19,000	15,029	15,844	0.6%
		Unsecured Class E Notes (7.32% (LIBOR + 7.00%), due 1/19/2023)	15,400	12,638	12,745	0.5%
				27,667	28,589	1.1%
Cinedigm DC Holdings, LLC (4)	New York / Software & Computer Services	Senior Secured Term Loan (11.00% (LIBOR + 9.00% with 2.00% LIBOR floor) plus 2.50% PIK, due 3/31/2021)	70,595	70,595	70,595	2.7%
				70,595	70,595	2.7%
The Copernicus Group, Inc.	North Carolina / Healthcare	Escrow Receivable		—	130	—%
				—	130	—%

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Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Correctional Healthcare Holding Company, Inc.	Colorado / Healthcare	Second Lien Term Loan (11.25%, due 1/11/2020)(3)	$27,100	$27,100	$27,100	1.0%
				27,100	27,100	1.0%
Coverall North America, Inc.	Florida / Commercial Services	Senior Secured Term Loan (11.50% (LIBOR + 8.50% with 3.00% LIBOR floor), due 12/17/2017)(3) ,(4)	39,303	39,303	39,303	1.5%
				39,303	39,303	1.5%
CP Well Testing, LLC	Oklahoma / Oil & Gas Products	Senior Secured Term Loan (13.50% (LIBOR + 11.00% with 2.50% LIBOR floor), due 10/03/2017)(4)	19,125	19,125	19,125	0.7%
				19,125	19,125	0.7%
CRT MIDCO, LLC	Wisconsin / Media	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 6/30/2017)(3), (4)	71,106	71,106	71,106	2.7%
				71,106	71,106	2.7%
Deltek, Inc.	Virginia / Software & Computer Services	Second Lien Term Loan (10.00% (LIBOR + 8.75% with 1.25% LIBOR floor), due 10/10/2019)(4)	12,000	11,833	12,000	0.5%
				11,833	12,000	0.5%
Diamondback Operating, LP	Oklahoma / Oil & Gas Production	Net Profits Interest (15.00% payable on Equity distributions)(7)		—	—	—%
				—	—	—%
Edmentum, Inc (f/k/a Archipelago Learning, Inc)(4)	Minnesota / Consumer Services	Second Lien Term Loan (11.25% (LIBOR + 9.75% with 1.50% LIBOR floor), due 5/17/2019)	50,000	48,218	50,000	1.9%
				48,218	50,000	1.9%
EIG Investors Corp	Massachusetts / Software & Computer Services	Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 5/09/2020)(4), (16)	22,000	21,792	22,000	0.8%

				21,792	22,000	0.8%
Empire Today, LLC	Illinois / Durable Consumer Products	Senior Secured Note (11.375%, due 2/1/2017)	15,700	15,332	14,650	0.6%
				15,332	14,650	0.6%
EXL Acquisition Corp.	South Carolina / Biotechnology	Escrow Receivable		—	14	—%
				—	14	—%
Evanta Ventures, Inc. (11)	Oregon / Commercial Services	Subordinated Unsecured (12.00% plus 1.00% PIK, due 9/28/2018)	10,479	10,479	10,479	0.4%
				10,479	10,479	0.4%

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LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Fairchild Industrial Products, Co.	North Carolina / Electronics	Escrow Receivable		$ —	$149	—%
				—	149	—%
Fischbein, LLC	North Carolina / Machinery	Escrow Receivable		—	225	—%
				—	225	—%
Focus Brands, Inc. (4).	Georgia / Consumer Services	Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 8/21/2018)	$18,000	17,731	18,000	0.7%
				17,731	18,000	0.7%
FPG, LLC	Illinois / Durable Consumer Products	Senior Secured Term Loan (12.00% (LIBOR + 11.00% with 1.00% LIBOR floor), due 1/20/2017)(4)	21,401	21,401	21,401	0.8%
		Common Stock (5,638 shares)		27	19	—%
				21,428	21,420	0.8%
Galaxy XII CLO, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	22,000	20,792	21,657	0.8%
				20,792	21,657	0.8%
Galaxy XV CLO, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	35,025	32,119	30,227	1.1%
				32,119	30,227	1.1%
Grocery Outlet, Inc.	California / Retail	Second Lien Term Loan (10.50% (LIBOR + 9.25% with 1.25% LIBOR floor), due 6/17/2019)(4)	14,457	14,127	14,457	0.5%
				14,127	14,457	0.5%
Gulf Coast Machine & Supply Company	Texas / Manufacturing	Senior Secured Term Loan (10.50% (LIBOR + 8.50% with 2.00% LIBOR floor), due 10/12/2017)(3),(4)	41,213	41,213	31,972	1.2%
				41,213	31,972	1.2%

Halcyon Loan Advisors Funding 2012-I, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	23,188	22,279	22,724	0.9%
				22,279	22,724	0.9%
Halcyon Loan Advisors Funding 2013-I, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	40,400	41,085	38,291	1.4%
				41,085	38,291	1.4%

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LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Hoffmaster Group, Inc.(4)	Wisconsin / Personal & Nondurable Consumer Products	Second Lien Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 1/3/2019)	$20,000	$19,831	$19,598	0.7%
		Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 1/3/2019)	1,000	991	955	—%
				20,822	20,553	0.7%
ICON Health & Fitness, Inc.	Utah / Durable Consumer Products	Senior Secured Note (11.875%, due 10/15/2016)(3)	43,100	43,310	33,929	1.3%
				43,310	33,929	1.3%
IDQ Holdings, Inc.	Texas / Automobile	Senior Secured Note (11.50%, due 4/1/2017)	12,500	12,300	12,500	0.5%
				12,300	12,500	0.5%
ING IM CLO 2012-II, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	38,070	34,904	36,848	1.4%
				34,904	36,848	1.4%
ING IM CLO 2012-III, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	46,632	44,454	46,361	1.7%
				44,454	46,361	1.7%
ING IM CLO 2012-IV, Ltd.(22)	Cayman Islands / Diversified Financial Services	Income Notes (Residual Interest)	40,613	39,255	41,153	1.5%
				39,255	41,153	1.5%
Injured Workers Pharmacy LLC	Massachusetts / Healthcare	Second Lien Debt (11.50% (LIBOR + 7.00% with 4.50% LIBOR floor) plus 1.00% PIK, due 5/31/2019)(3), (4)	22,430	22,430	22,430	0.8%
				22,430	22,430	0.8%
Interdent, Inc.(4)			53,475	53,475	53,475	2.0%

	California / Healthcare	Senior Secured Term Loan A (8.00% (LIBOR + 6.50% with 1.50% LIBOR floor), due 8/3/2017)				
		Senior Secured Term Loan B (13.00% (LIBOR + 10.00% with 3.00% LIBOR floor), due 8/3/2017)(3)	55,000	55,000	55,000	2.1%
				108,475	108,475	4.1%
JHH Holdings, Inc.	Texas / Healthcare	Second Lien Debt (12.00% (LIBOR + 10.00% with 2.00% LIBOR floor) plus 1.50% PIK, due 6/23/2018)(3), (4)	16,119	16,119	16,119	0.6%
				16,119	16,119	0.6%
LaserShip, Inc.(4)	Virginia / Transportation	Revolving Line of Credit — $5,000 Commitment (10.25% (LIBOR + 8.25% with 2.00% LIBOR floor), due 12/21/2014)(25)	—	—	—	—%
		Senior Secured Term Loan (10.25% (LIBOR + 8.25% with 2.00% LIBOR floor), due 12/21/2017)(3)	37,031	37,031	37,031	1.4%
				37,031	37,031	1.4%

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			June 30, 2013 (Audited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
LCM XIV CLO Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	$26,500	$25,838	$25,838	1.0%
				25,838	25,838	1.0%
LHC Holdings Corp.	Florida / Healthcare	Revolving Line of Credit — $750 Commitment (8.50% (LIBOR + 6.00% with 2.50% LIBOR floor), due 5/31/2015)(4), (25), (26)	—	—	—	—%
		Senior Subordinated Debt (10.50%, due 5/31/2015)(3)	2,865	2,865	2,865	0.1%
		Membership Interest (125 units)		216	245	—%
				3,081	3,110	0.1%
Madison Park Funding IX, Ltd.(22)	Cayman Islands / Diversified Financial Services	Income Notes (Residual Interest)	31,110	26,401	26,596	1.0%
				26,401	26,596	1.0%
Material Handling Services, LLC (4)	Ohio / Business Services	Senior Secured Term Loan (10.50% (LIBOR + 8.50% with 2.00% LIBOR floor), due 7/5/2017) (3)	27,580	27,580	27,199	1.0%
		Senior Secured Term Loan (10.00% (LIBOR + 8.00% with 2.00% LIBOR floor), due 12/21/2017)	37,959	37,959	37,035	1.4%
				65,539	64,234	2.4%
Maverick Healthcare, LLC	Arizona / Healthcare	Preferred Units (1,250,000 units)		1,252	780	—%
		Common Units (1,250,000 units)		—	—	—%
				1,252	780	—%
Mountain View CLO 2013-I Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	43,650	44,235	43,192	1.6%

				44,235	43,192	1.6%
Medical Security Card Company, LLC(4)	Arizona / Healthcare	Revolving Line of Credit — $1,500 Commitment (9.50% (LIBOR + 7.00% with 2.50% LIBOR floor), due 2/1/2016)(25)	—	—	—	—%
		First Lien Term Loan (11.25% (LIBOR + 8.75% with 2.50% LIBOR floor), due 2/1/2016)(3)	13,427	13,427	13,427	0.5%
				13,427	13,427	0.5%
National Bankruptcy Services, LLC (3),(4)	Texas / Diversified Financial Services	Senior Subordinated Term Loan (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor) plus 1.50% PIK, due 7/17/2017)	18,683	18,683	16,883	0.6%
				18,683	16,883	0.6%
Naylor, LLC(4)	Florida / Media	Revolving Line of Credit — $2,500 Commitment (11.00% (LIBOR + 8.00% with 3.00% LIBOR floor), due 6/7/2017)(25)	—	—	—	—%
		Senior Secured Term Loan (11.00% (LIBOR + 8.00% with 3.00% LIBOR floor), due 6/7/2017)(3)	46,170	46,170	46,170	1.7%
				46,170	46,170	1.7%

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			June 30, 2013 (Audited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
New Century Transportation, Inc.	New Jersey / Transportation	Senior Subordinated Term Loan (12.00% (LIBOR + 10.00% with 2.00% LIBOR floor) plus 3.00% PIK, due 2/3/2018)(3), (4)	$45,120	$45,120	$44,166	1.7%
				45,120	44,166	1.7%
New Star Metals, Inc.	Indiana / Metal Services & Minerals	Senior Subordinated Term Loan (11.50% (LIBOR + 8.50% with 3.00% LIBOR floor) plus 1.00% PIK, due 2/2/2018)(4)	50,274	50,274	50,274	1.9%
				50,274	50,274	1.9%
Nixon, Inc.	California / Durable Consumer Products	Senior Secured Term Loan (8.75% plus 2.75% PIK, due 4/16/2018)(16)	15,509	15,252	14,992	0.6%
				15,252	14,992	0.6%
NRG Manufacturing, Inc.	Texas / Manufacturing	Escrow Receivable		—	3,618	0.1%
				—	3,618	0.1%
Pegasus Business Intelligence, LP(4)	Texas / Diversified Financial Services	Revolving Line of Credit — $2,500 Commitment (9.00% (LIBOR + 7.75% with 1.25% LIBOR floor), due 4/18/2014)(25)	—	—	—	—%
		Senior Secured Term Loan A (6.75% (LIBOR + 5.50% with 1.25% LIBOR floor), due 4/18/2018)	15,938	15,938	15,938	0.6%
		Senior Secured Term Loan B (13.75% (LIBOR + 12.50% with 1.25% LIBOR floor), due 4/18/2018)	15,938	15,938	15,938	0.6%
				31,876	31,876	1.2%
Octagon Investment Partners XV, Ltd. (22)	Cayman Islands / Diversified Financial Services	Income Notes (Residual Interest)	26,901	26,919	25,515	1.0%

				26,919	25,515	1.0%
Pelican Products, Inc.(16)	California / Durable Consumer Products	Subordinated Secured (11.50% (LIBOR + 10.00% with 1.50% LIBOR floor), due 6/14/2019)(3),(4)	15,000	14,729	15,000	0.6%
				14,729	15,000	0.6%
Pinnacle (US) Acquisition Co Limited(16)	Texas / Software & Computer Services	Second Lien Term Loan (10.50% (LIBOR + 9.25% with 1.25% LIBOR floor), due 8/3/2020)(4)	10,000	9,815	10,000	0.4%
				9,815	10,000	0.4%
Pre-Paid Legal Services, Inc.(16)	Oklahoma / Consumer Services	Senior Subordinated Term Loan (11.50% (PRIME + 8.25%), due 12/31/2016)(3),(4)	5,000	5,000	5,000	0.2%
				5,000	5,000	0.2%
Prince Mineral Holding Corp.	New York / Metal Services & Minerals	Senior Secured Term Loan (11.50%, due 12/15/2019)	10,000	9,888	10,000	0.4%
				9,888	10,000	0.4%

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			June 30, 2013 (Audited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Progrexion Holdings, Inc.(4) (28)	Utah / Consumer Services	Senior Secured Term Loan (10.50% (LIBOR + 8.50% with 2.00% LIBOR floor), due 9/14/2017)(3)	$241,033	$241,033	$241,033	9.1%
				241,033	241,033	9.1%
Rocket Software, Inc.(3), (4)	Massachusetts / Software & Computer Services	Second Lien Term Loan (10.25% (LIBOR + 8.75% with 1.50% LIBOR floor), due 2/8/2019)	20,000	19,719	20,000	0.8%
				19,719	20,000	0.8%
Royal Adhesives & Sealants, LLC	Indiana / Chemicals	Senior Subordinated Unsecured Term Loan (12.00% plus 2.00% PIK, due 11/29/2016)	28,364	28,364	28,648	1.1%
				28,364	28,648	1.1%
Ryan, LLC(4)	Texas / Business Services	Subordinated Secured (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor) plus 3.00% PIK, due 6/30/2018)	70,000	70,000	70,000	2.6%
				70,000	70,000	2.6%
Sandow Media, LLC	Florida / Media	Senior Secured Term Loan (10.50% (LIBOR + 8.50% with 2.00% LIBOR floor) plus 1.50% PIK, due 5/8/2018)(4)	24,900	24,900	24,900	0.9%
				24,900	24,900	0.9%
Seaton Corp.(3), (4)	Illinois / Business Services	Subordinated Secured (12.50% (LIBOR + 9.00% with 3.50% LIBOR floor) plus 2.00% PIK, due 3/14/2014)	3,305	3,249	3,305	0.1%
		Subordinated Secured (12.50% (LIBOR + 9.00% with 3.50% LIBOR floor) plus 2.00% PIK, due 3/14/2015)	10,005	10,005	10,005	0.4%

				13,254	13,310	0.5%
SESAC Holdco II LLC(16)	Tennessee / Media	Second Lien Term Loan (10.00% (LIBOR + 8.75% with 1.25% LIBOR floor), due 7/12/2019)(4)	6,000	5,914	6,000	0.2%
				5,914	6,000	0.2%
Skillsoft Public Limited Company (22)	Ireland / Software & Computer Services	Senior Unsecured (11.125%, due 6/1/2018)	15,000	14,927	15,000	0.6%
				14,927	15,000	0.6%
Snacks Holding Corporation	Minnesota / Food Products	Series A Preferred Stock (4,021.45 shares)		56	56	—%
		Series B Preferred Stock (1,866.10 shares)		56	56	—%
		Warrant (to purchase 31,196.52 voting common shares, expires 11/12/2020)		479	484	—%
				591	596	—%
Southern Management Corporation (22), (30)	South Carolina / Consumer Finance	Second Lien Term Loan (12.00% plus 5.00% PIK, due 5/31/2017)	17,565	17,565	18,267	0.7%
				17,565	18,267	0.7%

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			June 30, 2013 (Audited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Spartan Energy Services, Inc.(3), (4)	Louisiana / Energy	Senior Secured Term Loan (10.50% (LIBOR + 9.00% with 1.50% LIBOR floor), due 12/28/2017)	$29,625	$29,625	$29,625	1.1%
				29,625	29,625	1.1%
Speedy Group Holdings Corp.	Canada / Consumer Finance	Senior Unsecured (12.00%, due 11/15/2017)(22)	15,000	15,000	15,000	0.6%
				15,000	15,000	0.6%
Sport Helmets Holdings, LLC(14)	New York / Personal & Nondurable Consumer Products	Escrow Receivable		—	389	—%
				—	389	—%
Stauber Performance Ingredients, Inc. (3), (4)	California / Food Products	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 1/21/2016)	16,594	16,594	16,594	0.6%
		Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 5/21/2017)	10,238	10,238	10,238	0.4%
				26,832	26,832	1.0%
Stryker Energy, LLC	Ohio / Oil & Gas Production	Subordinated Secured Revolving Credit Facility — $50,300 Commitment (8.50% (LIBOR + 7.00% with 1.50% LIBOR floor) plus 3.75% PIK, in non-accrual status effective 12/1/2011, due 12/1/2015)(4), (25)	34,738	32,711	—	—%
		Overriding Royalty Interests(18)		—	—	—%
				32,711	—	—%
Symphony CLO, IX Ltd.(22)	Cayman Islands / Diversified	LP Certificates (Residual Interest)	45,500	42,289	43,980	1.7%

	Financial Services					
				42,289	43,980	1.7%
System One Holdings, LLC (3),(4)	Pennsylvania / Business Services	Senior Secured Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 12/31/2018)	32,000	32,000	32,000	1.2%
				32,000	32,000	1.2%
TB Corp. (3)	Texas / Consumer Service	Senior Subordinated Note (12.00% plus 1.50% PIK, due 12/18/2018)	23,361	23,361	23,361	0.9%
				23,361	23,361	0.9%
Targus Group International, Inc. (16)	California / Durable Consumer Products	First Lien Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 5/25/2016)(3),(4)	23,520	23,209	23,520	0.9%
				23,209	23,520	0.9%
TGG Medical Transitory, Inc.	New Jersey / Healthcare	Second Lien Term Loan (11.25% (LIBOR + 10.00% with 1.25% LIBOR floor), due 6/27/2018)(4), (16)	8,000	7,773	8,000	0.3%
				7,773	8,000	0.3%

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Portfolio Company	Locale / Industry	Investments(1)	June 30, 2013 (Audited) Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
The Petroleum Place, Inc.	Colorado / Software & Computer Services	Second Lien Term Loan (10.00% (LIBOR + 8.75% with 1.25% LIBOR floor), due 5/20/2019)(4)	$22,000	$21,690	$22,000	0.8%
				21,690	22,000	0.8%
Totes Isotoner Corporation	Ohio / Nondurable Consumer Products	Second Lien Term Loan (10.75%, (LIBOR + 9.25% with 1.50% LIBOR floor), due 1/8/2018)(3), (4)	39,000	39,000	39,000	1.5%
				39,000	39,000	1.5%
Traeger Pellet Grills LLC(4)	Oregon / Durable Consumer Products	Revolving Line of Credit — $10,000 Commitment (9.00% (LIBOR + 7.00% with 2.00% LIBOR floor), due 6/18/2014)(25)	6,143	6,143	6,143	0.3%
		Senior Secured Term Loan A (6.50% (LIBOR + 4.50% with 2.00% LIBOR floor), due 6/18/2018)	30,000	30,000	30,000	1.1%
		Senior Secured Term Loan B (11.50% (LIBOR + 9.50% with 2.00% LIBOR floor), due 6/18/2018)	30,000	30,000	30,000	1.1%
				66,143	66,143	2.5%
TransFirst Holdings, Inc.(4)	New York / Software & Computer Services	Second Lien Term Loan (11.00%, (LIBOR + 9.75% with 1.25% LIBOR floor), due 6/27/2018)	5,000	4,860	5,000	0.2%
				4,860	5,000	0.2%
United Sporting Companies, Inc.(5)	South Carolina / Durable Consumer Products	Second Lien Term Loan (12.75% (LIBOR + 11.00% with 1.75% LIBOR floor), due 5/16/2018)(4)	160,000	160,000	160,000	6.0%
				160,000	160,000	6.0%
Wind River Resources Corp. and Wind River II Corp.	Utah / Oil & Gas Production	Senior Secured Note (13.00% (LIBOR + 7.50% with 5.50% LIBOR floor) plus 3.00% default interest	15,000	14,750	—	—%

	on principal, 16.00% default interest on past due interest, in non-accrual status effective 12/1/2008, past due)(4)			
	Net Profits Interest (5.00% payable on Equity distributions)(7)	—	—	—%
		14,750	—	—%
Total Non-control/Non-affiliate Investments (Level 3 Investments)		3,376,375	3,318,663	124.9%
Total Level 3 Portfolio Investments		4,255,715	4,172,740	157.1%

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			June 30, 2013 (Audited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 1 PORTFOLIO INVESTMENTS:						
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Dover Saddlery, Inc.	Massachusetts / Retail	Common Stock (30,974 shares)		$63	$112	—%
				63	112	—%
	Total Non-control/Non-affiliate Investments (Level 1 Investments)			63	112	—%
	Total Portfolio Investments			4,255,778	4,172,852	157.1%
SHORT TERM INVESTMENTS: Money Market Funds (Level 2 Investments)						
Fidelity Institutional Money Market Funds — Government Portfolio (Class I)				83,456	83,456	3.1%
Fidelity Institutional Money Market Funds — Government Portfolio (Class I)(3)				49,804	49,804	1.9%
Victory Government Money Market Funds				10,002	10,002	0.4%
		Total Money Market Funds		143,262	143,262	5.4%
		Total Investments		$4,399,040	$4,316,114	162.5%

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Endnote Explanations for the Consolidated Schedules of Investments as of December 31, 2013 and June 30, 2013

(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 December 31, 2013 and June 30, 2013, one of our portfolio investments, Dover Saddlery, Inc. was publicly traded and classified as Level 1 within the valuation hierarchy established by ASC 820, Fair Value Measurements ("ASC 820"). As of December 31, 2013 and June 30, 2013, 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 Notes 2 and 3 within the accompanying notes to consolidated financial statements for further discussion.

(3) Security, or a portion thereof, is held by Prospect Capital Funding LLC ("PCF"), our wholly-owned subsidiary and a bankruptcy remote special purpose entity, and is pledged as collateral for the revolving credit facility and such security is not available as collateral to our general creditors (see Note 4). The fair values of these investments held by PCF at December 31, 2013 and June 30, 2013 were $1,075,441 and $883,114, respectively; they represent 21.1% and 20.5% of our total investments and money market funds, respectively.

(4) Security, or portion thereof, has a floating interest rate which may be subject to a LIBOR or PRIME floor. Stated interest rate was in effect at December 31, 2013 and June 30, 2013.

(5) Ellett Brothers, LLC, Evans Sports, Inc., Jerry's Sports, Inc., Simmons Gun Specialties, Inc., Bonitz Brothers, Inc., and Outdoor Sports Headquarters, Inc. are joint borrowers on our second lien loan. United Sporting Companies, Inc. is a parent guarantor of this debt investment.

(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 were assigned to Manx, the holding company. On June 30, 2012, Manx reassigned our investment in Coalbed to Wolf Energy Holdings, Inc. ("Wolf"), a newly-formed, separately owned holding company. Our Board of Directors set the fair value at zero for the loan position in Coalbed LLC investment as of December 31, 2013 and June 30, 2013.

(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) During the quarter ended December 31, 2011, our ownership of Change Clean Energy Holdings, Inc., Change Clean Energy, Inc., Freedom Marine Services Holdings, LLC ("Freedom Marine"), and Yatesville Coal Holdings, Inc. was transferred to Energy Solutions Holdings, Inc. (f/k/a Gas Solutions Holdings, Inc.) ("Energy

Solutions") to consolidate all of our energy holdings under one management team. We own 100% of Energy Solutions. On November 25, 2013, we provided $13,000 in senior secured debt financing for the recapitalization of our investment in Jettco Marine Services, LLC ("Jettco"), a subsidiary of Freedom Marine. The subordinated secured loan to Jettco was replaced with a senior secured note to Vessel Holdings II, LLC, a new subsidiary of Freedom Marine. On December 3, 2013, we made a $16,000 senior secured investment in Vessel Holdings III, LLC, another new subsidiary of Freedom Marine.

(9) We own 1,000 shares of common stock in The Healing Staff, Inc. (f/k/a Lisamarie Fallon, Inc.), representing 100% ownership.

(10) GTP Operations, LLC (formerly known as CI (Transplace) Holdings, LLC), Transplace, LLC, CI (Transplace) International, LLC, Transplace Freight Services, LLC, Transplace Texas, LP, Transplace Stuttgart, LP, Transplace International, Inc., Celtic International, LLC, and Treetop Merger Sub, LLC are joint borrowers on our senior secured investment.

(11) Evanta Ventures, Inc. and Sports Leadership Institute, Inc. are joint borrowers on our investment.

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Endnote Explanations for the Consolidated Schedules of Investments as of December 31, 2013 and June 30, 2013 (Continued)

(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, Inc. ("Manx"), a new entity consisting of 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. On June 30, 2012, Manx reassigned our investments in Coalbed and AEH to Wolf, a newly-formed, separately owned holding company. We continue to fully reserve any income accrued for Manx. During the quarter ended June 30, 2013, we determined that the impairment of Manx was other-than-temporary and recorded a realized loss of $9,397 for the amount that the amortized cost exceeded the fair value. The Board of Directors set the fair value of our investment in Manx at zero and $346 as of December 31, 2013 and June 30, 2013, respectively.

(13) On a fully diluted basis represents 10.00% of voting common shares.

(14) A portion of the positions listed was issued by an affiliate of the portfolio company.

(15) 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 5,111 vested and unvested management options) of American Gilsonite Holding Company which owns 100% of American Gilsonite Company.

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

(17) Our wholly-owned entity, MITY Holdings of Delaware Inc., owns 98.6% (42,053 common shares) of MITY Enterprises, Inc., the operating company.

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

(19) On December 31, 2009, we sold our investment in Aylward Enterprises, LLC. AWCNC, LLC is the remaining holding company with zero assets. Our remaining outstanding debt after the sale was written off on December 31, 2009 and no value has been assigned to the equity position as of December 31, 2013 and June 30, 2013.

(20) We own a warrant to purchase 3,755,000 shares of Series A Preferred Stock, 625,000 shares of Series B Preferred Stock, and 43,800 shares of Voting Common Stock in Boxercraft Incorporated.

(21) 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 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.

(22) Certain investments that we have determined are not "qualifying" assets under Section 55(a) of the Investment Company Act of 1940 (the "1940 Act"). Under the 1940 Act, we may not acquire any non-qualifying asset unless,

at the time such acquisition is made, qualifying assets represent at least 70% of our total assets. We monitor the status of these assets on an ongoing basis.

(23) NCP Finance Limited Partnership, NCP Finance Ohio, LLC and certain affiliates thereof, are joint borrowers on our subordinated secured investment.

(24) On May 6, 2011, we made a secured first lien $24,250 debt investment to NMMB Acquisition, Inc., a $2,800 secured debt and $4,400 equity investment to NMMB Holdings, Inc. We owned 100% of the Series A Preferred Stock in NMMB Holdings, Inc. NMMB Holdings, Inc. owned 100% of the Convertible Preferred in NMMB Acquisition, Inc. On December 13, 2013, we provided $8,086 in preferred equity for the recapitalization of NMMB Holdings, Inc. After the restructuring, we received repayment of $2,800 secured debt outstanding. NMMB Holdings, Inc. now owns 7,200 shares (or 53.6%) of Series A Convertible Preferred Stock of NMMB Acquisition, Inc. and 5,286 shares (or 39.3%) of Series B Convertible Preferred Stock of NMMB Acquisition, Inc. Our fully diluted ownership in NMMB Holdings, Inc. is 100% as of December 31, 2013 and June 30, 2013. Our fully diluted ownership in NMMB Acquisition, Inc. is 89.8% and 83.5% as of December 31, 2013 and June 30, 2013, respectively.

(25) Undrawn committed revolvers to our portfolio companies incur commitment and unused fees ranging from 0.00% to 2.00%. As of December 31, 2013 and June 30, 2013, we had $200,990 and $202,518 of undrawn revolver commitments to our portfolio companies, respectively.

(26) Stated interest rates are based on December 31, 2013 and June 30, 2013 one month or three 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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(27) On July 30, 2010, we made a secured first lien $30,000 debt investment to AIRMALL USA, Inc., a $12,500 secured second lien to AMU Holdings, Inc., and acquired 100% of the Convertible Preferred Stock and Common stock of AMU Holdings, Inc. Our Convertible Preferred Stock in AMU Holdings, Inc. has a 12.0% dividend rate which is paid from the dividends received from the underlying operating company, AIRMALL USA, Inc. AMU Holdings, Inc. owns 100% of the common stock in AIRMALL USA, Inc. On December 4, 2013, we sold a $972 participation in both debt investments, equal to 2% of the outstanding principal amount of loans on that date. As of December 31, 2013, we own 98% of convertible preferred and common equity securities.

(28) Progrexion Marketing, Inc., Progrexion Teleservices, Inc., Progrexion ASG, Inc. Progrexion IP, Inc. and Efolks, LLC, are joint borrowers on our senior secured investment. Progrexion Holdings, Inc. and eFolks Holdings, Inc. are the guarantors of this debt investment.

(29) Our wholly-owned entity, First Tower Holdings of Delaware, LLC, owns 80.1% of First Tower Holdings LLC, which owns 100% of First Tower, LLC, the operating company.

(30) Southern Management Corporation, Thaxton Investment Corporation, Southern Finance of Tennessee, Inc., Covington Credit of Texas, Inc., Covington Credit, Inc., Covington Credit of Alabama, Inc., Covington Credit of Georgia, Inc., Southern Finance of South Carolina, Inc. and Quick Credit Corporation, are joint borrowers on our senior secured investment. SouthernCo, Inc. is the guarantor of this debt investment.

(31) We own 2.8% (13,220 shares) of the Mineral Fusion Natural, LLC, a subsidiary of Caleel + Hayden, common and preferred interest.

(32) Our wholly-owned entity, APH Property Holdings, LLC (“APH”), owns 100% of the common equity of American Property Holdings Corp., a REIT which holds investments in several real estate properties. See Note 3 for further discussion of the properties.

(33) Our wholly-owned entity, CCPI Holdings, Inc., owns 95.13% of CCPI Inc., the operating company.

(34) Our wholly-owned entity, Credit Central Holdings of Delaware, LLC, owns 74.8% of Credit Central Holdings, LLC, which owns 100% of each of Credit Central, LLC, Credit Central South, LLC, Credit Central of Texas, LLC, and Credit Central of Tennessee, LLC, the operating companies.

(35) Our wholly-owned entity, Valley Electric Holdings I, Inc. (“HoldCo”), owns 100% of Valley Electric Holdings II, Inc. (“Valley II”). Valley II owns 96.3% of Valley Electric Co. of Mt. Vernon, Inc. (“OpCo”), the operating company. Our debt investments are with both HoldCo and OpCo.

(36) Our wholly-owned entity, Nationwide Acceptance Holdings, LLC, owns 93.8% of Nationwide Acceptance LLC, the operating company.

(37)

On April 15, 2013, assets previously held by H&M were assigned to Wolf in exchange for a $66,000 term loan secured by the assets. The cost basis in this loan of $44,632 was determined in accordance with ASC 310-40, Troubled Debt Restructurings by Creditors, and was equal to the fair value of assets at the time of transfer resulting in a capital loss of $19,647 in connection with the foreclosure on the assets. On May 17, 2013, Wolf sold the assets located in Martin County, which were previously held by H&M, for $66,000. Proceeds from the sale were primarily used to repay the loan and net profits interest receivable due to us resulting in a realized capital gain of $11,826. We received $3,960 of structuring and advisory fees from Wolf during the year ended June 30, 2013 related to the sale and $991 under the net profits interest agreement which was recognized as other income during the fiscal year ended June 30, 2013.

(38) Our wholly-owned entity, CP Holdings of Delaware LLC, owns 82.9% of CP Energy Services Inc., which owns 100% of CP Well Testing Holding Company, LLC and 100% of Fluid Management Holdings, Inc., the operating companies.

(39) Wind River Resources Corporation and Wind River II Corporation are joint borrowers on our senior secured loan.

(40) Our wholly-owned entity, NPH Property Holdings, LLC (“NPH”), owns 100% of the common equity of National Property Holdings Corp., a REIT which holds investments in several real estate properties, and 100% of the membership interests of NPH Property Holdings II, LLC, a peer-to-peer lending company. See Note 3 for further discussion of the properties.

(41) Our wholly-owned entity, UPH Property Holdings, LLC (“UPH”), owns 100% of the common equity of United Property Holdings Corp., a REIT which holds investments in several real estate properties. See Note 3 for further discussion of the properties.

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(42) As defined in the 1940 Act, we are deemed to be an "Affiliated Company" of and "Control" these portfolio companies because we own more than 25% of the portfolio company's outstanding voting securities and we have the power to exercise control over the management or policies of such portfolio company (including through a management agreement). Our transactions with these portfolio companies during the six months ended December 31, 2013 are as follows:

Company	Purchases	Redemptions	Sales	Interest income	Dividend income	Other income	Net realized gains (losses)	Net unrealized gains (losses)
AIRMALL USA, Inc.	$7,600	$(299)	$(972)	$3,111	$12,000	$—	$—	$(11,511)
Ajax Rolled Ring & Machine, Inc.	25,000	(20,208)	—	2,082	—	50	—	(19,956)
APH Property Holdings, LLC	155,464	(118,186)*	—	9,182	—	4,945	—	—
AWCNC, LLC	—	—	—	—	—	—	—	—
Borga, Inc.	—	—	—	—	—	—	—	(112)
CCPI Holdings, Inc.	—	(226)	—	1,660	—	71	—	5,725
CP Holdings of Delaware LLC	113,501	(100)	—	5,756	—	1,864	—	5,727
Credit Central Holdings of Delaware, LLC	—	—	—	3,914	3,000	233	—	784
Energy Solutions Holdings, Inc.	16,496	(8,500)	—	6,033	—	2,480	496	(1,142)
First Tower Holdings of Delaware, LLC	10,000	—	—	27,074	—	9,381	—	14,427
Gulf Coast Machine & Supply Company	28,450	(26,213)	—	349	—	—	—	(2,821)
The Healing Staff, Inc.	—	—	—	—	—	5,000	—	—
Manx Energy, Inc.	—	(275)	—	—	—	—	—	(71)
MITY Holdings of Delaware Inc.	47,985	—	—	1,718	—	1,049	—	—
Nationwide Acceptance Holdings, LLC	—	—	—	2,178	—	1,685	—	1,739
NMMB Holdings, Inc.	8,086	(8,086)	—	1,297	—	—	—	(1,982)
NPH Property Holdings, LLC	10,620	95,624*	—	6	—	319	—	—
R-V Industries, Inc.	—	—	—	1,639	952	—	—	(388)
UPH Property Holdings, LLC	—	22,562*	—	—	—	—	—	—
Valley Electric Holdings I, Inc.	—	(100)	—	3,720	—	72	—	(16,287)
Wolf Energy Holdings, Inc.	—	—	—	—	—	—	—	(386)
Total	$423,202	$(64,007)	$(972)	$69,719	$15,952	$27,149	$496	$(26,254)

* These amounts represent the investments transferred from APH to NPH and UPH, respectively.

(43) As defined in the 1940 Act, we are deemed to be an "Affiliated Company" of these portfolio companies because we own more than 5% of the portfolio company's outstanding voting securities and we have the power to exercise control over the management or policies of such portfolio company (including through a management agreement). Our transactions with these portfolio companies during the six months ended December 31, 2013 are as follows:

Company	Purchases	Redemptions	Sales	Interest income	Dividend income	Other income	Net realized gains (losses)	Net unrealized gains (losses)
BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork)	$—	$(300)	$—	$1,507	$—	$—	$—	$(1,091)
Boxercraft Incorporated	—	(100)	—	1,388	—	7	—	(4,163)
Smart, LLC	—	—	—	—	—	—	—	1,602
Total	$—	$(400)	$—	$2,895	$—	$7	$—	$(3,652)

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(44) As defined in the 1940 Act, we are deemed to be an "Affiliated Company" of and "Control" these portfolio companies because we own more than 25% of the portfolio company's outstanding voting securities and we have the power to exercise control over the management or policies of such portfolio company (including through a management agreement). Our transactions with these portfolio companies during the year ended June 30, 2013 are as follows:

Company	Purchases	Redemptions	Sales	Interest income	Dividend income	Other income	Net realized gains (losses)	Net unrealized gains (losses)
AIRMALL USA, Inc.	$—	$(600)	$—	$5,822	$—	$—	$—	$7,266
Ajax Rolled Ring & Machine, Inc.	23,300	(19,065)	—	5,176	—	155	—	(17,208)
APH Property Holdings, LLC	151,648	—	—	2,898	—	4,650	—	—
AWCNC, LLC	—	—	—	—	—	—	—	—
Borga, Inc.	150	—	—	—	—	—	—	(232)
CCPI Holdings, Inc.	34,081	(338)	—	1,792	—	607	—	—
Credit Central Holdings of Delaware, LLC	47,663	—	—	3,893	—	1,680	—	2,799
Energy Solutions Holdings, Inc.	—	(28,500)	(475)	24,809	53,820	—	—	(71,198)
First Tower Holdings of Delaware, LLC	20,000	—	—	52,476	—	2,426	—	(9,869)
The Healing Staff, Inc.	975	—	(894)	2	—	—	(12,117)	12,117
Manx Energy, Inc.	—	—	—	—	—	—	(9,397)	18,865
Nationwide Acceptance Holdings, LLC	25,151	—	—	1,787	—	884	—	—
NMMB Holdings, Inc.	—	—	(5,700)	3,026	—	—	—	(5,903)
R-V Industries, Inc.	32,750	—	—	781	24,462	143	—	1,463
Valley Electric Holdings I, Inc.	52,098	—	(100)	3,511	—	1,325	—	—
Wolf Energy Holdings, Inc.	50	—	—	452	—	4,951	11,826	(3,092)
Total	$387,866	$(48,503)	$(7,169)	$106,425	$78,282	$16,821	$(9,688)	$(64,992)

(45) As defined in the 1940 Act, we are deemed to be an "Affiliated Company" of these portfolio companies because we own more than 5% of the portfolio company's outstanding voting securities and we have the power to exercise control over the management or policies of such portfolio company (including through a management agreement). Our transactions with these portfolio companies during the year ended June 30, 2013 are as follows:

Company	Purchases	Redemptions	Sales	Interest income	Dividend income	Other income	Net realized gains (losses)	Net unrealized gains (losses)

BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork)	$30,000	$(26,677)	$—	$3,159	$—	$623	$—	$672
Boxercraft Incorporated	—	—	—	3,356	—	—	—	(9,413)
Smart, LLC	—	—	—	—	728	—	—	108
Total	$30,000	$(26,677)	$—	$6,515	$728	$623	$—	$(8,633)

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			December 31, 2013 (Unaudited)			
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets
LEVEL 3 PORTFOLIO INVESTMENTS:						
Affiliate Investments (5.00% to 24.99% voting control)(43)						
BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork)	Michigan / Healthcare	Senior Secured Note (10.00% (LIBOR + 8.00% with 2.00% LIBOR floor), due 12/17/2017)(3),(4)	$29,250	$29,250	$29,250	0.9%
		Preferred Stock Series A (9,925.455 shares)(13)		2,300	1,869	0.1%
		Preferred Stock Series B (1,753.64 shares)(13)		579	405	—%
				32,129	31,524	1.0%
Boxercraft Incorporated(20)	Georgia / Textiles & Leather	Senior Secured Term Loan A (10.00% plus 1.00% PIK, due 9/15/2015)	1,621	1,621	1,621	—%
		Senior Secured Term Loan B (10.00% plus 1.00% PIK, due 9/15/2015)	4,918	4,918	3,990	0.1%
		Senior Secured Term Loan C (10.00% plus 1.00% PIK, due 9/15/2015)	2,383	2,383	—	—%
		Senior Secured Term Loan (10.00% plus 1.00% PIK, due 9/15/2015)	8,368	8,227	—	—%
		Preferred Stock (1,000,000 shares)		—	—	—%
		Common Stock (10,000 shares)		—	—	—%
		Warrants (1 warrant, expiring 8/31/2022)		—	—	—%
				17,149	5,611	0.1%
Smart, LLC(14)	New York / Diversified / Conglomerate Service	Membership Interest		—	1,745	0.1%
				—	1,745	0.1%
		Total Affiliate Investments		49,278	38,880	1.2%
Non-control/Non-affiliate Investments (less than 5.00% of voting control)						
Aderant North America, Inc.	Georgia / Software &	Second Lien Term Loan (10.00% (LIBOR + 8.75%	7,000	6,907	7,000	0.2%

	Computer Services	with 1.25% LIBOR floor), due 6/20/2019)(4)				
				6,907	7,000	0.2%
Aircraft Fasteners International, LLC	California / Machinery	Convertible Preferred Stock (32,500 units)		396	571	—%
				396	571	—%
ALG USA Holdings, LLC	Pennsylvania / Hotels, Restaurants & Leisure	Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 2/28/2020)(4)	12,000	11,778	12,000	0.4%
				11,778	12,000	0.4%
Allied Defense Group, Inc.	Virginia / Aerospace & Defense	Common Stock (10,000 shares)		5	—	—%
				5	—	—%
American Broadband Holding Company and Cameron Holdings of NC, Inc	North Carolina / Telecommunication Services	Senior Secured Term Loan B (11.00% (LIBOR + 9.75% with 1.25% LIBOR floor), due 9/30/2018) (3), (4)	75,000	75,000	75,000	2.3%
				75,000	75,000	2.3%
American Gilsonite Company	Utah / Specialty Minerals	Second Lien Term Loan (11.50%, due 9/1/2017)	38,500	38,500	38,500	1.2%
		Membership Interest in AGC/PEP, LLC (99.9999%)(15)		—	1,988	0.1%
				38,500	40,488	1.3%

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Note 1. Organization

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

We were organized on April 13, 2004 and were funded in an initial public offering completed on July 27, 2004. We are a closed-end investment company incorporated in Maryland. We have elected to be regulated as a business development company ("BDC") under the Investment Company Act of 1940 (the "1940 Act"). As a BDC, we have elected to be treated as a regulated investment company ("RIC"), under Subchapter M of the Internal Revenue Code of 1986 (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, recapitalizations and other purposes.

On May 15, 2007, we formed a wholly-owned subsidiary, Prospect Capital Funding LLC ("PCF"), a Delaware limited liability company and a bankruptcy remote special purpose entity, which holds certain of our portfolio loan investments that are used as collateral for the credit facility at PCF.

Note 2. Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles ("GAAP") for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Articles 6 or 10 of Regulation S-X. The financial results of our portfolio investments are not consolidated in the financial statements.

Reclassifications

Certain reclassifications have been made in the presentation of prior consolidated financial statements and accompany notes to conform to the presentation as of and for the three and six months ended December 31, 2013.

Use of Estimates

The preparation of GAAP consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of income, gains and losses, 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, the regulations pursuant to Article 6 of Regulation S-X and ASC 946, Financial Services—Investment Companies ("ASC 946"), 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 consolidated financial statements include our accounts and the accounts of PCF, 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, controlled 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

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Note 2. Significant Accounting Policies (Continued)

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. Under the 1940 Act, 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.

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. 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

Our 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 we would incur if the counterparties failed to perform pursuant to the terms of their agreements with us.

Liquidity Risk

Liquidity risk represents the possibility that we may not be able to rapidly adjust the size of our investment 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

Many of our 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

To value our investments, we follow the guidance of ASC 820 that defines fair value, establishes a framework for measuring fair value in conformity with GAAP and requires disclosures about fair value measurements. 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.

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.

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Note 2. Significant Accounting Policies (Continued)

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.
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 independent valuation firms engaged by our Board of Directors;

2) the independent valuation firms conduct independent valuations and make their own independent assessment;

3) the Audit Committee of our Board of Directors reviews and discusses the preliminary valuation of Prospect Capital Management LLC (the “Investment Adviser”) and that of the independent valuation firms; 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 the Investment Adviser, the respective independent valuation firm and the Audit Committee.

Investments are valued utilizing a yield analysis, enterprise value (“EV”) analysis, net asset value analysis, liquidation analysis, discounted cash flow analysis, or a combination of methods, as appropriate. The yield analysis uses loan spreads and other relevant information implied by market data involving identical or comparable assets or liabilities. Under the enterprise value analysis, the enterprise value of a portfolio company is first determined and allocated over the portfolio company’s securities in order of their preference relative to one another (i.e., “waterfall” allocation). To determine the enterprise value, we typically use a market multiples approach that considers relevant and applicable market trading data of guideline public companies, transaction metrics from precedent M&A transactions and/or a discounted cash flow analysis. The net asset value analysis is used to derive a value of an underlying investment (such as real estate property) by dividing a relevant earnings stream by an appropriate capitalization rate. For this purpose, we consider capitalization rates for similar properties as may be obtained from guideline public companies and/or relevant transactions. The liquidation analysis is intended to approximate the net recovery value of an investment based on, among other things, assumptions regarding liquidation proceeds based on a hypothetical liquidation of a portfolio company’s assets. The discounted cash flow analysis uses valuation techniques to convert future cash flows or earnings to a range of fair values from which a single estimate may be derived utilizing an appropriate discount rate. The measurement is based on the net present value indicated by current market expectations about those future amounts.

In applying these methodologies, additional factors that we consider in fair value pricing our investments may include, as we deem relevant: security covenants, call protection provisions, and information rights; the nature and realizable value of any collateral; the portfolio company's ability to make payments; the principal markets in which the portfolio company does business; publicly available financial ratios of peer companies; the principal market; and enterprise values, among other factors.

Our investments in CLOs are classified as ASC 820 Level 3 securities, and are valued using a dynamic discounted cash flow model, where the projected future cash flow is estimated using Monte Carlo simulation techniques. The valuations have been accomplished through the analysis of the CLO deal structures to identify the risk exposures from the modeling point of view. For each CLO security, the most appropriate valuation approach has been chosen from alternative approaches to ensure the most accurate valuation for such security. To value a CLO, both the assets and the liabilities of the CLO capital structure are modeled. We use a waterfall engine to store the collateral data, generate numerous collateral cash flows from the assets based on various assumptions for the risk factors, and distribute the cash flow to the liability structure based on the payment priorities, and discount them back using current market discount rates to the various cash flows along each simulation path. The main risk factors are: default risk, interest rate risk, downgrade risk, and credit spread risk.

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Note 2. Significant Accounting Policies (Continued)

Valuation of Other Financial Assets and Financial Liabilities

The Fair Value Option within ASC 825, Financial Instruments, specifically ASC 825-10-25, permits an entity to elect fair value as the initial and subsequent measurement attribute for eligible assets and liabilities for which the assets and liabilities are measured using another measurement attribute. For our non-investment assets and liabilities, we have elected not to value them at fair value as would be permitted by ASC 825-10-25.

Senior Convertible Notes

We have recorded the Senior Convertible Notes (see Note 5) at their contractual amounts. The Senior Convertible Notes were analyzed for any features that would require their accounting to be bifurcated and such features were determined to be immaterial.

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 amortization of 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 Capital Funding, Inc. (“Patriot”) was determined based on the difference between par value and fair value as of December 2, 2009, and continues to accrete until maturity or repayment of the respective loans (see Note 3).

Interest income from investments in the “equity” class of security of CLO funds (typically income notes or subordinated notes) is recorded based upon an estimation of an effective yield to expected maturity utilizing assumed cash flows in accordance with ASC 325-40, Beneficial Interests in Securitized Financial Assets. We monitor the expected cash inflows from our CLO equity investments, including the expected residual payments, and the effective yield is determined and updated periodically.

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 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 December 31, 2013, approximately 0.3% of our total assets are in non-accrual status.

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 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 ordinary income and 98.2% of our capital gains 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 ordinary income and 98.2% of our capital gains exceed 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. For the calendar year ended December 31, 2012, we elected to retain a portion of our annual taxable income and have paid $4,500 for the excise tax due with the filing of the return. As of December 31, 2013, we have $4,000 accrued as an estimate of the excise tax due for continuing to retain a portion of our annual taxable income for the calendar year ending December 31, 2013.

If we fail to satisfy the annual distribution requirement or otherwise fail to qualify as a RIC in any taxable year, 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 we be required to make distributions. Distributions would generally be taxable to our individual and other non-corporate taxable stockholders as ordinary dividend income eligible for the reduced maximum rate applicable to qualified dividend income to the extent of our current and accumulated earnings and profits, provided certain holding period and other requirements are met. Subject to certain limitations under the Internal Revenue Code, corporate distributions would be eligible for the dividends-received deduction. To qualify again to be taxed as a RIC in a subsequent year, we would be required to distribute to our shareholders our accumulated earnings and profits attributable to non-RIC years reduced by an interest charge of 50% of such earnings and profits payable by us as an additional tax. In addition, if we failed to qualify as a RIC for a period greater than two taxable years, then, in order to qualify as a RIC in a subsequent year, we would be required to elect to recognize and pay tax on any net built-in gain (the excess of aggregate gain, including items of income, over aggregate loss that would have been realized if we had been liquidated) or, alternatively, be subject to taxation on such built-in gain recognized for a period of ten years.

We follow ASC 740, Income Taxes (“ASC 740”). ASC 740 provides guidance for how uncertain tax positions should be recognized, measured, presented, and disclosed in the consolidated 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. As of December 31, 2013 and for the three and six months 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. Although we file both federal and state income tax returns, our major tax jurisdiction is federal. Our tax returns for each of our federal tax years since 2009 remain subject to examination by the Internal Revenue Service.

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 monthly dividend or distribution is approved by our Board of Directors quarterly 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 and Senior Convertible Notes, Senior Unsecured Notes and Prospect Capital InterNotes® (collectively, our "Senior Notes"), as deferred financing costs. These expenses are deferred and amortized as part of interest expense using the straight-line method for our revolving credit facility and the effective interest method for our Senior Notes, over the respective expected life or maturity.

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 are charged to capital upon the receipt of proceeds from an equity offering or charged to expense if no offering is completed.

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Guarantees and Indemnification Agreements

We follow ASC 460, Guarantees (“ASC 460”). ASC 460 elaborates on the disclosure requirements of a guarantor in its interim and annual consolidated 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.

Per Share Information

Net increase or decrease in net assets resulting from operations per common share is calculated using the weighted average number of common shares outstanding for the period presented. In accordance with ASC 946, convertible securities are not considered in the calculation of net asset value per share.

Recent Accounting Pronouncements

In June 2013, the FASB issued Accounting Standards Update 2013-08, Financial Services — Investment Companies (Topic 946) — Amendments to the Scope, Measurement, and Disclosure Requirements (“ASU 2013-08”). The update clarifies the approach to be used for determining whether an entity is an investment company and provides new measurement and disclosure requirements. ASU 2013-08 is effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013. Earlier application is prohibited. The adoption of ASU 2013-08 is not expected to materially affect our consolidated financial statements and disclosures.

Note 3. Portfolio Investments

At December 31, 2013, we had investments in 130 long-term portfolio investments, which had an amortized cost of $4,976,354 and a fair value of $4,886,020 and at June 30, 2013, we had investments in 124 long-term portfolio investments, which had an amortized cost of $4,255,778 and a fair value of $4,172,852.

The original cost basis of debt placements and equity securities acquired, including follow-on investments for existing portfolio companies, totaled $1,164,500 and $1,520,062 during the six months ended December 31, 2013 and December 31, 2012, respectively. Debt repayments and proceeds from sales of equity securities of approximately $419,405 and $507,392 were received during the six months ended December 31, 2013 and December 31, 2012, respectively.

As of December 31, 2013, we own controlling interests in AIRMALL USA, Inc. (“AIRMALL”), Ajax Rolled Ring & Machine, Inc., APH Property Holdings, LLC (“APH”), AWCNC, LLC, Borga, Inc. (“Borga”), CCPI Holdings, Inc. (“CCPI”), CP Holdings of Delaware LLC (“CP Holdings”), Credit Central Holdings of Delaware, LLC (“Credit Central”), Energy Solutions Holdings, Inc. (f/k/a Gas Solutions Holdings, Inc.) (“Energy Solutions”), First Tower Holdings of Delaware, LLC (“First Tower”), Gulf Coast Machine & Supply Company (“Gulf Coast”), The Healing Staff, Inc. (“THS”), Manx Energy, Inc. (“Manx”), MITY Holdings of Delaware Inc., Nationwide Acceptance Holdings, LLC, NMMB Holdings, Inc., NPH Property Holdings, LLC (“NPH”), R-V Industries, Inc. (“R-V”), UPH Property Holdings, LLC, Valley Electric Holdings I, Inc. (“Valley Electric”) and Wolf Energy Holdings, Inc. (“Wolf”). We also own an affiliated interest in BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork), Boxercraft Incorporated and Smart, LLC.

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Note 3. Portfolio Investments (Continued)

The composition of our investments and money market funds as of December 31, 2013 and June 30, 2013 at cost and fair value was as follows:

	December 31, 2013		June 30, 2013	
	Cost	Fair Value	Cost	Fair Value
Revolving Line of Credit	$12,595	$11,974	$9,238	$8,729
Senior Secured Debt	2,746,971	2,682,361	2,262,327	2,207,091
Subordinated Secured Debt	1,012,293	980,206	1,062,386	1,024,901
Subordinated Unsecured Debt	99,933	100,000	88,470	88,827
CLO Debt	27,889	33,466	27,667	28,589
CLO Residual Interest	821,653	864,618	660,619	658,086
Equity	255,020	213,395	145,071	156,629
Total Investments	4,976,354	4,886,020	4,255,778	4,172,852
Money Market Funds	220,850	220,850	143,262	143,262
Total Investments and Money Market Funds	$5,197,204	$5,106,870	$4,399,040	$4,316,114

The fair values of our investments and money market funds as of December 31, 2013 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Investments at fair value				
Revolving Line of Credit	$ —	$—	$11,974	$11,974
Senior Secured Debt	—	—	2,682,361	2,682,361
Subordinated Secured Debt	—	—	980,206	980,206
Subordinated Unsecured Debt	—	—	100,000	100,000
CLO Debt	—	—	33,466	33,466
CLO Residual Interest	—	—	864,618	864,618
Equity	166	—	213,229	213,395
Total Investments	166	—	4,885,854	4,886,020
Money Market Funds	—	220,850	—	220,850
Total Investments and Money Market Funds	$ 166	$220,850	$4,885,854	$5,106,870

	Fair Value Hierarchy			
	Level 1	Level 2	Level 3	Total
Investments at fair value				
Control investments	$—	$—	$1,163,300	$1,163,300
Affiliate investments	—	—	38,880	38,880
Non-control/non-affiliate investments	166	—	3,683,674	3,683,840
Total Investments	166	—	4,885,854	4,886,020
Money Market Funds	—	220,850	—	220,850

Total Investments and Money Market Funds	$166	$220,850	$4,885,854	$5,106,870

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Note 3. Portfolio Investments (Continued)

The fair values of our investments and money market funds as of June 30, 2013 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Investments at fair value				
Revolving Line of Credit	$ —	$—	$8,729	$8,729
Senior Secured Debt	—	—	2,207,091	2,207,091
Subordinated Secured Debt	—	—	1,024,901	1,024,901
Subordinated Unsecured Debt	—	—	88,827	88,827
CLO Debt	—	—	28,589	28,589
CLO Residual Interest	—	—	658,086	658,086
Equity	112	—	156,517	156,629
Total Investments	112	—	4,172,740	4,172,852
Money Market Funds	—	143,262	—	143,262
Total Investments and Money Market Funds	$ 112	$143,262	$4,172,740	$4,316,114

	Fair Value Hierarchy			
	Level 1	Level 2	Level 3	Total
Investments at fair value				
Control investments	$—	$—	$811,634	$811,634
Affiliate investments	—	—	42,443	42,443
Non-control/non-affiliate investments	112	—	3,318,663	3,318,775
Total Investments	112	—	4,172,740	4,172,852
Money Market Funds	—	143,262	—	143,262
Total Investments and Money Market Funds	$112	$143,262	$4,172,740	$4,316,114

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Note 3. Portfolio Investments (Continued)

The aggregate values of Level 3 portfolio investments changed during the six months ended December 31, 2013 as follows:

	Fair Value Measurements Using Unobservable Inputs (Level 3)			
	Control Investments	Affiliate Investments	Non-Control/ Non-Affiliate Investments	Total
Fair value as of June 30, 2013	$ 811,634	$ 42,443	$ 3,318,663	$ 4,172,740
Total realized gain (loss), net	496	—	(2,404)	(1,908)
Change in unrealized (depreciation) appreciation	(26,254)	(3,652)	22,443	(7,463)
Net realized and unrealized (loss) gain	(25,758)	(3,652)	20,039	(9,371)
Purchases of portfolio investments	423,202	—	731,950	1,155,152
Payment-in-kind interest	6,699	89	3,057	9,845
Accretion (amortization) of discounts and premiums	—	400	(23,533)	(23,133)
Repayments and sales of portfolio investments	(65,475)	(400)	(353,504)	(419,379)
Transfers within Level 3(1)	12,998	—	(12,998)	—
Transfers in (out) of Level 3(1)	—	—	—	—
Fair value as of December 31, 2013	$ 1,163,300	$ 38,880	$ 3,683,674	$ 4,885,854

	Fair Value Measurements Using Unobservable Inputs (Level 3)							
	Revolver	Senior Secured Debt	Subordinated Secured Debt	Subordinated Unsecured Debt	CLO Debt	CLO Residual Interest	Equity	Total
Fair value as of June 30, 2013	$ 8,729	$ 2,207,091	$ 1,024,901	$ 88,827	$ 28,589	$ 658,086	$ 156,517	$ 4,172,740
Total realized (loss) gain, net	—	93	(7,062)	—	—	1,183	3,878	(1,908)
Change in unrealized (depreciation) appreciation	(112)	(9,375)	5,402	(290)	4,656	45,494	(53,238)	(7,463)
Net realized and unrealized (loss) gain	(112)	(9,282)	(1,660)	(290)	4,656	46,677	(49,360)	(9,371)
Purchases of portfolio investments	9,500	688,071	141,719	—	—	205,720	110,142	1,155,152
Payment-in-kind interest	—	7,889	1,619	336	—	1	—	9,845
Accretion (amortization) of discounts and premiums	—	524	912	6	221	(24,796)	—	(23,133)

Repayments and sales of portfolio investments	(6,143)	(211,932)	(117,285)	(58,879)	—	(21,070)	(4,070)	(419,379)
Transfers within Level 3(1)	—	—	(70,000)	70,000	—	—	—	—
Transfers in (out) of Level 3(1)	—	—	—	—	—	—	—	—
Fair value as of December 31, 2013	$11,974	$2,682,361	$980,206	$100,000	$33,466	$864,618	$213,229	$4,885,854

(1) Transfers are assumed to have occurred at the beginning of the period.

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Note 3. Portfolio Investments (Continued)

The aggregate values of Level 3 portfolio investments changed during the six months ended December 31, 2012 as follows:

	Fair Value Measurements Using Unobservable Inputs (Level 3)			
	Control Investments	Affiliate Investments	Non-Control/ Non-Affiliate Investments	Total
Fair value as of June 30, 2012	$ 564,489	$ 46,116	$ 1,483,487	$ 2,094,092
Total realized (loss) gain, net	(12,198)	—	5,727	(6,471)
Change in unrealized depreciation	(63,454)	(2,279)	(7,400)	(73,133)
Net realized and unrealized loss	(75,652)	(2,279)	(1,673)	(79,604)
Purchases of portfolio investments	184,343	30,000	1,301,671	1,516,014
Payment-in-kind interest	44	360	3,644	4,048
Amortization of discounts and premiums	—	446	10,976	11,422
Repayments and sales of portfolio investments	(23,844)	(26,377)	(457,048)	(507,269)
Transfers within Level 3(1)	—	—	—	—
Transfers in (out) of Level 3(1)	—	—	—	—
Fair value as of December 31, 2012	$ 649,380	$ 48,266	$ 2,341,057	$ 3,038,703

	Fair Value Measurements Using Unobservable Inputs (Level 3)							
	Revolver	Senior Secured Debt	Subordinated Secured Debt	Subordinated Unsecured Debt	CLO Debt	CLO Residual Interest	Equity	Total
Fair value as of June 30, 2012	$ 868	$ 1,093,019	$ 475,147	$ 73,195	$ 27,717	$ 218,009	$ 206,137	$ 2,094,092
Total realized (loss) gain, net	—	—	(11,520)	—	—	—	5,049	(6,471)
Change in unrealized (depreciation) appreciation	(46)	(8,215)	10,816	(39)	1,470	(702)	(76,417)	(73,133)
Net realized and unrealized (loss) gain	(46)	(8,215)	(704)	(39)	1,470	(702)	(71,368)	(79,604)
Purchases of portfolio investments	7,150	734,016	460,610	99,000	—	182,522	32,716	1,516,014
Payment-in-kind interest	—	618	1,843	1,587	—	—	—	4,048
Amortization of discounts and premiums	—	1,169	1,792	38	202	8,221	—	11,422
Repayments and sales of portfolio investments	(1,100)	(312,476)	(182,857)	—	—	—	(10,836)	(507,269)
Transfers within Level 3(1)	—	—	—	—	—	—	—	—

Transfers in (out) of Level 3(1)	—	—	—	—	—	—	—	—
Fair value as of December 31, 2012	$6,872	$1,508,131	$755,831	$173,781	$29,389	$408,050	$156,649	$3,038,703

(1) Transfers are assumed to have occurred at the beginning of the period.

For the six months ended December 31, 2013 and 2012, the net change in unrealized depreciation on the investments that use Level 3 inputs was $29,324 and $67,286 for assets still held as of December 31, 2013 and 2012, respectively.

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Note 3. Portfolio Investments (Continued)

The ranges of unobservable inputs used in the fair value measurement of our Level 3 investments as of December 31, 2013 were as follows:

			Unobservable Input		
Asset Category	Fair Value	Primary Valuation Technique	Input	Range	Weighted Average
Senior Secured	$1,779,254	Yield Analysis	Market Yield	5.7%-22.7%	10.7%
Senior Secured	641,938	EV Analysis	EBITDA Multiple	3.0x-9.6x	6.4x
Senior Secured	268,626	Net Asset Value Analysis	Capitalization Rate	4.9%-10.1%	7.0%
Senior Secured	4,517	Liquidation Analysis	N/A	N/A	N/A
Subordinated Secured	927,758	Yield Analysis	Market Yield	8.1%-20.0%	11.7%
Subordinated Secured	52,448	EV Analysis	EBITDA Multiple	4.7x-7.0x	5.9x
Subordinated Unsecured	100,000	Yield Analysis	Market Yield	6.1%-15.2%	12.7%
CLO Debt	33,466	Discounted Cash Flow	Discount Rate	4.0%-6.0%	4.9%
CLO Residual Interest	864,618	Discounted Cash Flow	Discount Rate	9.0%-24.0%	17.0%
Equity	211,287	EV Analysis	EBITDA Multiple	0.0x-9.6x	4.1x
Escrow	1,942	Discounted Cash Flow	Discount Rate	6.8%-7.9%	7.4%
Total	$4,885,854				

The ranges of unobservable inputs used in the fair value measurement of our Level 3 investments as of June 30, 2013 were as follows:

			Unobservable Input		
Asset Category	Fair Value	Primary Valuation Technique	Input	Range	Weighted Average
Senior Secured	$1,616,485	Yield Analysis	Market Yield	5.7%-20.8%	10.8%
Senior Secured	468,082	EV Analysis	EBITDA Multiple	3.3x-8.8x	6.7x
Senior Secured	5,361	Liquidation Analysis	N/A	N/A	N/A
Senior Secured	125,892	Net Asset Value Analysis	Capitalization Rate	5.0%-10.0%	7.5%
Subordinated Secured	962,702	Yield Analysis	Market Yield	7.7%-19.8%	11.6%
Subordinated Secured	62,199	EV Analysis	EBITDA Multiple	3.3x-7.0x	4.4x
Subordinated Unsecured	69,127	Yield Analysis	Market Yield	6.1%-14.6%	10.7%
Subordinated Unsecured	19,700	EV Analysis	EBITDA Multiple	5.5x-6.5x	6.0x
CLO Debt	28,589	Discounted Cash Flow	Discount Rate	12.1%-20.1%	15.7%
CLO Residual Interest	658,086	Discounted Cash Flow	Discount Rate	11.3%-19.8%	15.3%
Equity	151,855	EV Analysis	EBITDA Multiple	0.1x-8.8x	3.9x
Escrow	4,662	Discounted Cash Flow	Discount Rate	6.5%-7.0%	6.8%

Total	$4,172,740

In determining the range of value for debt instruments except CLOs, management and the independent valuation firms generally estimate corporate and security credit ratings and identify corresponding yields to maturity for each loan from relevant market data. A discounted cash flow analysis was then prepared using the appropriate yield to maturity as the discount rate, to determine ranges of value. For non-traded equity investments, the enterprise value was determined by applying earnings before income tax, depreciation and amortization ("EBITDA") multiples for similar recent investment sales. For stressed equity investments, a liquidation analysis was prepared.

In determining the range of value for our investments in CLOs, management and the independent valuation firms used dynamic discounted cash flow models, where the projected future cash flow was estimated using Monte Carlo simulation techniques. The valuations were accomplished through the analysis of the CLO deal structures to identify the risk exposures from the modeling point of view. For each CLO security, the most appropriate valuation approach was chosen from alternative approaches to ensure the most accurate valuation for such security. A discounted cash flow model is prepared, utilizing a waterfall engine to store the collateral data, generate numerous collateral cash flows from the assets based on various assumptions for the risk factors, and

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Note 3. Portfolio Investments (Continued)

distribute the cash flow to the liability structure based on the payment priorities, and discount them back using proper discount rates to the various cash flows along each simulation path.

The significant unobservable input used to value our investments based on the yield analysis and discounted cash flow analysis, is the market yield (or applicable discount rate) used to discount the estimated future cash flows expected to be received from the underlying investment, which includes both future principal and interest payments. Significant increases or decreases in the discount rate would result in a decrease or increase, respectively, in the fair value measurement. Included in the consideration and selection of discount rates are the following factors: risk of default, rating of the investment and comparable company investments, and call provisions.

The significant unobservable inputs used to value our investments based on the enterprise value analysis may include market multiples of specified financial measures such as EBITDA of identified guideline public companies, implied valuation multiples from precedent M&A transactions, and/or discount rates applied in a discounted cash flow analysis. The independent valuation firm identifies a population of publicly traded companies with similar operations and key attributes to that of the portfolio company. Using valuation and operating metrics of these guideline public companies and/or as implied by relevant precedent transactions, a range of multiples of enterprise value to the latest twelve months EBITDA, or other measure, is typically calculated. The independent valuation firm utilizes the determined multiples to estimate the portfolio company's enterprise value based on, generally, the latest twelve months EBITDA of the portfolio company (or other meaningful measure). Significant increases or decreases in the multiple may result in an increase or decrease, respectively, in enterprise value, which may increase or decrease the fair value estimate of the debt and/or equity investment, as applicable. In certain instances, a discounted cash flow analysis may be considered in estimating enterprise value, in which case, discount rates based on a weighted average cost of capital and application of the Capital Asset Pricing Model may be utilized.

The significant unobservable input used to value our investments based on the net asset value analysis is the capitalization rate applied to earnings measure of the underlying property. Significant increases or decreases in the discount rate would result in a decrease or increase, respectively, in the fair value measurement.

Changes in market yields, discount rates or EBITDA multiples, each in isolation, may change the fair value of certain of our investments. Generally, an increase in market yields, discount rates or capitalization rate, or decrease in EBITDA multiples, may result in a decrease in the fair value of certain of our investments.

Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments may fluctuate from period to period. Additionally, the fair value of our investments may differ significantly from the values that would have been used had a ready market existed for such investments and may differ materially from the values that we may ultimately realize. Further, such investments are generally subject to legal and other restrictions on resale or otherwise are less liquid than publicly traded securities. If we were required to liquidate a portfolio investment in a forced or liquidation sale, we could realize significantly less than the value at which we have recorded it.

In addition, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the unrealized gains or losses reflected in the valuations currently assigned.

During the six months ended December 31, 2013, the valuation methodology for Gulf Coast changed to incorporate an enterprise value analysis in place of the yield analysis used in previous periods. Management adopted the enterprise value analysis due to a deterioration in operating results and resulting foreclosure culminating in our obtaining majority voting control of the company. As a result of this change, and in recognition of recent company performance and current market conditions, we decreased the fair value of our investment in Gulf Coast to $12,414 as of December 31, 2013, a discount of $31,036 to its amortized cost, compared to the $9,241 unrealized depreciation recorded at June 30, 2013.

During the six months ended December 31, 2013, the valuation methodology for ICON Health & Fitness, Inc. ("ICON") changed to incorporate weighted broker quotes in addition to the yield analysis and enterprise value analysis used in previous periods. Management considered weighted broker quotes because they are representative of sufficient liquidity to provide an indication of value. As a result of this change, and in recognition of recent company performance and current market conditions,

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we increased the fair value of our investment in ICON to $38,790 as of December 31, 2013, a discount of $4,493 to its amortized cost, compared to the $9,381 unrealized depreciation recorded at June 30, 2013.

During the year ended June 30, 2013, we provided $125,892 and $26,648 of debt and equity financing, respectively, to APH for the acquisition of various real estate properties. During the six months ended December 31, 2013, we provided
$129,850 and $25,614 of debt and equity financing, respectively, to APH for the acquisition of certain properties. In December 2013, American Property Holdings Corp. (“APHC”), a wholly-owned subsidiary of APH, distributed its investments in fourteen properties: eight to National Property Holdings Corp. (“NPHC”); and six to United Property Holdings Corp. (“UPHC”), two newly formed REIT holding companies which are discussed below. The investments transferred consisted of $98,164 and $20,022 of debt and equity financing, respectively. There was no gain or loss realized on these transactions.

As of December 31, 2013, APHC’s real estate portfolio was comprised of 12 properties. The following table shows the location, acquisition date, purchase price, and mortgage outstanding due to other parties for each of the properties:

No.	Property Name	City	Acquisition Date	Purchase Price	Mortgage Outstanding
1	Abbington Pointe	Marietta, GA	12/28/2012	$23,500	$15,275
2	Amberly Place	Tampa, FL	1/17/2013	63,400	39,600
3	Lofton Place	Tampa, FL	4/30/2013	26,000	16,965
4	Vista at Palma Sola	Bradenton, FL	4/30/2013	27,000	17,550
5	Arlington Park	Marietta, GA	5/8/2013	14,850	9,650
6	The Resort	Pembroke Pines, FL	6/24/2013	225,000	157,500
7	Inverness Lakes(1)	Mobile, AL	11/15/2013	29,600	19,400
8	Kings Mill Apartments(1)	Pensacola, FL	11/15/2013	20,750	13,622
9	Crestview at Oakleigh(1)	Pensacola, FL	11/15/2013	17,500	11,488
10	Plantations at Pine Lake(1)	Tallahassee, FL	11/15/2013	18,000	11,817
11	Cordova Regency(1)	Pensacola, FL	11/15/2013	13,750	9,026
12	Verandas at Rocky Ridge(1)	Birmingham, AL	11/15/2013	15,600	10,205
				$494,950	$332,098

(1) These properties comprise the Gulf Coast Portfolio.

During the six months ended December 31, 2013, we provided $8,800 and $1,820 of debt and equity financing, respectively, to NPH for the acquisition of certain properties. The eight investments transferred to NPHC from APHC consisted of $79,309 and $16,315 of debt and equity financing, respectively. There was no gain or loss realized on these transactions.

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As of December 31, 2013, NPHC's real estate portfolio was comprised of nine properties. The following table shows the location, acquisition date, purchase price, and mortgage outstanding due to other parties for each of the properties:

No.	Property Name	City	Acquisition Date	Purchase Price	Mortgage Outstanding
1	146 Forest Parkway	Forest Park, GA	10/24/2012	$7,400	$—
2	Bexley	Marietta, GA	11/1/2013	30,600	22,497
3	St. Marin(1)	Coppell, TX	11/19/2013	73,078	53,863
4	Mission Gate(1)	Plano, TX	11/19/2013	47,621	36,148
5	Vinings Corner(1)	Smyrna, GA	11/19/2013	35,691	26,640
6	Central Park(1)	Altamonte Springs, FL	11/19/2013	36,590	27,471
7	City West(1)	Orlando, FL	11/19/2013	23,562	18,533
8	Matthews Reserve(1)	Matthews, NC	11/19/2013	22,063	17,571
9	Indigo	Jacksonville, FL	12/31/2013	38,000	28,500
				$314,605	$231,223

(1) These properties comprise the Oxford Portfolio.

The six investments transferred to UPHC from APHC consisted of $18,855 and $3,707 of debt and equity financing, respectively. There was no gain or loss realized on these transactions.

As of December 31, 2013, UPHC's real estate portfolio was comprised of six properties. The following table shows the location, acquisition date, purchase price, and mortgage outstanding due to other parties for each of the properties:

No.	Property Name	City	Acquisition Date	Purchase Price	Mortgage Outstanding
1	Eastwood Village(1)	Stockbridge, GA	12/12/2013	$25,957	$19,785
2	Monterey Village(1)	Jonesboro, GA	12/12/2013	11,501	9,193
3	Hidden Creek(1)	Morrow, GA	12/12/2013	5,098	3,619
4	Meadow Springs(1)	College Park, GA	12/12/2013	13,116	10,180
5	Meadow View(1)	College Park, GA	12/12/2013	14,354	11,141
6	Peachtree Landing(1)	Fairburn, GA	12/12/2013	17,224	13,575
				$87,250	$67,493

(1) These properties comprise the Stonemark Portfolio.

On January 4, 2012, Energy Solutions sold its gas gathering and processing assets ("Gas Solutions") for a sale price of $199,805, adjusted for the final working capital settlement, including a potential earnout of $28,000 that may be paid based on the future performance of Gas Solutions. Through December 31, 2013, we have not accrued income for any portion of the $28,000 potential payment. After expenses, including structuring fees of $9,966 paid to us, Energy Solutions received $158,687 in cash. The sale of Gas Solutions by Energy Solutions resulted in significant earnings and profits, as defined by the Internal Revenue Code, at Energy Solutions for calendar year 2012. As a result, distributions from Energy Solutions to us were required to be recognized as dividend income, in accordance with ASC 946, as cash distributions were received from Energy Solutions, to the extent there are current year earnings and profits sufficient to support such recognition. During the three and six months ended December 31, 2012, we received distributions of $20,570 and $53,820 from Energy Solutions which were recorded as dividend income, respectively. No such dividends were received during the three or six months ended December 31, 2013.

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During the six months ended December 31, 2013, Energy Solutions repaid the remaining $8,500 of our subordinated secured debt to the company. In addition to the repayment of principal, we received $4,812 of make-whole fees for early repayment of the outstanding loan receivables, which was recorded as additional interest income during the six months ended December 31, 2013.

On November 25, 2013, we provided $13,000 in senior secured debt financing for the recapitalization of our investment in Freedom Marine Services Holdings, LLC (“Freedom Marine”), a subsidiary of Energy Solutions. The subordinated secured loan to Jettco Marine Services, LLC (“Jettco”), a subsidiary of Freedom Marine, was replaced with a senior secured note to Vessel Holdings II, LLC (“Vessel II”), a new subsidiary of Freedom Marine. On December 3, 2013, we made a $16,000 senior secured investment in Vessel Holdings III, LLC, another new subsidiary of Freedom Marine. Overall the restructuring of our investment in Freedom Marine provided approximately $16,000 net senior secured debt financing to support the acquisition of two new vessels. We received $2,480 of structuring fees from Energy Solutions related to the Freedom Marine restructuring which was recognized as other income during the six months ended December 31, 2013.

During the three months ended December 31, 2012, we determined that the impairment of Integrated Contract Solutions, Inc. (“ICS”) was other-than-temporary and recorded a realized loss of $12,198 for the amount that the amortized cost exceeded the fair market value. Our remaining investment in THS, an affiliate of ICS, was valued at zero as of December 31, 2013 and continues to provide staffing solutions for health care facilities and security staffing.

On November 30, 2012, we made a secured second lien investment of $9,500 to support the recapitalization of R-V. As part of the recapitalization, we received a dividend of $11,073 for our investment in R-V’s common stock.

On August 6, 2013, we received a distribution of $3,252 related to our investment in NRG Manufacturing, Inc. (“NRG”), for which we realized a gain of the same amount. This was a partial release of the amount held in escrow.

On October 31, 2013, we sold $18,755 of the National Bankruptcy Services, LLC loan receivable. The loan receivable was sold at a discount and we realized a loss of $7,853.

During the six months ended December 31, 2013, we provided an additional $7,600 of subordinated secured financing to AIRMALL. During the three and six months ended December 31, 2013, we received distributions of $5,000 and $12,000, respectively, from AIRMALL which were recorded as dividend income. No dividends were received from AIRMALL during the three and six months ended December 31, 2012.

During the six months ended December 31, 2013, we received an $8,000 fee from First Tower Delaware related to the renegotiation and expansion of First Tower’s revolver in December 2013 which was recorded as other income and we provided an additional $8,500 and $1,500 of senior secured first-lien and common equity financing, respectively, to First Tower Delaware.

During the three and six months ended December 31, 2013, we recognized $160 and $400, respectively, of interest income due to purchase discount accretion from the assets acquired from Patriot. No accelerated accretion was recorded during the three or six months ended December 31, 2013.

During the three and six months ended December 31, 2012, we recognized $655 and $939 of interest income due to purchase discount accretion from the assets acquired from Patriot. Included in the $655 recorded during the three months ended December 31, 2012 is $285 of normal accretion and $370 of accelerated accretion resulting from the repayment of Hudson Products Holdings, Inc. (“Hudson”). Included in the $939 recorded during the six months ended December 31, 2012 is $569 of normal accretion and $370 of accelerated accretion resulting from the repayment of Hudson.

As of December 31, 2013, $141 of purchase discount from the assets acquired from Patriot remains to be accreted as interest income, which is expected to be amortized during the three months ending March 31, 2014.

As of December 31, 2013, $3,465,228 of our loans, at fair value, bear interest at floating rates and $3,431,762 of those loans have Libor floors ranging from 1.25% to 6.00%.

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At December 31, 2013, eight loan investments were on non-accrual status: Borga, Vessel II (formerly Jettco), THS, Manx, Stryker, Wind River, Wolf and Yatesville. At June 30, 2013, eight loan investments were on non-accrual status: Borga, Jettco, THS, Manx, Stryker, Wind River, Wolf and Yatesville. Principal balances of these loans amounted to $113,708 and $106,395 as of December 31, 2013 and June 30, 2013, respectively. The fair value of these loans amounted to $16,965 and $13,810 as of December 31, 2013 and June 30, 2013, respectively. The fair values of these investments represent approximately 0.3% of our total assets as of December 31, 2013 and June 30, 2013. For the three months ended December 31, 2013 and December 31, 2012, the income foregone as a result of not accruing interest on non-accrual debt investments amounted to $5,086 and $6,629, respectively. For the six months ended December 31, 2013 and December 31, 2012, the income foregone as a result of not accruing interest on non-accrual debt investments amounted to $10,656 and $13,756, respectively.

Undrawn committed revolvers to our portfolio companies incur commitment fees ranging from 0.00% to 2.00%. As of December 31, 2013 and June 30, 2013, we have $200,990 and $202,518 of undrawn revolver commitments to our portfolio companies, respectively.

Note 4. Revolving Credit Agreements

On March 27, 2012, we closed on an expanded five-year $650,000 revolving credit facility with a syndicate of lenders through PCF (the “2012 Facility”). The lenders have extended commitments of $650,000 under the 2012 Facility as of December 31, 2013, which was increased to $712,500 in January 2014 (see Note 17). The 2012 Facility includes an accordion feature which allows commitments to be increased up to $1,000,000 in the aggregate after the 2012 Facility accordion feature was increased from $650,000 in January 2014 (see Note 17). The revolving period of the 2012 Facility extends through March 2015, with an additional two year amortization period (with distributions allowed) after the completion of the revolving period. During such two year amortization period, all principal payments on the pledged assets will be applied to reduce the balance. At the end of the two year amortization period, the remaining balance will become due, if required by the lenders.

The 2012 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 2012 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 2012 Facility. The 2012 Facility also requires the maintenance of a minimum liquidity requirement. At December 31, 2013, we were in compliance with the applicable covenants.

Interest on borrowings under the 2012 Facility is one-month Libor plus 275 basis points with no minimum Libor floor. Additionally, the lenders charge a fee on the unused portion of the 2012 Facility equal to either 50 basis points, if at least half of the credit facility is drawn, or 100 basis points otherwise. The 2012 Facility requires us to pledge assets as collateral in order to borrow under the credit facility. As of December 31, 2013 and June 30, 2013, we had $577,548 and $473,508, respectively, available to us for borrowing under the 2012 Facility, of which the amount outstanding was zero and $124,000, respectively. As additional investments that are eligible are transferred to PCF and pledged under the 2012 Facility, PCF will generate additional availability up to the current commitment amount of $712,500. At December 31, 2013, the investments used as collateral for the 2012 Facility had an aggregate fair value of $1,075,441, which represents 21.1% of our total investments and money market funds. These assets are held and owned by PCF, a bankruptcy remote special purpose entity, and as such, these investments are not available to our general creditors. The release of any assets from PCF requires the approval of the facility agent.

In connection with the origination and amendments of the 2012 Facility, we incurred $12,127 of fees, including $1,319 of fees carried over from the previous facility, which are being amortized over the term of the facility in accordance with ASC 470-50, Debt Modifications and Extinguishments, of which $5,639 remains to be amortized and is included within deferred financing costs on the Consolidated Statements of Assets and Liabilities as of December 31, 2013.

During the three months ended December 31, 2013 and December 31, 2012, we recorded $2,600 and $2,227, respectively, of interest costs, unused fees and amortization of financing costs on the 2012 Facility as interest expense. During the six months ended December 31, 2013 and December 31, 2012, we recorded $5,076 and $4,395, respectively, of interest costs, unused fees and amortization of financing costs on the 2012 Facility as interest expense.

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Note 5. Senior Convertible Notes

On December 21, 2010, we issued $150,000 aggregate principal amount of senior convertible notes that mature on December 15, 2015 (the "2015 Notes"), unless previously converted or repurchased in accordance with their terms. The 2015 Notes bear interest at a rate of 6.25% per year, payable semi-annually on June 15 and December 15 of each year, beginning June 15, 2011. Total proceeds from the issuance of the 2015 Notes, net of underwriting discounts and offering costs, were $145,200.

On February 18, 2011, we issued $172,500 aggregate principal amount of senior convertible notes that mature on August 15, 2016 (the "2016 Notes"), unless previously converted or repurchased in accordance with their terms. The 2016 Notes bear interest at a rate of 5.50% per year, payable semi-annually on February 15 and August 15 of each year, beginning August 15, 2011. Total proceeds from the issuance of the 2016 Notes, net of underwriting discounts and offering costs, were $167,325. Between January 30, 2012 and February 2, 2012, we repurchased $5,000 of the 2016 Notes at a price of 97.5, including commissions. The transactions resulted in our recognizing $10 of loss in the year ended June 30, 2012.

On April 16, 2012, we issued $130,000 aggregate principal amount of senior convertible notes that mature on October 15, 2017 (the "2017 Notes"), unless previously converted or repurchased in accordance with their terms. The 2017 Notes bear interest at a rate of 5.375% per year, payable semi-annually on April 15 and October 15 of each year, beginning October 15, 2012. Total proceeds from the issuance of the 2017 Notes, net of underwriting discounts and offering costs, were $126,035.

On August 14, 2012, we issued $200,000 aggregate principal amount of senior convertible notes that mature on March 15, 2018 (the "2018 Notes"), unless previously converted or repurchased in accordance with their terms. The 2018 Notes bear interest at a rate of 5.75% per year, payable semi-annually on March 15 and September 15 of each year, beginning March 15, 2013. Total proceeds from the issuance of the 2018 Notes, net of underwriting discounts and offering costs, were $193,600.

On December 21, 2012, we issued $200,000 aggregate principal amount of senior convertible notes that mature on January 15, 2019 (the "2019 Notes"), unless previously converted or repurchased in accordance with their terms. The 2019 Notes bear interest at a rate of 5.875% per year, payable semi-annually on January 15 and July 15 of each year, beginning July 15, 2013. Total proceeds from the issuance of the 2019 Notes, net of underwriting discounts and offering costs, were $193,600.

Certain key terms related to the convertible features for the 2015 Notes, the 2016 Notes, the 2017 Notes, the 2018 Notes, and the 2019 Notes (collectively, the "Senior Convertible Notes") are listed below.

	2015 Notes	2016 Notes	2017 Notes	2018 Notes	2019 Notes
Initial conversion rate(1)	88.0902	78.3699	85.8442	82.3451	79.7766
Initial conversion price	$11.35	$12.76	$11.65	$12.14	$12.54
Conversion rate at December 31, 2013(1)(2)	89.0157	78.5395	86.1162	82.8631	79.7885
Conversion price at December 31, 2013(2)(3)	11.23	12.73	11.61	12.07	12.53
Last conversion price calculation date	12/21/2013	2/18/2013	4/16/2013	8/14/2013	12/21/2013
Dividend threshold amount (per share)(4)	$0.101125	$0.101150	$0.101500	$0.101600	$0.110025

(1) Conversion rates denominated in shares of common stock per $1 principal amount of the Senior Convertible Notes converted.

(2) Represents conversion rate and conversion price, as applicable, taking into account certain de minimis adjustments that will be made on the conversion date.

(3) The conversion price in effect at December 31, 2013 was calculated on the last anniversary of the issuance and will be adjusted again on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary.

(4) The conversion rate is increased if monthly cash dividends paid to common shares exceed the monthly dividend threshold amount, subject to adjustment.

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Note 5. Senior Convertible Notes (Continued)

In no event will the total number of shares of common stock issuable upon conversion exceed 96.8992 per $1 principal amount of the 2015 Notes (the “conversion rate cap”), except that, to the extent we receive written guidance or a no-action letter from the staff of the Securities and Exchange Commission (the “Guidance”) permitting us to adjust the conversion rate in certain instances without regard to the conversion rate cap and to make the 2015 Notes convertible into certain reference property in accordance with certain reclassifications, business combinations, asset sales and corporate events by us without regard to the conversion rate cap, we will make such adjustments without regard to the conversion rate cap and will also, to the extent that we make any such adjustment without regard to the conversion rate cap pursuant to the Guidance, adjust the conversion rate cap accordingly. We will use our commercially reasonable efforts to obtain such Guidance as promptly as practicable.

Prior to obtaining the Guidance, we will not engage in certain transactions that would result in an adjustment to the conversion rate increasing the conversion rate beyond what it would have been in the absence of such transaction unless we have engaged in a reverse stock split or share combination transaction such that in our reasonable best estimation, the conversion rate following the adjustment for such transaction will not be any closer to the conversion rate cap than it would have been in the absence of such transaction.

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

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

Subject to certain exceptions, holders may require us to repurchase, for cash, all or part of their Senior Convertible Notes upon a fundamental change at a price equal to 100% of the principal amount of the Senior Convertible Notes being repurchased plus any accrued and unpaid interest up to, but excluding, the fundamental change repurchase date. In addition, upon a fundamental change that constitutes a non-stock change of control we will also pay holders an amount in cash equal to the present value of all remaining interest payments (without duplication of the foregoing amounts) on such Senior Convertible Notes through and including the maturity date.

In connection with the issuance of the Senior Convertible Notes, we incurred $27,030 of fees which are being amortized over the terms of the notes, of which $18,015 remains to be amortized and is included within deferred financing costs on the Consolidated Statements of Assets and Liabilities as of December 31, 2013.

During the three months ended December 31, 2013 and December 31, 2012, we recorded $13,360 and $10,564, respectively, of interest costs and amortization of financing costs on the Senior Convertible Notes as interest expense.

During the six months ended December 31, 2013 and December 31, 2012, we recorded $26,670 and $19,230, respectively, of interest costs and amortization of financing costs on the Senior Convertible Notes as interest expense.

Note 6. Senior Unsecured Notes

On May 1, 2012, we issued $100,000 aggregate principal amount of senior unsecured notes that mature on November 15, 2022 (the "2022 Notes"). The 2022 Notes bear interest at a rate of 6.95% per year, payable quarterly on February 15, May 15, August 15 and November 15 of each year, beginning August 15, 2012. Total proceeds from the issuance of the 2022 Notes, net of underwriting discounts and offering costs, were $97,000.

On March 15, 2013, we issued $250,000 aggregate principal amount of senior unsecured notes that mature on March 15, 2023 (the “2023 Notes”). The 2023 Notes bear interest at a rate of 5.875% per year, payable semi-annually on March 15 and September 15 of each year, beginning September 15, 2013. Total proceeds from the issuance of the 2023 Notes, net of underwriting discounts and offering costs, were $245,885.

The 2022 Notes and the 2023 Notes (collectively, the “Senior Unsecured Notes”) are direct unsecured obligations and rank equally with all of our unsecured senior indebtedness from time to time outstanding.

In connection with the issuance of the Senior Unsecured Notes, we incurred $7,364 of fees which are being amortized over the term of the notes, of which $6,732 remains to be amortized and is included within deferred financing costs on the Consolidated Statements of Assets and Liabilities as of December 31, 2013.

During the three months ended December 31, 2013 and December 31, 2012, we recorded $5,596 and $1,814, respectively, of interest costs and amortization of financing costs on the Senior Unsecured Notes as interest expense. During the six months ended December 31, 2013 and December 31, 2012, we recorded $11,173 and $3,621, respectively, of interest costs and amortization of financing costs on the Senior Unsecured Notes as interest expense.

Note 7. Prospect Capital InterNotes®

On February 16, 2012, we entered into a Selling Agent Agreement (the “Selling Agent Agreement”) with Incapital LLC, as purchasing agent for our issuance and sale from time to time of up to $500,000 of Prospect Capital InterNotes® (the “InterNotes® Offering”), which was subsequently increased to $1,000,000. Additional agents may be appointed by us from time to time in connection with the InterNotes® Offering and become parties to the Selling Agent Agreement.

These notes are direct unsecured senior obligations and rank equally with all of our unsecured senior indebtedness outstanding. Each series of notes will be issued by a separate trust. These notes bear interest at fixed interest rates and offer a variety of maturities no less than twelve months from the original date of issuance.

During the six months ended December 31, 2013, we issued $238,780 aggregate principal amount of our Prospect Capital InterNotes® for net proceeds of approximately $234,239. These notes were issued with stated interest rates ranging from 4.0% to 6.75% with a weighted average rate of 5.25%. These notes mature between October 15, 2016 and October 15, 2043.

Tenor at Origination (in years)	Principal Amount	Interest Rate Range	Weighted Average Interest Rate		Maturity Date Range
3	$5,710	4.00%	4.00	%	October 15, 2016
3.5	3,149	4.00%	4.00	%	April 15, 2017
4	16,545	4.00%	4.00	%	November 15, 2017 – December 15, 2017
5	125,580	4.75%–5.00%	4.99	%	July 15, 2018 – December 15, 2018
5.5	3,820	5.00%	5.00	%	February 15, 2019
6.5	1,800	5.50%	5.50	%	February 15, 2020
7	34,438	5.50%–5.75%	5.54	%	June 15, 2020 – December 15, 2020
7.5	1,996	5.75%	5.75	%	February 15, 2021
12	2,978	6.00%	6.00	%	November 15, 2025 – December 15, 2025
15	2,495	6.00%	6.00	%	August 15, 2028 – November 15, 2028
18	4,062	6.00%–6.25%	6.21	%	July 15, 2031 – August 15, 2031
20	2,791	6.00%	6.00	%	September 15, 2033 – October 15, 2033

25	13,266	6.50%	6.50 %	August 15, 2038 – December 15, 2038
30	20,150	6.50%–6.75%	6.60 %	July 15, 2043 – October 15, 2043
	$238,780			

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Note 7. Prospect Capital InterNotes® (Continued)

During the six months ended December 31, 2013, we repaid $1,650 in aggregate principal amount of our Prospect Capital InterNotes® in accordance with the Survivor's Option, as defined in the InterNotes® Offering prospectus. Below are the Prospect Capital InterNotes® outstanding as of December 31, 2013:

Tenor at Origination (in years)	Principal Amount	Interest Rate Range	Weighted Average Interest Rate		Maturity Date Range
3	$5,710	4.00%	4.00	%	October 15, 2016
3.5	3,149	4.00%	4.00	%	April 15, 2017
4	16,545	4.00%	4.00	%	November 15, 2017 – December 15, 2017
5	125,580	4.75%–5.00%	4.99	%	July 15, 2018 – December 15, 2018
5.5	3,820	5.00%	5.00	%	February 15, 2019
6.5	1,800	5.50%	5.50	%	February 15, 2020
7	229,220	4.00%–6.55%	5.40	%	June 15, 2019 – December 15, 2020
7.5	1,996	5.75%	5.75	%	February 15, 2021
10	18,102	3.24%–7.00%	6.55	%	March 15, 2022 – April 15, 2023
12	2,978	6.00%	6.00	%	November 15, 2025 – December 15, 2025
15	17,495	5.00%–6.00%	5.14	%	May 15, 2028 – November 15, 2028
18	26,099	4.125%–6.25%	5.48	%	December 15, 2030 – August 15, 2031
20	5,897	5.625%–6.00%	5.84	%	November 15, 2032 – October 15, 2033
25	13,266	6.50%	6.50	%	August 15, 2038 – December 15, 2038
30	129,250	5.50%–6.75%	6.22	%	November 15, 2042 – October 15, 2043
	$600,907				

In connection with the issuance of the Prospect Capital InterNotes®, we incurred $15,868 of fees which are being amortized over the term of the notes, of which $15,084 remains to be amortized and is included within deferred financing costs on the Consolidated Statements of Assets and Liabilities as of December 31, 2013.

During the three months ended December 31, 2013 and December 31, 2012, we recorded $7,700 and $1,809, respectively, of interest costs and amortization of financing costs on the Prospect Capital InterNotes® as interest expense. During the six months ended December 31, 2013 and December 31, 2012, we recorded $13,744 and $2,679, respectively, of interest costs and amortization of financing costs on the Prospect Capital InterNotes® as interest expense.

Note 8. Fair Value and Maturity of Debt Outstanding

The following table shows the Revolving Credit Facility, Senior Convertible Notes, Senior Unsecured Notes and Prospect Capital InterNotes® amounts and outstanding borrowings at December 31, 2013 and June 30, 2013:

	As of December 31, 2013		As of June 30, 2013	
	Maximum Draw Amount	Amount Outstanding	Maximum Draw Amount	Amount Outstanding
Revolving Credit Facility	$650,000	$—	$552,500	$124,000
Senior Convertible Notes	847,500	847,500	847,500	847,500

Senior Unsecured Notes	347,814	347,814	347,725	347,725
Prospect Capital InterNotes®	600,907	600,907	363,777	363,777
Total	$2,446,221	$1,796,221	$2,111,502	$1,683,002

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The following table shows the contractual maturity of our Revolving Credit Facility, Senior Convertible Notes, Senior Unsecured Notes and Prospect Capital InterNotes® at December 31, 2013:

	Payments Due by Period				
	Total	Less than 1 Year	1 – 3 Years	3 – 5 Years	After 5 Years
Revolving Credit Facility	$—	$—	$—	$—	$—
Senior Convertible Notes	847,500	—	317,500	330,000	200,000
Senior Unsecured Notes	347,814	—	—	—	347,814
Prospect Capital InterNotes®	600,907	—	5,710	144,588	450,609
Total Contractual Obligations	$1,796,221	$—	$323,210	$474,588	$998,423

The following table shows the contractual maturity of our Revolving Credit Facility, Senior Convertible Notes, Senior Unsecured Notes and InterNotes® at June 30, 2013:

	Payments Due by Period				
	Total	Less than 1 Year	1 – 3 Years	3 – 5 Years	After 5 Years
Revolving Credit Facility	$124,000	$—	$—	$124,000	$—
Senior Convertible Notes	847,500	—	150,000	297,500	400,000
Senior Unsecured Notes	347,725	—	—	—	347,725
Prospect Capital InterNotes®	363,777	—	—	—	363,777
Total Contractual Obligations	$1,683,002	$—	$150,000	$421,500	$1,111,502

The fair values of our financial liabilities disclosed, but not carried, at fair value as of December 31, 2013 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Fair Value Hierarchy			
	Level 1	Level 2	Level 3	Total
Revolving Credit Facility	$—	$—	$—	$—
Senior Convertible Notes(1)	—	899,713	—	899,713
Senior Unsecured Notes(1)	102,680	248,038	—	350,718
Prospect Capital InterNotes®(2)	—	594,906	—	594,906
Total	$102,680	$1,742,657	$—	$1,845,337

(1) We use available market quotes to estimate the fair value of the Senior Convertible Notes and Senior Unsecured Notes.
(2) The fair value of our Prospect Capital InterNotes® is estimated by discounting remaining payments using current Treasury rates.

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The fair values of our financial liabilities disclosed, but not carried, at fair value as of June 30, 2013 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Fair Value Hierarchy			
	Level 1	Level 2	Level 3	Total
Revolving Credit Facility(1)	$—	$124,000	$—	$124,000
Senior Convertible Notes(2)	—	886,210	—	886,210
Senior Unsecured Notes(2)	101,800	242,013	—	343,813
Prospect Capital InterNotes®(3)	—	336,055	—	336,055
Total	$101,800	$1,588,278	$—	$1,690,078

(1) The carrying value of our Revolving Credit Facility approximates the fair value.
(2) We use available market quotes to estimate the fair value of the Senior Convertible Notes and Senior Unsecured Notes.
(3) The fair value of our Prospect Capital InterNotes® is estimated by discounting remaining payments using current Treasury rates.

Note 9. Equity Offerings, Offering Expenses, and Distributions

Excluding dividend reinvestments, we issued 52,618,409 and 74,915,013 shares of our common stock during the six months ended December 31, 2013 and December 31, 2012, respectively. The proceeds raised, the related underwriting fees, the offering expenses and the prices at which these shares were issued are as follows:

Issuances of Common Stock	Number of Shares Issued	Gross Proceeds	Underwriting Fees	Offering Expenses	Average Offering Price
During the six months ended December 31, 2013:					
July 5, 2013 – August 21, 2013(1)	9,818,907	$107,725	$902	$169	$10.97
August 2, 2013(2)	1,918,342	21,006	—	—	$10.95
August 29, 2013 – November 4, 2013(3)	24,127,242	272,114	2,703	414	$11.28
November 12, 2013 – December 31, 2013(4)	16,753,918	189,237	1,893	436	$11.30
During the six months ended December 31, 2012:					
July 2, 2012 – July 12, 2012(5)	2,247,275	26,040	260	—	$11.59
July 16, 2012	21,000,000	234,150	2,100	62	$11.15
July 27, 2012	3,150,000	35,123	315	—	$11.15
September 13, 2012 – October 9, 2012(6)	8,010,357	94,610	946	638	$11.81
November 7, 2012	35,000,000	388,500	4,550	814	$11.10
December 13, 2012(2)	467,928	5,021	—	—	$10.73
December 28, 2012(2)	897,906	9,581	—	—	$10.67
December 31, 2012(2)	4,141,547	44,649	—	—	$10.78

(1) On May 8, 2013, we established an at-the-market program through which we may sell, from time to time and at our sole discretion, 45,000,000 shares of our common stock. Through this program, we issued 9,818,907 shares of our common stock at an average price of $10.97 per share, raising $107,725 of gross proceeds, from July 5, 2013 through August 21, 2013.

(2) On December 13, 2012, December 28, 2012, December 31, 2012, and August 2, 2013, we issued 467,928, 897,906, 4,141,547 and 1,918,342 shares of our common stock, respectively, in conjunction with investments in CCPI, Credit Central, Valley Electric and CP Holdings which are controlled portfolio companies.

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(3) On August 22, 2013, we established an at-the-market program through which we may sell, from time to time and at our sole discretion, 45,000,000 shares of our common stock. Through this program, we issued 24,127,242 shares of our common stock at an average price of $11.28 per share, raising $272,114 of gross proceeds, from August 29, 2013 through November 4, 2013.

(4) On November 5, 2013, we established an at-the-market program through which we may sell, from time to time and at our sole discretion, 50,000,000 shares of our common stock. Through this program, we issued 16,753,918 shares of our common stock at an average price of $11.30 per share, raising $189,237 of gross proceeds, from November 12, 2013 through December 31, 2013.

(5) On June 1, 2012, we established an at-the-market program through which we may sell, from time to time and at our sole discretion, 9,500,000 shares of our common stock. Through this program, we issued 2,247,275 shares of our common stock at an average price of $11.59 per share, raising $26,040 of gross proceeds, from July 2, 2012 through July 12, 2012.

(6) On September 10, 2012, we established an at-the-market program through which we may sell, from time to time and at our sole discretion, 9,750,000 shares of our common stock. Through this program, we issued 8,010,357 shares of our common stock at an average price of $11.81 per share, raising $94,610 of gross proceeds, from September 13, 2012 through October 9, 2012.

Our shareholders' equity accounts at December 31, 2013 and June 30, 2013 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 August 24, 2011, our Board of Directors approved a share repurchase plan under which we may repurchase up to $100,000 of our common stock at prices below our net asset value. We have not made any purchases of our common stock during the period from August 24, 2011 to December 31, 2013 pursuant to this plan. Prior to any repurchase we are required to notify shareholders of our intention to purchase our common stock. This notice lasts for six months after notice is given. Our last notice was delivered with our annual proxy mailing on September 10, 2013.

On October 15, 2013, our Registration Statement on Form N-2 was declared effective by the SEC. Under this Shelf Registration Statement, we can issue up to $4,595,882 of additional debt and equity securities in the public market as of December 31, 2013.

On August 21, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110325 per share for January 2014 to holders of record on January 31, 2014 with a payment date of February 20, 2014;
- $0.110350 per share for February 2014 to holders of record on February 28, 2014 with a payment date of March 20, 2014; and
- $0.110375 per share for March 2014 to holders of record on March 31, 2014 with a payment date of April 17, 2014.

On November 4, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110400 per share for April 2014 to holders of record on April 30, 2014 with a payment date of May 22, 2014;
- $0.110425 per share for May 2014 to holders of record on May 30, 2014 with a payment date of June 19, 2014; and
- $0.110450 per share for June 2014 to holders of record on June 30, 2014 with a payment date of July 24, 2014.

During the six months ended December 31, 2013 and December 31, 2012, we issued 804,062 and 624,527 shares of our common stock, respectively, in connection with the dividend reinvestment plan.

At December 31, 2013, we have reserved 70,507,990 shares of our common stock for issuance upon conversion of the Senior Convertible Notes (see Note 5).

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Note 10. Other Investment Income

Other investment income consists of structuring fees, overriding royalty interests, revenue receipts related to net profit interests, deal deposits, administrative agent fee, and other miscellaneous and sundry cash receipts. Income from such sources for the three and six months ended December 31, 2013 and December 31, 2012 were as follows:

	For The Three Months Ended December 31,		For The Six Months Ended December 31,	
Income Source	2013	2012	2013	2012
Structuring, advisory and amendment fees (Note 3)	$20,721	$15,697	$29,799	$24,657
Recovery of legal costs from prior periods from legal settlement	—	—	5,000	—
Overriding royalty interests	1,273	1,326	2,612	1,340
Administrative agent fee	101	191	208	335
Other Investment Income	$22,095	$17,214	$37,619	$26,332

Note 11. 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 three and six months ended December 31, 2013 and December 31, 2012, respectively.

	For The Three Months Ended December 31,		For The Six Months Ended December 31,	
	2013	2012	2013	2012
Net increase in net assets resulting from operations	$85,362	$46,489	$165,262	$93,738
Weighted average common shares outstanding	287,016,433	195,585,502	272,550,293	179,039,198
Net increase in net assets resulting from operations per common share	$0.30	$0.24	$0.61	$0.52

Note 12. 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, the 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.

The total base management fees incurred to the favor of the Investment Adviser for the three months ended December 31, 2013 and December 31, 2012 were $25,075 and $16,306, respectively. The fees incurred for the six months ended December 31, 2013 and December 31, 2012 were $48,120 and $29,534, 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

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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.

For the three months ended December 31, 2013 and December 31, 2012, $23,054 and $24,804, respectively, of income incentive fees were incurred. For the six months ended December 31, 2013 and December 31, 2012, $43,638 and $43,311, respectively, were incurred. No capital gains incentive fees were incurred for the three or six months ended December 31, 2013 and December 31, 2012, respectively.

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

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by Prospect Administration in performing its obligations under the Administration Agreement, including rent and our allocable portion of the costs of our chief financial officer and chief compliance officer and his staff. For the three months ended December 31, 2013 and 2012, the reimbursement was approximately $3,986 and $2,139, respectively. For the six months ended December 31, 2013 and 2012, the reimbursement was approximately $7,972 and $4,323, 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 the 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.

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. As of December 31, 2013 and June 30, 2013, $1,632 and $1,291 of managerial assistance fees remain on the Consolidated Statements of Assets and Liabilities as a payable to Prospect Administration for reimbursement of its cost in providing such assistance.

Note 13. 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. During the six months ended December 31, 2013, we received $5,000 of legal cost reimbursement from a litigation settlement, which had been expensed in prior quarters, and is recognized as other income on our consolidated financial statements. We are not aware of any other material litigation as of the date of this report.

Note 14. Proposed Investment

On December 17, 2013, we entered into a definitive agreement to acquire 100% of the common stock of Nicholas Financial, Inc. ("Nicholas") for $16.00 per share. Nicholas is a specialty finance company headquartered in Clearwater, Florida. Nicholas is engaged primarily as an indirect lender in the consumer automobile lending business, where Nicholas purchases loans originated by more than 1,600 car dealerships. Subject to certain conditions, the transaction is currently contemplated to close in April 2014, although this timing could be earlier or later depending on the time required to obtain the requisite approvals.

If the arrangement is completed, each outstanding Common Share of Nicholas Financial-Canada will be converted into the right to receive the number of shares of common stock of Prospect determined by dividing $16.00 by the volume-weighted average price of Prospect common stock for the 20 trading days prior to and ending on the trading day immediately preceding the effective time of the arrangement. Each option to acquire shares of Nicholas Financial-Canada common stock outstanding immediately

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prior to the effective time of the arrangement will be cancelled or transferred by the holder thereof in exchange for a cash amount equal to the amount by which (i) the product obtained by multiplying (x) the number of Common Shares of Nicholas Financial-Canada underlying such option by (y) $16.00 exceeds (ii) the aggregate exercise price payable under such option. As of January 31, 2014, the last reported sales price for Prospect common stock was $10.87.

Including the $199,466 equity valuation for Nicholas and after taking into consideration its outstanding net debt, which is currently $126,526, the overall value placed on Nicholas in the transaction is approximately $325,992 before estimated transaction fees and expenses. Upon closing the transaction, Prospect intends to refinance the business using proceeds from a newly committed $250,000 revolving credit facility from bank lenders and an operating company term loan that Prospect will provide. The aggregate net proceeds from this recapitalization will be used to repay the existing debt of Nicholas and return a portion of capital issued by Prospect to complete the transaction on the closing date. After receipt of the recapitalization cash distribution, Prospect will have a net investment in the transaction of approximately $139,521.

Prospect’s post-recapitalization $139,521 investment in Nicholas is expected to consist of $124,593 of operating and holding company term loans and $14,928 of a holding company equity investment.

Note 15. Financial Highlights (Unaudited)

	For The Three Months Ended December 31,		For The Six Months Ended December 31,	
	2013	2012	2013	2012
Per Share Data(1):				
Net asset value at beginning of period	$10.72	$10.88	$10.72	$10.83
Net investment income	0.32	0.51	0.64	0.97
Net realized loss	(0.02)	(0.04)	(0.01)	(0.04)
Net unrealized depreciation	—	(0.23)	(0.03)	(0.41)
Net increase in net assets as a result of public offerings	0.04	—	0.07	0.08
Dividends declared and paid	(0.33)	(0.31)	(0.66)	(0.62)
Net asset value at end of period	$10.73	$10.81	$10.73	$10.81
Per share market value at end of period	$11.22	$10.87	$11.22	$10.87
Total return based on market value(2)	3.41%	(2.99)%	10.12%	0.71%
Total return based on net asset value(2)	3.04%	2.14%	6.09%	5.33%
Shares outstanding at end of period	301,259,436	215,173,410	301,259,436	215,173,410
Average weighted shares outstanding for period	287,016,433	195,585,502	272,550,293	179,039,198
Ratio / Supplemental Data:				
Net assets at end of period	$3,231,099	$2,326,635	$3,231,099	$2,326,625
Portfolio turnover rate	8.89%	17.79%	9.24%	19.52%
Annualized ratio of operating expenses to average net assets	11.22%	12.06%	11.24%	11.97%
Annualized ratio of net investment income to average net assets	11.98%	19.49%	11.89%	18.40%

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	Year Ended June 30, 2013	2012	2011	2010	2009
Per Share Data(1):					
Net asset value at beginning of period	$10.83	$10.36	$10.30	$12.40	$14.55
Net investment income	1.57	1.63	1.10	1.13	1.87
Net realized (loss) gain	(0.13)	0.32	0.19	(0.87)	(1.24)
Net unrealized (depreciation) appreciation	(0.37)	(0.28)	0.09	0.07	0.48
Net increase (decrease) in net assets as a result of public offering	0.13	0.04	(0.08)	(0.85)	(2.11)
Net increase in net assets as a result of shares issued for Patriot acquisition	—	—	—	0.12	—
Dividends to shareholders	(1.31)	(1.24)	(1.24)	(1.70)	(1.15)
Net asset value at end of period	$10.72	$10.83	$10.36	$10.30	$12.40
Per share market value at end of period	$10.80	$11.39	$10.11	$9.65	$9.20
Total return based on market value(2)	6.24%	27.21%	17.22%	17.66%	(18.60)%
Total return based on net asset value(2)	10.91%	18.03%	12.54%	(6.82)%	(0.61)%
Shares outstanding at end of period	247,836,965	139,633,870	107,606,690	69,086,862	42,943,084
Average weighted shares outstanding for period	207,069,971	114,394,554	85,978,757	59,429,222	31,559,905
Ratio / Supplemental Data:					
Net assets at end of period	$2,656,494	$1,511,974	$1,114,357	$711,424	$532,596
Portfolio turnover rate	29.24%	29.06%	27.63%	21.61%	4.99%
Annualized ratio of operating expenses to average net assets	11.50%	10.73%	8.47%	7.54%	9.03%
Annualized ratio of net investment income to average net assets	14.86%	14.92%	10.60%	10.69%	13.14%

(1) Financial highlights are based on weighted average shares (except for dividends declared and paid which is based on actual rate per share).

(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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Note 16. Selected Quarterly Financial Data (Unaudited)

	Investment Income		Net Investment Income		Net Realized and Unrealized Gains (Losses)		Net Increase in Net Assets from Operations	
Quarter Ended	Total	Per Share (1)	Total	Per Share (1)	Total	Per Share (1)	Total	Per Share (1)
September 30, 2010	$35,212	$ 0.47	$20,995	$ 0.28	$ 4,585	$ 0.06	$ 25,580	$ 0.34
December 31, 2010	33,300	0.40	19,080	0.23	12,860	0.16	31,940	0.38
March 31, 2011	44,573	0.51	23,956	0.27	9,803	0.11	33,759	0.38
June 30, 2011	56,391	0.58	30,190	0.31	(3,231)	(0.03)	26,959	0.28
September 30, 2011	55,342	0.51	27,877	0.26	12,023	0.11	39,900	0.37
December 31, 2011	67,263	0.61	36,508	0.33	27,984	0.26	64,492	0.59
March 31, 2012	95,623	0.84	58,072	0.51	(7,863)	(0.07)	50,209	0.44
June 30, 2012	102,682	0.82	64,227	0.52	(27,924)	(0.22)	36,303	0.29
September 30, 2012	123,636	0.76	74,027	0.46	(26,778)	(0.17)	47,249	0.29
December 31, 2012	166,035	0.85	99,216	0.51	(52,727)	(0.27)	46,489	0.24
March 31, 2013	120,195	0.53	59,585	0.26	(15,156)	(0.07)	44,429	0.20
June 30, 2013	166,470	0.68	92,096	0.38	(9,407)	(0.04)	82,689	0.34
September 30, 2013	161,034	0.62	82,337	0.32	(2,437)	(0.01)	79,900	0.31
December 31, 2013	178,090	0.62	92,215	0.32	(6,853)	(0.02)	85,362	0.30

(1) Per share amounts are calculated using weighted average shares during period.

Note 17. Subsequent Events

During the period from January 1, 2014 to January 31, 2014, we issued $44,717 in aggregate principal amount of our Prospect Capital InterNotes® for net proceeds of $43,957. In addition, we sold $11,172 in aggregate principal amount of our Prospect Capital InterNotes® for net proceeds of $10,980 with expected closing on February 6, 2014.

During the period from January 1, 2014 to January 31, 2014 (with settlement through February 5, 2014), we sold 10,547,971 shares of our common stock at an average price of $11.17 per share, and raised $117,809 of gross proceeds, under the ATM Program. Net proceeds were $116,632 after commissions to the broker-dealer on shares sold and offering costs.

On January 7, 2014, we made a $2,000 investment in NPH to support the peer-to-peer lending initiative. We invested $300 of equity and $1,700 of debt in NPH.

On January 8, 2014, we made a $161,500 follow-on investment in Broder Bros., Co., a distributor of imprintable sportswear and accessories in the United States.

On January 13, 2014, we made a $2,000 follow-on investment in NPH to support the peer-to-peer lending initiative. We invested $300 of equity and $1,700 of debt in NPH.

On January 14, 2014, we made a $2,000 follow-on investment in NPH to support the peer-to-peer lending initiative. We invested $300 of equity and $1,700 of debt in NPH.

On January 15, 2014, we expanded the accordion feature of our credit facility from $650,000 to $1,000,000 and increased the commitments to the credit facility by $62,500. The commitments to the credit facility now stand at $712,500.

On January 17, 2014, we made a $2,000 follow-on investment in NPH to support the peer-to-peer lending initiative. We invested $300 of equity and $1,700 of debt in NPH.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2013
(Unaudited)
(in thousands, except share and per share data)
Note 17. Subsequent Events (Continued)

On January 17, 2014, we made a $6,565 follow-on investment in APH to acquire the Gulf Coast II Portfolio, a portfolio of two multi-family residential properties located in Alabama and Florida. We invested $1,065 of equity and $5,500 of debt in APH.

On January 23, 2014, we issued 109,087 shares of our common stock in connection with the dividend reinvestment plan.

On January 31, 2014, we made a $4,805 follow-on investment in NPH to acquire Island Club, a multi-family residential property located in Jacksonville, Florida. We invested $805 of equity and $4,000 of debt in NPH.

On February 3, 2014, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110475 per share for July 2014 to holders of record on July 31, 2014 with a payment date of August 21, 2014;
- $0.110500 per share for August 2014 to holders of record on August 29, 2014 with a payment date of September 18, 2014; and
- $0.110525 per share for September 2014 to holders of record on September 30, 2014 with a payment date of October 22, 2014.

Filed pursuant to Rule 497
File No. 333-190850

$5,000,000,000
PROSPECT CAPITAL CORPORATION
Common Stock
Preferred Stock
Debt Securities
Subscription Rights
Warrants
Units

We may offer, from time to time, in one or more offerings or series, together or separately, up to $5,000,000,000 of our common stock, preferred stock, debt securities, subscription rights to purchase our securities, warrants representing rights to purchase our securities or separately tradeable units combining two or more of our securities, collectively, the Securities, to provide us with additional capital. Securities may be offered at prices and on terms to be disclosed in one or more supplements to this prospectus. You should read this prospectus and the applicable prospectus supplement carefully before you invest in our Securities.

We may offer shares of common stock, subscription rights, units, warrants, options or rights to acquire shares of common stock, at a discount to net asset value per share in certain circumstances. Sales of common stock at prices below net asset value per share dilute the interests of existing stockholders, have the effect of reducing our net asset value per share and may reduce our market price per share. At our 2012 annual meeting, held on December 7, 2012, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering, our stockholders approved our ability to sell or otherwise issue shares of our common stock at any level of discount from net asset value per share for a twelve month period expiring on the anniversary of the date of stockholder approval. We are currently seeking stockholder approval at our 2013 annual meeting, to be held on December 6, 2013, to continue for an additional year our ability to issue shares of common stock below net asset value, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering.

Our Securities may be offered directly to one or more purchasers, or through agents designated from time to time by us, or to or through underwriters or dealers. The prospectus supplement relating to the offering will identify any agents, underwriters or dealers involved in the sale of our Securities, and will disclose any applicable purchase price, fee, commission or discount arrangement between us and our agents, underwriters or dealers, or the basis upon which such amount may be calculated. See "Plan of Distribution." We may not sell any of our Securities through agents, underwriters or dealers without delivery of the prospectus and a prospectus supplement describing the method and terms of the offering of such Securities. Our common stock is traded on The NASDAQ Global Select Market under the symbol "PSEC." As of October 10, 2013, the last reported sales price for our common stock was $11.07.

Prospect Capital Corporation, or the Company, is a company that lends to and invests in middle market privately-held companies. Prospect Capital Corporation, a Maryland corporation, has been organized as a closed-end investment company since April 13, 2004 and has filed an election to be treated as a business development company under the Investment Company Act of 1940, as amended, or the 1940 Act, and is a non-diversified investment company within the meaning of the 1940 Act.

Prospect Capital Management LLC, our investment adviser, manages our investments and Prospect Administration LLC, our administrator, provides the administrative services necessary for us to operate.

Investing in our Securities involves a heightened risk of total loss of investment. Before buying any Securities, you should read the discussion of the material risks of investing in our Securities in "Risk Factors" beginning on page 10 of this prospectus.

This prospectus contains important information about us that you should know before investing in our Securities. Please read it before making an investment decision and keep it for future reference. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission, or the SEC. You may make inquiries or obtain this information free of charge by writing to Prospect Capital Corporation at 10 East 40th Street, 44th Floor, New York, NY 10016, or by calling 212-448-0702. Our Internet address is http://www.prospectstreet.com. Information contained on our website is not incorporated by reference into this prospectus and you should not consider information contained on our website to be a part of this prospectus. You may also obtain information about us from our website and the SEC's website (http://www.sec.gov).

The SEC has not approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

This prospectus may not be used to consummate sales of securities unless accompanied by a prospectus supplement.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the SEC, using the "shelf" registration process. Under the shelf registration process, we may offer, from time to time on a delayed basis, up to $5,000,000,000 of our common stock, preferred stock, debt securities, subscription rights to purchase shares of our securities, warrants representing rights to purchase our securities or separately tradeable units combining two or more of our securities, on the terms to be determined at the time of the offering. The Securities may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the Securities that we may offer. Each time we use this prospectus to offer Securities, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any prospectus supplement together with any exhibits and the additional information described under the heading "Available Information" and the section under the heading "Risk Factors" before you make an investment decision.

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PROSPECTUS SUMMARY

The following summary contains basic information about this offering. It does not contain all the information that may be important to an investor. For a more complete understanding of this offering, we encourage you to read this entire document and the documents to which we have referred.

Information contained or incorporated by reference in this prospectus may contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, which are statements about the future that may be identified by the use of forward-looking terminology such as "may," "will," "expect," "intend," "plans," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. These forward-looking statements do not meet the safe harbor for forward-looking statements pursuant to Section 27A of the Securities Act of 1933, as amended, or the Securities Act. The matters described in "Risk Factors" and certain other factors noted throughout this prospectus and in any exhibits to the registration statement of which this prospectus is a part, constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements. The Company reminds all investors that no forward-looking statement can be relied upon as an accurate or even mostly accurate forecast because humans cannot forecast the future.

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

The Company

We are a financial services company that lends to and invests in middle market privately-held companies. In this prospectus, we use the term "middle-market" to refer to companies typically with annual revenues between $50 million and $2 billion.

From our inception to the fiscal year ended June 30, 2007, we invested primarily in industries related to the industrial/energy economy, which consists of companies in the discovery, production, transportation, storage and use of energy resources as well as companies that sell products and services to, or acquire products and services from, these companies. Since then, we have widened our strategy to focus on other sectors of the economy and continue to broaden our portfolio holdings.

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.

The Investment Adviser

Prospect Capital Management, an affiliate of the Company, manages our investment activities. Prospect Capital Management is an investment adviser that has been registered under the Investment Advisers Act of 1940, or the Advisers Act, since March 31, 2004. Under an investment advisory and management agreement between us and Prospect Capital Management, or the Investment Advisory Agreement, we have agreed to pay Prospect Capital Management investment advisory fees, which will consist of an annual base management fee based on our gross assets, which we define as total assets without deduction for any liabilities (and, accordingly, includes the value of assets acquired with proceeds from borrowings), as well as a two-part incentive fee based on our performance.

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. We are a non-diversified company within the meaning of the 1940 Act.

We invest primarily in first and second lien senior loans and mezzanine debt. First and second lien senior loans generally are senior debt instruments that rank ahead of subordinated debt of a given portfolio company. These loans also have the benefit of security interests on the assets of the portfolio company, which may rank ahead of or be junior to other security interests. Mezzanine debt and our investments in CLOs are subordinated to senior loans and are generally unsecured. Our investments have generally ranged between $5 million and $250 million each, although the investment size may be more or less than this range. Our investment sizes are expected to grow as our capital base expands.

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We also acquire controlling interests in companies in conjunction with making secured debt investments in such companies. These may be in several industries, including industrial, service, real estate and financial businesses.

We seek to maximize returns and minimize 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. 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. Such investments may also include purchases (either in the primary or secondary markets) of the equity and junior debt tranches of a type of such pools known as CLOs. Structurally, CLOs are entities that are formed to hold a portfolio of senior secured loans ("Senior Secured Loans") made to companies whose debt is rated below investment grade or, in limited circumstances, unrated. The Senior Secured Loans within a CLO are limited to Senior Secured Loans which meet specified credit and diversity criteria and are subject to concentration limitations in order to create an investment portfolio that is diverse by Senior Secured Loan, borrower, and industry, with limitations on non-U.S. borrowers. CLOs are typically highly levered up to approximately 10 times, and therefore the junior debt and equity tranches that we will invest in are subject to a higher risk of total loss. Our potential investment in CLOs is limited by the 1940 Act to 30% of our portfolio. Within this 30% basket, we have and may make additional investments in debt and equity securities of financial companies and companies located outside of the United States.

The Offering

We may offer, from time to time, in one or more offerings or series, together or separately, up to $5,000,000,000 of our Securities, which we expect to use initially to maintain balance sheet liquidity, involving repayment of debt under our credit facility, investment in high quality short-term debt instruments or a combination thereof, and thereafter to make long-term investments in accordance with our investment objectives.

Our Securities may be offered directly to one or more purchasers, through agents designated from time to time by us, or to or through underwriters or dealers. The prospectus supplement relating to a particular offering will disclose the terms of that offering, including the name or names of any agents, underwriters or dealers involved in the sale of our Securities by us, the purchase price, and any fee,
commission or discount arrangement between us and our agents, underwriters or dealers, or the basis upon which such amount may be calculated. See "Plan of Distribution." We may not sell any of our Securities through agents, underwriters or dealers without delivery of a prospectus supplement describing the method and terms of the offering of our Securities.

We may sell our common stock, subscription rights, units, warrants, options or rights to acquire our common stock, at a price below the current net asset value of our common stock upon approval of our directors, including a majority of our independent directors, in certain circumstances. Our stockholders approved our ability to issue warrants, options or rights to acquire our common stock at our 2008 annual meeting of stockholders for an unlimited time period and in accordance with the 1940 Act which provides that the conversion or exercise price of such warrants, options or rights may be less than net asset value per share at the date such securities are issued or at the date such securities are converted into or exercised for shares of our common stock. At our 2012 annual meeting, held on December 7, 2012, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering, our stockholders approved our ability to sell or otherwise issue shares of our common stock at any level of discount from net asset value per share for a twelve month period expiring on the anniversary of the date of the stockholder approval. We are currently seeking stockholder approval at our 2013 annual meeting, to be held on December 6, 2013, to continue for an additional year our ability to issue shares of common stock below net asset value, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering. See "Sales of Common Stock Below Net Asset Value" in this prospectus and in the prospectus supplement, if applicable. Sales of common stock at prices below net asset value per share dilute the interests of existing stockholders, have the effect of reducing our net asset value per share and may reduce our market price per share. We have no current intention of engaging in a rights offering, although we reserve the right to do so in the future.

Set forth below is additional information regarding the offering of our Securities:

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Use of proceeds	Unless otherwise specified in a prospectus supplement, we intend to use the net proceeds from selling Securities pursuant to this prospectus initially to maintain balance sheet liquidity, involving repayment of debt under our credit facility, if any, investments in high quality short-term debt instruments or a combination thereof, and thereafter to make long-term investments in accordance with our investment objective. Interest on borrowings under the credit facility is one-month LIBOR plus 275 basis points, with no minimum LIBOR floor. Additionally, the lenders charge a fee on the unused portion of the credit facility equal to either 50 basis points if at least half of the credit facility is drawn or 100 basis points otherwise. See "Use of Proceeds."
Distributions	In June 2010, our Board of Directors approved a change in dividend policy from quarterly distributions to monthly distributions. Since that time, we have paid monthly distributions to the holders of our common stock and generally intend to continue to do so. The amount of the monthly distributions is determined by our Board of Directors and is based on our estimate of our investment company taxable income and net short-term capital gains. Certain amounts of the monthly distributions may from time to time be paid out of our capital rather than from earnings for the month as a result of our deliberate planning or accounting reclassifications. Distributions in excess of our current and accumulated earnings and profits constitute a return of capital and will reduce the stockholder's adjusted tax basis in such stockholder's common stock. A return of capital (1) is a return of the original amount invested, (2) does not constitute earnings or profits and (3) while such returns are initially tax free, they will have the effect of reducing the basis such that when a stockholder sells its shares, it may be subject to additional tax even if the shares are sold for less than the original purchase price. After the adjusted basis is reduced to zero, these distributions will constitute capital gains to such stockholders. Certain additional amounts may be deemed as distributed to stockholders for income tax purposes. Other types of Securities will likely pay distributions in accordance with their terms. See "Price Range of Common Stock," "Distributions" and "Material U.S. Federal Income Tax Considerations."
Taxation	We have qualified and elected to be treated for U.S. federal income tax purposes as a regulated investment company, or a RIC, under Subchapter M of the Internal Revenue Code of 1986, or 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 maintain our qualification as a RIC and obtain RIC tax treatment, we must satisfy certain source-of-income and asset diversification requirements and distribute annually 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. See "Distributions" and "Material U.S. Federal Income Tax Considerations."
Dividend reinvestment plan	We have a dividend reinvestment plan for our stockholders. This is an "opt out" dividend reinvestment plan. As a result, when we declare a dividend, the dividends are automatically reinvested in additional shares of our common stock, unless a stockholder specifically "opts out" of the dividend

	reinvestment plan so as to receive cash dividends. Stockholders who receive distributions in the form of stock are subject to the same U.S. federal, state and local tax consequences as stockholders who elect to receive their distributions in cash. See "Dividend Reinvestment Plan."
The NASDAQ Global Select Market Symbol	PSEC
Anti-takeover provisions	Our charter and bylaws, as well as certain statutory and regulatory requirements, contain provisions that may have the effect of discouraging a third party from making an acquisition proposal for us. These anti-takeover provisions may inhibit a change in control in circumstances that could give the holders of our common stock the opportunity to realize a premium over the market price of our common stock. See "Description Of Our Capital Stock."
Management arrangements	Prospect Capital Management serves as our investment adviser. Prospect Administration serves as our administrator. For a description of Prospect Capital Management, Prospect Administration and our contractual arrangements with these companies, see "Business—Management Services—Investment Advisory Agreement," and "Business— Management Services—Administration Agreement."

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Risk factors	Investment in our Securities involves certain risks relating to our structure and investment objective that should be considered by prospective purchasers of our Securities. In addition, as a business development company, our portfolio primarily includes securities issued by privately-held companies. These investments generally involve a high degree of business and financial risk, and are less liquid than public securities. We are required to mark the carrying value of our investments to fair value on a quarterly basis, and economic events, market conditions and events affecting individual portfolio companies can result in quarter-to-quarter mark-downs and mark-ups of the value of individual investments that collectively can materially affect our net asset value, or NAV. Also, our determinations of fair value of privately-held securities may differ materially from the values that would exist if there was a ready market for these investments. A large number of entities compete for the same kind of investment opportunities as we do. Moreover, our business requires a substantial amount of capital to operate and to grow and we seek additional capital from external sources. In addition, the failure to qualify as a RIC eligible for pass-through tax treatment under the Code on income distributed to stockholders could have a materially adverse effect on the total return, if any, obtainable from an investment in our Securities. See "Risk Factors" and the other information included in this prospectus for a discussion of factors you should carefully consider before deciding to invest in our Securities.
Plan of distribution	We may offer, from time to time, up to $5,000,000,000 of our common stock, preferred stock, debt securities, subscription rights to purchase shares of our securities, warrants representing rights to purchase our securities or separately tradeable units combining two or more of our securities on the terms to be determined at the time of the offering. Securities may be offered at prices and on terms described in one or more supplements to this prospectus directly to one or more purchasers, through agents designated from time to time by us, or to or through underwriters or dealers. The supplement to this prospectus relating to the offering will identify any agents or underwriters involved in the sale of our Securities, and will set forth any applicable purchase price, fee and commission or discount arrangement or the basis upon which such amount may be calculated. We may not sell Securities pursuant to this prospectus without delivering a prospectus supplement describing the method and terms of the offering of such Securities. For more information, see "Plan of Distribution."

Fees and Expenses

The following tables are intended to assist you in understanding the costs and expenses that an investor in this offering will bear directly or indirectly. We caution you that some of the percentages indicated in the table below are estimates and may vary. In these tables, we assume that we have borrowed $2.3 billion. We do not intend to issue preferred stock during the year. Except where the context suggests otherwise, whenever this prospectus contains a reference to fees or expenses paid by "you" or "us" or that "we" will pay fees or expenses, the Company will pay such fees and expenses out of our net assets and, consequently, you will indirectly bear such fees or expenses as an investor in the Company. However, you will not be required to deliver any money or otherwise bear personal liability or responsibility for such fees or expenses.

Stockholder transaction expenses:		
Sales load (as a percentage of offering price)(1)	3.00	%
Offering expenses borne by the Company (as a percentage of offering price)(2)	0.20	%
Dividend reinvestment plan expenses(3)	None	
Total stockholder transaction expenses (as a percentage of offering price)(4)	3.20	%
Annual expenses (as a percentage of net assets attributable to common stock)(4):		
Management fees(5)	3.88	%
Incentive fees payable under Investment Advisory Agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)(6)	3.06	%
Total advisory fees	6.94	%
Total interest expense(7)	4.32	%
Acquired Fund Fees and Expenses(8)	0.02	%
Other expenses(9)	1.21	%
Total annual expenses(6)(9)	12.49	%

Example
The following table demonstrates the projected dollar amount of cumulative expenses we would pay out of net assets and that you would indirectly bear over various periods with respect to a hypothetical investment in our common stock. In calculating the following expense amounts, we have assumed we would have borrowed $2.3 billion, that our annual operating expenses would remain at the levels set forth in the table above and that we would pay the costs shown in the table above.

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5% annual return	$123.32	$293.98	$449.85	$782.94

While the example assumes, as required by the SEC, a 5% annual return, our performance will vary and may result in a return greater or less than 5%. The income incentive fee under our Investment Advisory Agreement with Prospect Capital Management is unlikely to be material assuming a 5% annual return and is not included in the example. If we achieve sufficient returns on our investments, including through the realization of capital gains, to trigger an incentive fee of a material amount, our distributions to our common stockholders and our expenses would likely be higher. In addition, while the example assumes reinvestment of all dividends and other distributions at NAV, participants in our dividend reinvestment plan will receive a number of shares of our common stock determined by dividing the total dollar amount of the distribution payable to a participant by the market price per share of our common stock at the close of trading on the valuation date for the distribution. See "Dividend Reinvestment Plan" for additional information regarding our dividend reinvestment plan.

This example and the expenses in the table above should not be considered a representation of our future expenses. Actual expenses (including the cost of debt, if any, and other expenses) may be greater or less than those shown.

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(1) In the event that the Securities to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will disclose the estimated applicable sales load.
(2) The related prospectus supplement will disclose the estimated amount of offering expenses, the offering price and the estimated offering expenses borne by us as a percentage of the offering price.
(3) The expenses of the dividend reinvestment plan are included in "other expenses."

(4) The related prospectus supplement will disclose the offering price and the total stockholder transaction expenses as a percentage of the offering price.

(5) Our base management fee is 2% of our gross assets (which include any amount borrowed, i.e., total assets without deduction for any liabilities, including any borrowed amounts for non-investment purposes, for which purpose we have not and have no intention of borrowing). Although we have no intent to borrow the entire amount available under

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our line of credit, assuming that we borrowed $2.3 billion, the 2% management fee of gross assets equals approximately 3.88% of net assets. Based on our borrowings as of October 10, 2013 of $1.6 billion, the 2% management fee of gross assets equals approximately 3.44% of net assets. See "Business— Management Services—Investment Advisory Agreement" and footnote 6 below.

(6) Based on the incentive fee paid during our fiscal year ended June 30, 2013, all of which consisted of an income incentive fee. The capital gain incentive fee is paid without regard to pre-incentive fee income. For a more detailed discussion of the calculation of the two-part incentive fee, see "Management Services—Investment Advisory Agreement" in this prospectus.

(7) On December 21, 2010, the Company issued $150.0 million in aggregate principal amount of 6.25% Convertible Senior Notes due 2015, which we refer to as the 2015 Notes. See "Business—General" and "Risk Factors—Risks Related to our Business" in the accompanying prospectus for more detail on the 2015 Notes. On February 18, 2011, the Company issued $172.5 million in aggregate principal amount of 5.5% Convertible Senior Notes due 2016, which we refer to as the 2016 Notes. Between January 30, 2012 and February 2, 2012, we repurchased $5.0 million of our 2016 Notes at a price of 97.5% of par, including commissions. The transactions resulted in us recognizing $10,000 of loss in the quarter ended March 31, 2012. See "Business—General" and "Risk Factors—Risks Related to our Business" in the accompanying prospectus for more detail on the 2016 Notes. On April 16, 2012, the Company issued $130.0 million in aggregate principal amount of 5.375% Convertible Senior Notes due 2017, which we refer to as the 2017 Notes. On August 14, 2012, the Company issued $200.0 million aggregate principal amount of 5.75% Convertible Senior Notes due 2018, which we refer to as the 2018 Notes. On December 21, 2012, the Company issued $200.0 million aggregate principal amount of 5.875% Convertible Senior Notes due 2019, which we refer to as the 2019 Notes. The 2015 Notes, 2016 Notes, 2017 Notes, 2018 Notes and 2019 Notes are referred to collectively as the Senior Convertible Notes. On May 1, 2012 the Company issued $100.0 million in aggregate principal amount of 6.95% Senior Notes due 2022, which we refer to as the 2022 Notes. On March 15, 2013 the Company issued $250.0 million in aggregate principal amount of 5.875% Senior Notes due 2023, which we refer to as the 2023 Notes. As of October 10, 2013, the Company has issued $0.5 billion in aggregate principal amount of our Prospect Capital InterNotes®. The Senior Convertible Notes, the 2022 Notes, the 2023 Notes and the Prospect Capital InterNotes® are referred to collectively as the Notes.

(8) The Company's stockholders indirectly bear the expenses of underlying investment companies in which the Company invests. This amount includes the fees and expenses of investment companies in which the Company is invested in as of June 30, 2013. When applicable, fees and expenses are based on historic fees and expenses for the investment companies and for those investment companies with little or no operating history, fees and expenses are based on expected fees and expenses stated in the investment companies' prospectus or other similar communication without giving effect to any performance. Future fees and expenses for certain investment companies may be substantially higher or lower because certain fees and expenses are based on the performance of the investment companies, which may fluctuate over time. The amount of the Company's average net assets used in calculating this percentage was based on net assets of approximately $2.7 billion as of June 30, 2013.

(9) "Other expenses" are based on estimated amounts for the current fiscal year. The amount shown above represents annualized expenses during our three months ended June 30, 2013 representing all of our estimated recurring operating expenses (except fees and expenses reported in other items of this table) that are deducted from our operating income and reflected as expenses in our Statement of Operations. The estimate of our overhead expenses, including payments under an administration agreement with Prospect Administration, or the Administration Agreement, based on our projected allocable portion of overhead and other expenses incurred by Prospect Administration in performing its obligations under the Administration Agreement. "Other expenses" does not include non-recurring expenses. See "Business—Management Services—Administration Agreement."

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SELECTED CONDENSED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and notes thereto included in this prospectus. Financial information below for the years ended June 30, 2013, 2012, 2011, 2010 and 2009 has been derived from the financial statements that were audited by our independent registered public accounting firm. Certain reclassifications have been made to the prior period financial information to conform to the current period presentation. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" starting on page 33 for more information.

	For the Year Ended June 30,				
	2013	2012	2011	2010	2009
	(in thousands except data relating to shares, per share and number of portfolio companies)				
Performance Data:					
Interest income	$435,455	$219,536	$134,454	$86,518	$62,926
Dividend income	82,705	64,881	15,092	15,366	22,793
Other income	58,176	36,493	19,930	12,675	14,762
Total investment income	576,336	320,910	169,476	114,559	100,481
Interest and credit facility expenses	(76,341)	(38,534)	(17,598)	(8,382)	(6,161)
Investment advisory expense	(151,031)	(82,507)	(46,051)	(30,727)	(26,705)
Other expenses	(24,040)	(13,185)	(11,606)	(8,260)	(8,452)
Total expenses	(251,412)	(134,226)	(75,255)	(47,369)	(41,318)
Net investment income	324,924	186,684	94,221	67,190	59,163
Realized and unrealized (losses) gains	(104,068)	4,220	24,017	(47,565)	(24,059)
Net increase in net assets from operations	$220,856	$190,904	$118,238	$19,625	$35,104
Per Share Data:					
Net increase in net assets from operations(1)	$1.07	$1.67	$1.38	$0.33	$1.11
Distributions declared per share	$(1.28)	$(1.22)	$(1.21)	$(1.33)	$(1.62)
Average weighted shares outstanding for the period	207,069,971	114,394,554	85,978,757	59,429,222	31,559,905
Assets and Liabilities Data:					
Investments	$4,172,852	$2,094,221	$1,463,010	$748,483	$547,168
Other assets	275,365	161,033	86,307	84,212	119,857
Total assets	4,448,217	2,255,254	1,549,317	832,695	667,025
Amount drawn on credit facility	124,000	96,000	84,200	100,300	124,800
Senior convertible notes	847,500	447,500	322,500	—	—
Senior unsecured notes	347,725	100,000	—	—	—
InterNotes®	363,777	20,638	—	—	—
Amount owed to related parties	6,690	8,571	7,918	9,300	6,713
Other liabilities	102,031	70,571	20,342	11,671	2,916
Total liabilities	1,791,723	743,280	434,960	121,271	134,429
Net assets	$2,656,494	$1,511,974	$1,114,357	$711,424	$532,596
Investment Activity Data:					
No. of portfolio companies at period end	124	85	72	58	30
Acquisitions	$3,103,217	$1,120,659	$953,337	$364,788	$98,305
Sales, repayments, and other disposals	$931,534	$500,952	$285,562	$136,221	$27,007
Total return based on market value(3)	6.2%	27.2%	17.2%	17.7%	(18.6)%
Total return based on net asset value(3)	10.9%	18.0%	12.5%	(6.8)%	(0.6)%
	13.6%	13.9%	12.8%	16.2%	14.6%

Weighted average yield at end of period(4)

(1) Per share data is based on average weighted shares for the period.
(2) Includes $207,126 of acquired portfolio investments from Patriot Capital Funding, Inc.

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(3) 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.

(4) Excludes equity investments and non-performing loans.

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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 prospectus, 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 occur, 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.

Risks Relating to Our Business

Capital markets could experience a period of disruption and instability. Such market conditions have historically and could again have a material and adverse effect on debt and equity capital markets in the United States and abroad, which had, and may in the future have, a negative impact on our business and operations.

The global capital markets have historically experienced an extended period of instability as evidenced by the periodic disruptions in liquidity in the debt capital markets, significant write-offs in the financial services sector, the re-pricing of credit risk in the broadly syndicated credit market and the failure of certain major financial institutions. Despite actions of the U.S. federal government and foreign governments during such period, these events contributed to worsening general economic conditions that materially and adversely impacted the broader financial and credit markets and reduced the availability of debt and equity capital for the market as a whole and financial services firms in particular. While recent market conditions have improved, there can be no assurance that adverse market conditions will not repeat themselves or worsen in the future. If these adverse and volatile market conditions repeat themselves or worsen in the future, we and other companies in the financial services sector may have to access, if available, alternative markets for debt and equity capital in order to grow. Equity capital may be difficult to raise because, subject to some limited exceptions, as a BDC, we are generally not able to issue additional shares of our common stock at a price less than net asset value without first obtaining approval for such issuance from our stockholders and our independent directors. At our annual meeting of stockholders held on December 7, 2012, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering, our stockholders approved our ability to sell or otherwise issue shares of our common stock at a price below its then current net asset value per share for a twelve month period expiring on the anniversary of the date of stockholder approval. It should be noted that, theoretically, we may offer up to 25% of our then outstanding common stock each day. In addition, our ability to incur indebtedness (including by issuing preferred stock) is limited by applicable regulations such that our asset coverage, as calculated in accordance with the Investment Company Act, must equal at least 200% immediately after each time we incur indebtedness. The debt capital that will be available to us in the future, if at all, may be at a higher cost and on less favorable terms and conditions than what we currently experience. Any inability to raise capital could have a negative effect on our business, financial condition and results of operations.

Moreover, the re-appearance of market conditions similar to those experienced from 2007 through 2009 for any substantial length of time could make it difficult to extend the maturity of or refinance our existing indebtedness under similar terms and any failure to do so could have a material adverse effect on our business.

Given the extreme volatility and dislocation that the capital markets have historically experienced, many BDCs have faced, and may in the future face, a challenging environment in which to raise or access capital. In addition, significant changes in the capital markets, including the extreme volatility and disruption over the past several years, has had, and may in the future have, a negative effect on the valuations of our investments and on the potential for liquidity events involving our investments. While most of our investments are not publicly traded, applicable accounting standards require us to assume as part of our valuation process that our investments are sold in a principal market to market participants (even if we plan on holding an investment through its maturity). As a result, volatility in the capital markets can adversely affect our investment valuations. Further, the illiquidity of our investments may make it difficult for us to sell such investments to access capital if required. As a result, we could realize significantly less than the value at which we have recorded our investments if we were required to sell them for liquidity purposes.

An inability to raise or access capital could have a material adverse impact on our business, financial condition or results of operations.

The current financial market situation, as well as various social and political tensions in the United States and around the world, particularly in the Middle East, may continue to contribute to increased market volatility, may have long-term effects on the United States and worldwide financial markets, and may cause further economic uncertainties or deterioration in the United States and worldwide. Since 2010, several European Union ("EU") countries, including Greece, Ireland, Italy, Spain, and Portugal have faced budget issues, some of which may have negative long-term effects for the economies of those countries and other EU countries. There is continued concern about national-level support for the euro and the accompanying coordination of fiscal and wage policy among European Economic and Monetary Union member countries. We do not know how long the financial markets will continue to be affected by these events and cannot predict the effects of these or similar events in the future on the United States economy and securities markets or on our investments. We monitor developments and seeks to manage our investments in a manner consistent with achieving our investment objective, but there can be no assurance that it will be successful in doing so; and we may not timely anticipate or manage existing, new or additional risks, contingencies or developments, including regulatory developments in the current or future market environment.

We may suffer credit losses.

Investment in small and middle-market companies is highly speculative and involves a high degree of risk of credit loss. These risks are likely to increase during volatile economic periods, such as the U.S. and many other economies have recently been experiencing. See "Risks Related to Our Investments."

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 the 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 the 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 diligence, skill and network of business contacts of the senior management of the Investment Adviser. We also depend, to a significant extent, on the 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 the 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 number of entities compete with us to make the types of investments that we make in middle-market companies. We compete with other BDCs, public and private funds, commercial and investment banks, commercial financing companies, insurance companies, hedge funds, and, to the extent they provide an alternative form of financing, private equity funds. Many of our competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. 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 relationships than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the Investment Company Act imposes on us as a BDC and that the Code imposes on us as a RIC. We cannot assure you that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. Also, as a result of this competition, we may not be able to pursue attractive investment opportunities from time to time.

We do not seek to compete primarily based on the interest rates we offer and we believe that some of our competitors may make loans with interest rates that are comparable to or lower than the rates we offer. Rather, we compete with our competitors based on our existing investment platform, seasoned investment professionals, experience and focus on middle-market companies, disciplined investment philosophy, extensive industry focus and flexible transaction structuring.

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. As a result of operating in such a competitive environment, we may make investments that are on less favorable terms than what we may have originally anticipated, which may impact our return on these investments.

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We fund a portion of our investments with borrowed money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us.

Borrowings and other types of financing, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. Our lenders have fixed dollar claims on our assets that are superior to the claims of our common stockholders or any preferred stockholders. If the value of our assets increases, then leveraging would cause the net asset value to increase more sharply than it would have had we not leveraged. Conversely, if the value of our assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

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

A portion of the debt investments we make bears interest at fixed rates and other debt investments bear interest at variable rates with floors 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, an increase in market interest rates could both reduce the value of our portfolio investments and increase our cost of capital, which could reduce our net investment income or net increase in net assets resulting from operations.

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 stockholders to maintain our status as a regulated investment company, or RIC, for U.S. federal income tax purposes. 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 generally may not borrow money or issue debt securities or issue preferred stock unless immediately thereafter our ratio of total assets to total borrowings and other senior securities is at least 200%. This may restrict our ability to obtain additional leverage in certain circumstances.

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, 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 NAV was calculated on June 30, 2013 and our NAV when calculated effective September 30, 2013 and thereafter may be higher or lower.

Our most recently estimated NAV per share is $10.75 on an as adjusted basis solely to give effect to our issuance of common stock since June 30, 2013 in connection with our dividend reinvestment plan, shares issued in connection with investment transactions, and our issuance of 26,733,617 shares of common stock during the period from July 1, 2013 to October 10, 2013 (including shares with settlement dates through October 16, 2013) under our at-the-market program (the "ATM Program"), $0.03 higher than the $10.72 determined by us as of June 30, 2013. NAV per share as of September 30, 2013 may be higher or lower than $10.75 based on potential changes in valuations, issuances of securities, dividends paid 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, 2013. 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 independent valuation firms, the Investment Adviser, the Administrator and the Audit Committee of our Board of Directors.

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The Investment Adviser's liability is limited under the Investment Advisory Agreement, and we are required to indemnify the Investment Adviser against certain liabilities, which may lead the Investment Adviser to act in a riskier manner on our behalf than it would when acting for its own account.
The Investment Adviser has not assumed any responsibility to us other than to render the services described in the Investment Advisory Agreement, and it will not be responsible for any action of our Board of Directors in declining to follow the Investment Adviser's advice or recommendations. Pursuant to the Investment Advisory Agreement, the Investment Adviser and its members and their respective officers, managers, partners, agents, employees, controlling persons and members and any other person or entity affiliated with it will not be liable to us for their acts under the Investment Advisory Agreement, absent willful misfeasance, bad faith, gross negligence or reckless disregard in the performance of their duties. We have agreed to indemnify, defend and protect the Investment Adviser and its members and their respective officers, managers, partners, agents, employees, controlling persons and members and any other person or entity affiliated with it with respect to all damages, liabilities, costs and expenses resulting from acts of the Investment Adviser not arising out of willful misfeasance, bad faith, gross negligence or reckless disregard in the performance of their duties under the Investment Advisory Agreement. These protections may lead the Investment Adviser to act in a riskier manner when acting on our behalf than it would when acting for its own account.
Potential conflicts of interest could impact our investment returns.
Our executive officers and directors, and the executive officers of the Investment Adviser, 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.
The Investment Adviser 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 Prospect Capital Management. 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 Prospect Capital Management 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, Prospect Capital Management 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 Prospect Capital Management to the extent that it may encourage Prospect Capital Management 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

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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.

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 the 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 the 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.

We may be obligated to pay our Investment Adviser incentive compensation even if we incur a loss.

The Investment Adviser is entitled to incentive compensation for each fiscal quarter based, in part, on our pre-incentive fee net investment income if any, for the immediately preceding calendar quarter above a performance threshold for that quarter. Accordingly, since the performance threshold is based on a percentage of our net asset value, decreases in our net asset value make it easier to achieve the performance threshold. Our pre-incentive fee net investment income for incentive compensation purposes excludes realized and unrealized capital losses or depreciation that we may incur in the fiscal quarter, even if such capital losses or depreciation result in a net loss on our statement of operations for that quarter. Thus, we may be required to pay the Investment Adviser incentive compensation for a fiscal quarter even if there is a decline in the value of our portfolio or we incur a net loss for that quarter.

The Investment Adviser and Administrator have the right to resign on 60 days' notice, and we may not be able to find a suitable replacement within that time, resulting in a disruption in our operations that could adversely affect our business, financial condition and results of operations.

The Investment Adviser and Administrator have the right, under the Investment Advisory Agreement and Administration Agreement, respectively, to resign at any time upon not less than 60 days' written notice, whether we have found a replacement or not. If the Investment Adviser or Administrator resigns, we may not be able to find a replacement or hire internal management or administration with similar expertise and ability to provide the same or equivalent services on acceptable terms within 60 days, or at all. If we are unable to do so quickly, our operations are likely to experience a disruption, our business, financial condition and results of operations as well as our ability to pay distributions are likely to be adversely affected and the market price of our shares may decline. In addition, the coordination of our internal management and investment activities or our internal administration activities, as applicable, is likely to suffer if we are unable to identify and reach an agreement with a single institution or group of executives having the expertise possessed by the Investment Adviser and its affiliates or the Administrator and its affiliates. Even if we are able to retain comparable management or administration, whether internal or external, the integration of such management or administration and their lack of familiarity with our investment objective may result in additional costs and time delays that may adversely affect our business, financial condition and results of operations.

Changes in the laws or regulations governing our business or the businesses of our portfolio companies and any failure by us or our portfolio companies to comply with these laws or regulations, could negatively affect the profitability of our operations or of our portfolio companies.

We are subject to changing rules and regulations of federal and state governments, as well as the stock exchange on which our common stock is listed. These entities, including the Public Company Accounting Oversight Board, the SEC and The NASDAQ Global Select Market, have issued a significant number of new and increasingly complex requirements and regulations over the course of the last several years and continue to develop additional regulations. In particular, changes in the

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laws or regulations or the interpretations of the laws and regulations that govern BDCs, RICs or non-depository commercial lenders could significantly affect our operations and our cost of doing business. We are subject to federal, state and local laws and regulations and are subject to judicial and administrative decisions that affect our operations, including our loan originations, maximum interest rates, fees and other charges, disclosures to portfolio companies, the terms of secured transactions, collection and foreclosure procedures and other trade practices. If these laws, regulations or decisions change, or if we expand our business into jurisdictions that have adopted more stringent requirements than those in which we currently conduct business, we may have to incur significant expenses in order to comply, or we might have to restrict our operations. In addition, if we do not comply with applicable laws, regulations and decisions, we may lose licenses needed for the conduct of our business and be subject to civil fines and criminal penalties, any of which could have a material adverse effect upon our business, financial condition and results of operations.

Foreign and domestic political risk may adversely affect our business.

We are exposed to political risk to the extent that Prospect Capital Management, on its behalf and subject to its investment guidelines, transacts in securities in the U.S. and foreign markets. The governments in any of these jurisdictions could impose restrictions, regulations or other measures, which may have a material adverse impact on our strategy.

Risks Relating to Our Operation as a Business Development Company

If we do not invest a sufficient portion of our assets in qualifying assets, we could fail to qualify as a BDC or be precluded from investing according to our current business strategy.

As a BDC, we may not acquire any assets other than "qualifying assets" unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets. We believe that most of the investments that we may acquire in the future will constitute qualifying assets. However, we may be precluded from investing in what we believe are attractive investments if such investments are not qualifying assets for purposes of the 1940 Act. If we do not invest a sufficient portion of our assets in qualifying assets, we could be found to be in violation of the 1940 Act provisions applicable to BDCs, which would have a material adverse effect on our business, financial condition and results of operations. Similarly, these rules could prevent us from making follow-on investments in existing portfolio companies (which could result in the dilution of our position) or could require us to dispose of investments at inappropriate times in order to come into compliance with the 1940 Act. Because most of our investments will be in private companies, and therefore will be relatively illiquid, any such dispositions could be made at disadvantageous prices and could result in substantial losses.

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 U.S. federal income tax purposes as a RIC under Subchapter M of the Internal Revenue Code of 1986, as amended, or 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 net short-term capital gains in excess of 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 on all of our taxable income.

To maintain our qualification as a RIC, we must also meet certain asset diversification requirements at the end of each quarter of our taxable year. 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 would 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 "Material U.S. Federal Income Tax Considerations" and "Business—Regulation as a Business Development Company".

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 or payment-in-kind interest, which represents contractual interest added to the loan balance and due at the end of the loan term. Such amounts could be significant relative to our overall investment activities. 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 distributing 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, as required 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 "Material U.S. Federal Income 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 through the issuance of the Notes and, in the future, may issue preferred stock or debt securities 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 in cash or other property 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 or otherwise increase our net assets. In addition, issuance of additional common stock could dilute the percentage ownership of our current stockholders in us.

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 without stockholder approval. 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.

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. See "Securitization of our assets subjects us to various risks."

Securitization of our assets subjects us to various risks.

We may securitize assets to generate cash for funding new investments. We refer to the term securitize to describe a form of leverage under which a company such as us (sometimes referred to as an "originator" or "sponsor") transfers income producing assets to a single-purpose, bankruptcy-remote subsidiary (also referred to as a "special purpose entity" or SPE), which is established solely for the purpose of holding such assets and entering into a structured finance transaction. The SPE then issues notes secured by such assets. The special purpose entity may issue the notes in the capital markets either publicly or privately to a variety of investors, including banks, non-bank financial institutions and other investors. There may be a single class of notes or multiple classes of notes, the most senior of which carries less credit risk and the most junior of which may carry substantially the same credit risk as the equity of the SPE.

An important aspect of most debt securitization transactions is that the sale and/or contribution of assets into the SPE be considered a true sale and/or contribution for accounting purposes and that a reviewing court would not consolidate the SPE with the operations of the originator in the event of the originator's bankruptcy based on equitable principles. Viewed as a whole, a debt securitization seeks to lower risk to the note purchasers by isolating the assets collateralizing the securitization in an SPE that is not subject to the credit and bankruptcy risks of the originator. As a result of this perceived reduction of risk, debt securitization transactions frequently achieve lower overall leverage costs for originators as compared to traditional secured lending transactions.

In accordance with the above description, to securitize loans, we may create a wholly owned subsidiary and contribute a pool of our assets to such subsidiary. The SPE may be funded with, among other things, whole loans and such loans may or may not be rated. The SPE would then sell its notes to purchasers who we would expect to be willing to accept a lower interest rate and the absence of any recourse against us to invest in a pool of income producing assets to which none of our creditors would have access. We would retain all or a portion of the equity in the SPE. An inability to successfully securitize portions of our portfolio or otherwise leverage our portfolio through secured and unsecured borrowings could limit our ability to grow our business and fully execute our business strategy, and could decrease our earnings. However, the successful securitization of portions of our portfolio exposes us to a risk of loss for the equity we retain in the SPE and might expose us to greater risk on our remaining portfolio because the assets we retain 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.

Interests we hold in the SPE, if any, will be subordinated to the other interests issued by the SPE. As such, we will only receive cash distributions on such interests if the SPE has made all cash interest and other required payments on all other interests it has issued. In addition, our subordinated interests will likely be unsecured and rank behind all of the secured creditors, known or unknown, of the SPE, including the holders of the senior interests it has issued. Consequently, to the extent that the value of the SPEs portfolio of assets has been reduced as a result of conditions in the credit markets, or as a result of defaults, the value of the subordinated interests we retain would be reduced. Securitization imposes on us the same risks as borrowing except that our risk in a securitization is limited to the amount of subordinated interests we retain, whereas in a borrowing or debt issuance by us directly we would be at risk for the entire amount of the borrowing or debt issuance.

If the SPE is not consolidated with us, our only interest will be the value of our retained subordinated interest and the income allocated to us, which may be more or less than the cash we receive from the SPE, and none of the SPEs liabilities will be reflected as our liabilities. If the assets of the SPE are not consolidated with our assets and liabilities, then our interest in the SPE may be deemed not to be a qualifying asset for purposes of determining whether 70% of our assets are qualifying assets and the leverage incurred by such SPE may or may not be treated as borrowings by us for purposes of the requirement that we not issue senior securities in an amount in excess of our net assets.

We may also engage in transactions utilizing SPEs and securitization techniques where the assets sold or contributed to the SPE remain on our balance sheet for accounting purposes. If, for example, we sell the assets to the SPE with recourse or provide a guarantee or other credit support to the SPE, its assets will remain on our balance sheet. Consolidation would also generally result if we, in consultation with the SEC, determine that consolidation would result in a more accurate reflection of our assets, liabilities and results of operations. In these structures, the risks will be essentially the same as in other securitization transactions but the assets will remain our assets for purposes of the limitations described above on investing in assets that are not qualifying assets and the leverage incurred by the SPE will be treated as borrowings incurred by us for purposes of our limitation on the issuance of senior securities.

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The Investment Adviser may have conflicts of interest with respect to potential securitizations in as much as securitizations that are not consolidated may reduce our assets for purposes of determining its investment advisory fee although in some circumstances the Investment Adviser may be paid certain fees for managing the assets of the SPE so as to reduce or eliminate any potential bias against securitizations.

Our ability to invest in public companies may be limited in certain circumstances.

As a BDC, we must not acquire any assets other than "qualifying assets" specified in the 1940 Act unless, at the time the acquisition is made, at least 70% of our total assets are qualifying assets (with certain limited exceptions). Subject to certain exceptions for follow-on investments and distressed companies, an investment in an issuer that has outstanding securities listed on a national securities exchange may be treated as qualifying assets only if such issuer has a market capitalization that is less than $250 million at the time of such investment.

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".

Most of our portfolio investments are recorded at fair value as determined in good faith under the direction of 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 the Investment Adviser, our Administrator, 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.

In addition, decreases in the market values or fair values of our investments are recorded as unrealized depreciation. Unprecedented declines in prices and liquidity in the corporate debt markets experienced during the recent financial crises resulted in significant net unrealized depreciation in our portfolio in the past. The effect of all of these factors on our portfolio reduced our NAV by increasing net unrealized depreciation in our portfolio. Depending on market conditions, we could incur substantial realized losses and may continue to suffer additional unrealized losses in future periods, which could have a material adverse impact on our business, financial condition and results of operations. We have no policy regarding holding a minimum level of liquid assets. As such, a high percentage of our portfolio generally is not liquid at any given point in time. See "The lack of liquidity may adversely affect our business."

Price declines and illiquidity in the corporate debt markets have adversely affected, and may in the future adversely affect, the fair value of our portfolio investments, reducing our net asset value through increased net unrealized depreciation.

As a BDC, we are required to carry our investments at market value or, if no market value is ascertainable, at fair value as determined in good faith by or under the direction of our Board of Directors. As part of the valuation process, the types of factors that we may take into account in determining the fair value of our investments include, as relevant and among other factors: 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, merger and acquisition comparables, our principal market (as the reporting entity) and enterprise values. Decreases in the market values or fair values of our investments are recorded as unrealized depreciation. The effect of all of these factors on our portfolio can reduce our net asset value by increasing net unrealized depreciation in our portfolio. Depending on market conditions, we could incur substantial realized losses and may suffer additional unrealized losses in future periods, which could have a material adverse impact on our business, financial condition and results of operations.

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 the Investment Adviser to obtain adequate information to evaluate these companies in making investment decisions. If the 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 may have difficulty accessing the capital markets to meet future capital needs;
- changes in laws and regulations, as well as their interpretations, may adversely affect their business, financial structure or prospects; 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 the 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.

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 the Investment Adviser has or could be deemed to have material non-public information regarding such business entity.

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

Many of our portfolio companies may be susceptible to economic slowdowns or recessions and may be unable to repay our loans 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.

Investments in equity securities, many of which are illiquid with no readily available market, involve a substantial degree of risk.

We may purchase common and other equity securities. Although common stock has historically generated higher average total returns than fixed income securities over the long-term, common stock also has experienced significantly more volatility in those returns and in recent years has significantly under performed relative to fixed income securities. The equity securities we acquire may fail to appreciate and may decline in value or become worthless and our ability to recover our investment will depend on our portfolio company's success. Investments in equity securities involve a number of significant risks, including:

- any equity investment we make in a portfolio company could be subject to further dilution as a result of the issuance of additional equity interests and to serious risks as a junior security that will be subordinate to all indebtedness (including trade creditors) or senior securities in the event that the issuer is unable to meet its obligations or becomes subject to a bankruptcy process;
- to the extent that the portfolio company requires additional capital and is unable to obtain it, we may not recover our investment; and
- in some cases, equity securities in which we invest will not pay current dividends, and our ability to realize a return on our investment, as well as to recover our investment, will be dependent on the success of the portfolio company. Even if the portfolio company is successful, our ability to realize the value of our investment may be dependent on the occurrence of a liquidity event, such as a public offering or the sale of the portfolio company. It is likely to take a significant amount of time before a liquidity event occurs or we can otherwise sell our investment. In addition, the equity securities we receive or invest in may be subject to restrictions on resale during periods in which it could be advantageous to sell them.

There are special risks associated with investing in preferred securities, including:

- preferred securities may include provisions that permit the issuer, at its discretion, to defer distributions for a stated period without any adverse consequences to the issuer. If we own a preferred security that is deferring its distributions, we may be required to report income for tax purposes before we receive such distributions;
- preferred securities are subordinated to debt in terms of priority to income and liquidation payments, and therefore will be subject to greater credit risk than debt;
- preferred securities may be substantially less liquid than many other securities, such as common stock or U.S. government securities; and
- generally, preferred security holders have no voting rights with respect to the issuing company, subject to limited exceptions.

Additionally, when we invest in first lien senior secured loans (including unitranche loans), second lien senior secured loans or mezzanine debt, we may acquire warrants or other equity securities as well. Our goal is ultimately to dispose of such equity interests and realize gains upon our disposition of such interests. However, the equity interests we receive may not appreciate in value and, in fact, may decline in value. Accordingly, we may not be able to realize gains from our equity interests and any gains that we do realize on the disposition of any equity interests may not be sufficient to offset any other losses we experience.

We may invest, to the extent permitted by law, in the equity securities of investment funds that are operating pursuant to certain exceptions to the Investment Company Act and in advisers to similar investment funds and, to the extent we so invest, will bear our ratable share of any such company's expenses, including management and performance fees. We will also remain obligated to pay management and incentive fees to Prospect Capital Management with respect to the assets invested in the securities and instruments of such companies. With respect to each of these investments, each of our common stockholders will bear his or her share of the management and incentive fee of Prospect Capital Management as well as indirectly bearing the management and performance fees and other expenses of any such investment funds or advisers.

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

If one of our portfolio companies were to go bankrupt, even though we may have structured our interest as senior debt, depending on the facts and circumstances, a bankruptcy court might recharacterize our debt holding as an equity investment and subordinate all or a portion of our claim to that of other creditors. In addition, lenders can be subject to lender liability claims for actions taken by them where they become too involved in the borrower's business or exercise control over the borrower. For example, we could become subject to a lender's liability claim, if, among other things, we actually render significant managerial assistance.

Our portfolio companies may incur debt or issue equity securities that rank equally with, or senior to, our investments in such companies.

Our portfolio companies may have, or may be permitted to incur, other debt, or issue other equity securities, that rank equally with, or senior to, our investments. 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 our investments. These debt instruments would usually prohibit the portfolio companies from paying interest on or repaying our investments in the event and during the continuance of a default under such debt. 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 typically are entitled to receive payment in full before we receive any distribution in respect of our investment. After repaying such 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 our investments, 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.

The rights we may have with respect to the collateral securing any junior priority loans we make to our portfolio companies may also be limited pursuant to the terms of one or more intercreditor agreements (including agreements governing "first out" and "last out" structures) that we enter into with the holders of senior debt. Under such an intercreditor agreement, at any time that senior obligations are outstanding, we may forfeit certain rights with respect to the collateral to the holders of the senior obligations. These rights may include the right to commence enforcement proceedings against the collateral, the right to control the conduct of such enforcement proceedings, the right to approve amendments to collateral documents, the right to release liens on the collateral and the right to waive past defaults under collateral documents. We may not have the ability to control or direct such actions, even if as a result our rights as junior lenders are adversely affected.

When we are a debt or minority equity investor in a portfolio company, we are often not in a position to exert influence on the entity, and other equity holders and management of the company may make decisions that could decrease the value of our portfolio holdings.

When we make debt or minority equity investments, we are subject to the risk that a portfolio company may make business decisions with which we disagree and the other equity holders and management of such company may take risks or otherwise act in ways that do not serve our interests. As a result, a portfolio company may make decisions that could decrease the value of our investment.

Our portfolio companies may be highly leveraged.

Some of our portfolio companies may be highly leveraged, which may have adverse consequences to these companies and to us as an investor. These companies may be subject to restrictive financial and operating covenants and the leverage may impair these companies' ability to finance their future operations and capital needs. As a result, these companies' flexibility to respond to changing business and economic conditions and to take advantage of business opportunities may be limited. Further, a leveraged company's income and net assets will tend to increase or decrease at a greater rate than if borrowed money were not used.

Our portfolio contains a limited number of portfolio companies, which subjects us to a greater risk of significant loss if any of these companies defaults on its obligations under any of its debt securities.

A consequence of the limited number of investments in our portfolio is that the aggregate returns we realize may be significantly adversely affected if one or more of our significant portfolio company investments perform poorly or if we need to write down the value of any one significant investment. Beyond our income tax diversification requirements, we do not have fixed guidelines for diversification, and our portfolio could contain relatively few portfolio companies.

Our failure to make follow-on investments in our portfolio companies could impair the value of our portfolio. Following an initial investment in a portfolio company, we may make additional investments in that portfolio company as "follow-on" investments, in order to: (1) increase or maintain in whole or in part our equity ownership percentage; (2) exercise

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warrants, options or convertible securities that were acquired in the original or subsequent financing or (3) attempt to preserve or enhance the value of our investment.

We may elect not to make follow-on investments, may be constrained in our ability to employ available funds, or otherwise may lack sufficient funds to make those investments. We have the discretion to make any follow-on investments, subject to the availability of capital resources. The failure to make follow-on investments may, in some circumstances, jeopardize the continued viability of a portfolio company and our initial investment, or may result in a missed opportunity for us to increase our participation in a successful operation. Even if we have sufficient capital to make a desired follow-on investment, we may elect not to make a follow-on investment because we may not want to increase our concentration of risk, because we prefer other opportunities, or because we are inhibited by compliance with BDC requirements or the desire to maintain our tax status.

We may be unable to invest the net proceeds raised from offerings and repayments from investments on acceptable terms, which would harm our financial condition and operating results.

Until we identify new investment opportunities, we intend to either invest the net proceeds of future offerings and repayments from investments in interest-bearing deposits or other short-term instruments or use the net proceeds from such offerings to reduce then-outstanding obligations under our credit facility. We cannot assure you that we will be able to find enough appropriate investments that meet our investment criteria or that any investment we complete using the proceeds from an offering will produce a sufficient return.

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 the 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 of 2002 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.

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 may be 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, including those located in emerging market countries. 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. Such risks are more pronounced in emerging market

countries.
Although currently all 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

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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.

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. Furthermore, our ability to engage in hedging transactions may also be adversely affected by recent rules adopted by the CFTC.

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. The Company has no current intention of engaging in any of the hedging transaction described above, although it reserves the right to do so in the future.

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.

Our investments in CLOs may be riskier and less transparent to us and our stockholders than direct investments in the underlying companies.

We invest in CLOs. Generally, there may be less information available to us regarding the underlying debt investments held by CLOs than if we had invested directly in the debt of the underlying companies. As a result, our stockholders will not know the details of the underlying securities of the CLOs in which we will invest. Our CLO investments are subject to the risk of leverage associated with the debt issued by such CLOs and the repayment priority of senior debt holders in such CLOs. Our investments in portfolio companies may be risky, and we could lose all or part of our investment.

CLOs typically will have no significant assets other than their underlying Senior Secured Loans; payments on CLO investments are and will be payable solely from the cashflows from such Senior Secured Loans.

CLOs typically will have no significant assets other than their underlying Senior Secured Loans. Accordingly, payments on CLO investments are and will be payable solely from the cashflows from such Senior Secured Loans, net of all management fees and other expenses. Payments to us as a holder of CLO junior securities are and will be made only after payments due on the senior secured notes, and, where appropriate, the junior secured notes, have been made in full. This means that relatively small numbers of defaults of Senior Secured Loans may adversely impact our

returns.
Our CLO investments are exposed to leveraged credit risk.
Generally, we are in a subordinated position with respect to realized losses on the Senior Secured Loans underlying our investments in CLOs. The leveraged nature of CLOs, in particular, magnifies the adverse impact of Senior Secured Loan defaults. CLO investments represent a leveraged investment with respect to the underlying Senior Secured Loans. Therefore,

changes in the market value of the CLO investments could be greater than the change in the market value of the underlying Senior Secured Loans, which are subject to credit, liquidity and interest rate risk.
There is the potential for interruption and deferral of cashflow from CLO investments.
If certain minimum collateral value ratios and/or interest coverage ratios are not met by a CLO, primarily due to Senior Secured Loan defaults, then cashflow that otherwise would have been available to pay distributions to us on our CLO investments may instead be used to redeem any senior notes or to purchase additional Senior Secured Loans, until the ratios again exceed the minimum required levels or any senior notes are repaid in full. This could result in an elimination, reduction or deferral in the distribution and/or principal paid to the holders of the CLO investments, which would adversely impact our returns.
Investments in foreign securities may involve significant risks in addition to the risks inherent in U.S. investments.
Our CLO investment strategy involves investments in foreign CLOs. Investing in foreign entities may expose us to additional risks not typically associated with investing in U.S. issuers. 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. Further, we, and the CLOs in which we invest, may have difficulty enforcing creditor's rights in foreign jurisdictions. In addition, the underlying companies of the CLOs in which we invest may be foreign, which may create greater exposure for us to foreign economic developments.
The payment of underlying portfolio manager fees and other charges on CLO investments could adversely impact our returns.
We may invest in CLO investments where the underlying portfolio securities may be subject to management, administration and incentive or performance fees, in addition to those payable by us. Payment of such additional fees could adversely impact the returns we achieve.
The inability of a CLO collateral manager to reinvest the proceeds of the prepayment of Senior Secured Loans may adversely affect us.
There can be no assurance that for any CLO investment, in the event that any of the Senior Secured Loans of a CLO underlying such investment are prepaid, the CLO collateral manager will be able to reinvest such proceeds in new Senior Secured Loans with equivalent investment returns. If the CLO collateral manager cannot reinvest in new Senior Secured Loans with equivalent investment returns, the interest proceeds available to pay interest on the rated liabilities and investments may be adversely affected.
Our CLO investments are subject to prepayments and calls, increasing re-investment risk.
Our CLO investments and/or the underlying senior secured loans may be prepaid more quickly than expected, which could have an adverse impact on our value. Prepayment rates are influenced by changes in interest rates and a variety of economic, geographic and other factors beyond our control, and consequently cannot be predicted with certainty. In addition, for a CLO collateral manager there is often a strong incentive to refinance well performing portfolios once the senior tranches amortize. The yield to maturity of the investments will depend on the amount and timing of payments of principal on the loans and the price paid for the investments. Such yield may be adversely affected by a higher or lower than anticipated rate of prepayments of the debt.
Furthermore, our CLO investments generally do not contain optional call provisions, other than a call at the option of the holders of the equity tranches for the senior notes and the junior secured notes to be paid in full after the expiration of an initial period in the deal (referred to as the "non-call period").
The exercise of the call option is by the relevant percentage (usually a majority) of the holders of the equity tranches and, therefore, where we do not hold the relevant percentage we will not be able to control the timing of the exercise of the call option. The equity tranches also generally have a call at any time based on certain tax event triggers. In any event, the call can only be exercised by the holders of equity tranches if they can demonstrate (in accordance with the detailed provisions in the transaction) that the senior notes and junior secured notes will be paid in full if the call is exercised.

Early prepayments and/or the exercise of a call option other than at our request may also give rise to increased re-investment risk with respect to certain investments, as we may realize excess cash earlier than expected. If we are unable to reinvest such cash in a new investment with an expected rate of return at least equal to that of the investment repaid, this may reduce our net income and, consequently, could have an adverse impact on our ability to pay dividends.

We have limited control of the administration and amendment of Senior Secured Loans owned by the CLOs in which we invest.

We may not be able to directly enforce any rights and remedies in the event of a default of a Senior Secured Loan held by a CLO vehicle. In addition, the terms and conditions of the Senior Secured Loans underlying our CLO investments may be amended, modified or waived only by the agreement of the underlying lenders. Generally, any such agreement must include a majority or a super majority (measured by outstanding loans or commitments) or, in certain circumstances, a unanimous vote of the lenders. Consequently, the terms and conditions of the payment obligations arising from Senior Secured Loans could be modified, amended or waived in a manner contrary to our preferences.

We have limited control of the administration and amendment of any CLO in which we invest.

The terms and conditions of target securities may be amended, modified or waived only by the agreement of the underlying security holders. Generally, any such agreement must include a majority or a super majority (measured by outstanding amounts) or, in certain circumstances, a unanimous vote of the security holders. Consequently, the terms and conditions of the payment obligation arising from the CLOs in which we invest be modified, amended or waived in a manner contrary to our preferences.

Senior Secured Loans of CLOs may be sold and replaced resulting in a loss to us.

The Senior Secured Loans underlying our CLO investments may be sold and replacement collateral purchased within the parameters set out in the relevant CLO indenture between the CLO and the CLO trustee and those parameters may typically only be amended, modified or waived by the agreement of a majority of the holders of the senior notes and/or the junior secured notes and/or the equity tranche once the CLO has been established. If these transactions result in a net loss, the magnitude of the loss from the perspective of the equity tranche would be increased by the leveraged nature of the investment.

Our financial results may be affected adversely if one or more of our significant equity or junior debt investments in a CLO vehicle defaults on its payment obligations or fails to perform as we expect.

We expect that a majority of our portfolio will consist of equity and junior debt investments in CLOs, which involve a number of significant risks. CLOs are typically highly levered up to approximately 10 times, and therefore the junior debt and equity tranches that we will invest in are subject to a higher risk of total loss. In particular, investors in CLOs indirectly bear risks of the underlying debt investments held by such CLOs. We will generally have the right to receive payments only from the CLOs, and will generally not have direct rights against the underlying borrowers or the entities that sponsored the CLOs. Although it is difficult to predict whether the prices of indices and securities underlying CLOs will rise or fall, these prices, and therefore, the prices of the CLOs, will be influenced by the same types of political and economic events that affect issuers of securities and capital markets generally.

The investments we make in CLOs are thinly traded or have only a limited trading market. CLO investments are typically privately offered and sold, in the primary and secondary markets. As a result, investments in CLOs may be characterized as illiquid securities. In addition to the general risks associated with investing in debt securities, CLOs carry additional risks, including, but not limited to: (i) the possibility that distributions from the underlying Senior Secured Loans will not be adequate to make interest or other payments; (ii) the quality of the underlying Senior Secured Loans may decline in value or default; and (iii) the complex structure of the security may not be fully understood at the time of investment and may produce disputes with the CLO or unexpected investment results. Further, our investments in equity and junior debt tranches of CLOs are subordinate to the senior debt tranches thereof.

Investments in structured vehicles, including equity and junior debt instruments issued by CLOs, involve risks, including credit risk and market risk. Changes in interest rates and credit quality may cause significant price fluctuations. Additionally, changes in the underlying Senior Secured Loans held by a CLO may cause payments on the instruments we hold to be reduced, either temporarily or permanently. Structured investments, particularly the subordinated interests in which we invest, are less liquid than many other types of securities and may be more volatile than the Senior Secured Loans underlying the CLOs in which we invest.

Non-investment grade debt involves a greater risk of default and higher price volatility than investment grade debt.

The Senior Secured Loans underlying our CLO investments typically are rated non-investment grade and, in limited circumstances, are unrated. Non-investment grade securities are predominantly speculative with respect to the issuer's capacity to pay interest and repay principal when due and therefore involve a greater risk of default and higher price volatility than investment grade debt.

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We will have no influence on management of underlying investments managed by non-affiliated third party CLO collateral managers.

We are not responsible for and have no influence over the asset management of the portfolios underlying the CLO investments we hold as those portfolios are managed by non-affiliated third party CLO collateral managers. Similarly, we are not responsible for and have no influence over the day-to-day management, administration or any other aspect of the issuers of the individual securities. As a result, the values of the portfolios underlying our CLO investments could decrease as a result of decisions made by third party CLO collateral managers.

Risks Relating To Our Securities

Our credit ratings may not reflect all risks of an investment in our debt securities.

Our credit ratings are an assessment by third parties of our ability to pay our obligations. Consequently, real or anticipated changes in our credit ratings will generally affect the market value of our debt securities. Our credit ratings, however, may not reflect the potential impact of risks related to market conditions generally or other factors discussed above on the market value of or trading market for the publicly issued debt securities. Our debt securities are rated by Standard & Poors.

Senior securities, including debt, expose us to additional risks, including the typical risks associated with leverage and could adversely affect our business, financial condition and results of operations.

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. We also have the Senior Notes outstanding, which are a form of leverage and are senior in payment rights to our common stock.

With certain limited exceptions, as a business development company, or a BDC, we are only allowed to borrow amounts or otherwise issue senior securities such that our asset coverage, as defined in the 1940 Act, is at least 200% after such borrowing or other issuance. The amount of leverage that we employ will depend on the 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, any of which could adversely affect our business, financial condition and results of operations, including the following:

- 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, such as the Senior Convertible Notes outstanding or those issued in the future may have rights, preferences and privileges more favorable than those of our common stock;
- 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 will be distributed to our stockholders;
- Making it more difficult for us to meet our payment and other obligations under the Notes and our other outstanding debt;
- The occurrence of an event of default if we fail to comply with the financial and/or other restrictive covenants contained in our debt agreements, including the credit agreement and each indenture governing the Notes, which event of default could result in all or some of our debt becoming immediately due and payable;
- Reduced availability of our cash flow to fund investments, acquisitions and other general corporate purposes, and limiting our ability to obtain additional financing for these purposes;
- The risk of increased sensitivity to interest rate increases on our indebtedness with variable interest rates, including borrowings under our amended senior credit facility; and
- Reduced flexibility in planning for, or reacting to, and increasing our vulnerability to, changes in our business, the industry in which we operate and the general economy.

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. The 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.

In addition, our ability to meet our payment and other obligations of the Notes and our credit facility depends on our ability to generate significant cash flow in the future. This, to some extent, is subject to general economic, financial, competitive, legislative and regulatory factors as well as other factors that are beyond our control. We cannot assure you that our business will generate cash flow from operations, or that future borrowings will be available to us under our existing credit facility or otherwise, in an amount sufficient to enable us to meet our payment obligations under the Notes and our other debt and to fund other liquidity needs. If we are not able to generate sufficient cash flow to service our debt obligations, we may need to refinance or restructure our debt, including the Notes, sell assets, reduce or delay capital investments, or seek to raise additional capital. If we are unable to implement one or more of these alternatives, we may not be able to meet our payment obligations under the Notes and our other debt.

Illustration. The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of interest expense. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) $4.4 billion in total assets, (ii) an average cost of funds of 5.63%, (iii) $1.7 billion in debt outstanding and (iv) $2.7 billion of shareholders' equity.

Assumed Return on Our Portfolio (net of expenses)	(10)%	(5)%	— %	5 %	10 %
Corresponding Return to Stockholder	(19.8)%	(11.7)%	(3.5)%	4.6 %	12.7 %

The assumed portfolio return is required by regulation of the SEC and is not a prediction of, and does not represent, our projected or actual performance. Actual returns may be greater or less than those appearing in the table.

The Senior Convertible Notes, the 2022 Notes and the 2023 Notes present other risks to holders of our common stock, including the possibility that such Notes could discourage an acquisition of the Company by a third party and accounting uncertainty.

Certain provisions of the Senior Convertible Notes, the 2022 Notes and the 2023 Notes could make it more difficult or more expensive for a third party to acquire us. Upon the occurrence of certain transactions constituting a fundamental change, holders of the Senior Convertible Notes, the 2022 Notes and the 2023 Notes will have the right, at their option, to require us to repurchase all of their Senior Convertible Notes, the 2022 Notes and the 2023 Notes or any portion of the principal amount of such Senior Convertible Notes, the 2022 Notes and the 2023 Notes in integral multiples of $1,000, in the case of the Senior Convertible Notes and the 2023 Notes, and $25, in the case of the 2022 Notes. We may also be required to increase the conversion rate or provide for conversion into the acquirer's capital stock in the event of certain fundamental changes with respect to the Senior Convertible Notes. These provisions could discourage an acquisition of us by a third party.

The accounting for convertible debt securities is subject to frequent scrutiny by the accounting regulatory bodies and is subject to change. We cannot predict if or when any such change could be made and any such change could have an adverse impact on our reported or future financial results. Any such impacts could adversely affect the market price of our common stock.

We may in the future determine to fund a portion of our investments with preferred stock, which would magnify the potential for gain or loss and the risks of investing in us in the same way as our borrowings.

Preferred stock, which is another form of leverage, has the same risks to our common stockholders as borrowings because the dividends on any preferred stock we issue must be cumulative. Payment of such dividends and repayment of the liquidation preference of such preferred stock must take preference over any dividends or other payments to our common stockholders, and preferred stockholders are not subject to any of our expenses or losses and are not entitled to participate in any income or appreciation in excess of their stated preference.

Holders of any preferred stock we might issue would have the right to elect members of the board of directors and class voting rights on certain matters.

Holders of any preferred stock we might issue, voting separately as a single class, would have the right to elect two members of the board of directors at all times and in the event dividends become two full years in arrears would have the right to elect a majority of the directors until such arrearage is completely eliminated. In addition, preferred stockholders have class voting rights on certain matters, including changes in fundamental investment restrictions and conversion to open-end status, and accordingly can veto any such changes. Restrictions imposed on the declarations and payment of dividends or other distributions to the holders of our common stock and preferred stock, both by the

1940 Act and by requirements imposed by rating agencies or the terms of our credit facilities, might impair our ability to maintain our qualification as a RIC for federal income tax purposes. While we would intend to redeem our preferred stock to the extent necessary to enable us to distribute our income as required to maintain our qualification as a RIC, there can be no assurance that such actions could be effected in time to meet the tax requirements.

In addition to regulatory restrictions that restrict our ability to raise capital, our credit facility contains various covenants which, if not complied with, could accelerate repayment under the facility, thereby materially and adversely affecting our liquidity, financial condition and results of operations.

The agreement governing our credit facility requires us to comply with certain financial and operational covenants. These covenants include:

- restrictions on the level of indebtedness that we are permitted to incur in relation to the value of our assets;
- restrictions on our ability to incur liens; and
- maintenance of a minimum level of stockholders' equity.

As of June 30, 2013, we were in compliance with these covenants. However, our continued compliance with these covenants depends on many factors, some of which are beyond our control. Accordingly, there are no assurances that we will continue to comply with the covenants in our credit facility. Failure to comply with these covenants would result in a default under this facility which, if we were unable to obtain a waiver from the lenders thereunder, could result in an acceleration of repayments under the facility and thereby have a material adverse impact on our business, financial condition and results of operations.

Failure to extend our existing credit facility, the revolving period of which is currently scheduled to expire on March 27, 2015, could have a material adverse effect on our results of operations and financial position and our ability to pay expenses and make distributions.

The revolving period for our credit facility with a syndicate of lenders is currently scheduled to terminate on March 27, 2015, with an additional two year amortization period (with distributions allowed) after the completion of the revolving period. During such two year amortization period, all principal payments on the pledged assets will be applied to reduce the balance. At the end of the two year amortization period, the remaining balance will become due if required by the lenders. If the credit facility is not renewed or extended by the participant banks by March 27, 2015, we will not be able to make further borrowings under the facility after such date and the outstanding principal balance on that date will be due and payable on March 27, 2017. At June 30, 2013 we had $124.0 million of outstanding borrowings under our credit facility. Interest on borrowings under the credit facility is one-month LIBOR plus 275 basis points with no minimum LIBOR floor. Additionally, the lenders charge a fee on the unused portion of the credit facility equal to either 50 basis points if at least half of the credit facility is drawn or 100 basis points otherwise. The credit facility requires us to pledge assets as collateral in order to borrow under the credit facility. If we are unable to extend our facility or find a new source of borrowing on acceptable terms, we will be required to pay down the amounts outstanding under the facility during the two-year term-out period through one or more of the following: (1) principal collections on our securities pledged under the facility, (2) at our option, interest collections on our securities pledged under the facility and cash collections on our securities not pledged under the facility, or (3) possible liquidation of some or all of our loans and other assets, any of which could have a material adverse effect on our results of operations and financial position and may force us to decrease or stop paying certain expenses and making distributions until the facility is repaid. In addition, our stock price could decline significantly, we would be restricted in our ability to acquire new investments and, in connection with our year-end audit, our independent registered accounting firm could raise an issue as to our ability to continue as a going concern.

Failure to refinance our existing Senior Notes, could have a material adverse effect on our results of operations and financial position.

Our Senior Notes mature at various dates from December 15, 2015 to June 15, 2043. If we are unable to refinance our Senior Notes or find a new source of borrowing on acceptable terms, we will be required to pay down the amounts outstanding at maturity under the facility during the two-year term-out period through one or more of the following: (1) borrowing additional funds under our then current credit facility, (2) issuance of additional common stock or (3) possible liquidation of some or all of our loans and other assets, any of which could have a material adverse effect on our results of operations and financial position. In addition, our stock price could decline significantly; we would be restricted in our ability to acquire new investments and, in connection with our year-end audit, our independent registered accounting firm could raise an issue as to our ability to continue as a going concern.

The trading market or market value of our publicly issued debt securities may fluctuate.

Our publicly issued debt securities may or may not have an established trading market. We cannot assure our noteholders that a trading market for our publicly issued debt securities will ever develop or be maintained if developed. In addition to our creditworthiness, many factors may materially adversely affect the trading market for, and market value of, our publicly issued debt securities. These factors include, but are not limited to, the following:

- the time remaining to the maturity of these debt securities;
- the outstanding principal amount of debt securities with terms identical to these debt securities;
- the ratings assigned by national statistical ratings agencies;
- the general economic environment;
- the supply of debt securities trading in the secondary market, if any;
- the redemption or repayment features, if any, of these debt securities;
- the level, direction and volatility of market interest rates generally; and
- market rates of interest higher or lower than rates borne by the debt securities.

Our noteholders should also be aware that there may be a limited number of buyers when they decide to sell their debt securities. This too may materially adversely affect the market value of the debt securities or the trading market for the debt securities.

Terms relating to redemption may materially adversely affect our noteholders return on any debt securities that we may issue.

If our noteholders' debt securities are redeemable at our option, we may choose to redeem their debt securities at times when prevailing interest rates are lower than the interest rate paid on their debt securities. In addition, if our noteholders' debt securities are subject to mandatory redemption, we may be required to redeem their debt securities also at times when prevailing interest rates are lower than the interest rate paid on their debt securities. In this circumstance, our noteholders may not be able to reinvest the redemption proceeds in a comparable security at an effective interest rate as high as their debt securities being redeemed.

Our shares of common stock have traded at a discount from net asset value and may do so again in the future, which could limit our ability to raise additional equity capital.

Shares of closed-end investment companies frequently trade at a market price that is less than the net asset value that is attributable to those shares. This characteristic of closed-end investment companies is separate and distinct from the risk that our net asset value per share may decline. It is not possible to predict whether any shares of our common stock will trade at, above, or below net asset value. In the recent past, including during much of 2009, the stocks of BDCs as an industry, including at times shares of our common stock, traded below net asset value and at near historic lows as a result of concerns over liquidity, leverage restrictions and distribution requirements. When our common stock is trading below its net asset value per share, we will generally not be able to issue additional shares of our common stock at its market price without first obtaining approval for such issuance from our stockholders and our independent directors. At our 2012 annual meeting of stockholders held on December 7, 2012, our stockholders approved our ability, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering, to sell shares of our common stock at any level of discount from net asset value per share during the 12 month period following December 7, 2012. It should be noted that, theoretically, we may offer up to 25% of our then outstanding common stock each day.

There is a risk that investors in our common stock may not receive dividends or that our dividends may not grow over time and investors in our debt securities may not receive all of the interest income to which they are entitled.

We intend to make distributions on a monthly basis to our stockholders out of assets legally available for distribution. We cannot assure you that we will achieve investment results that will allow us to make a specified level of cash distributions or year-to-year increases in cash distributions. If we declare a dividend and if more stockholders opt to receive cash distributions rather than participate in our dividend reinvestment plan, we may be forced to sell some of our investments in order to make cash dividend payments.

In addition, due to the asset coverage test applicable to us as a BDC, we may be limited in our ability to make distributions. Further, if we invest a greater amount of assets in equity securities that do not pay current dividends, it could reduce the amount available for distribution.

The above-referenced restrictions on distributions may also inhibit our ability to make required interest payments to holders of our debt, which may cause a default under the terms of our debt agreements. Such a default could materially increase our cost of raising capital, as well as cause us to incur penalties under the terms of our debt agreements.

Investing in our securities may involve a high degree of risk and is highly speculative.

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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.

Our stockholders will experience dilution in their ownership percentage if they opt out of our dividend reinvestment plan.

All dividends declared in cash payable to stockholders that are participants in our dividend reinvestment plan are automatically reinvested in shares of our common stock. As a result, our stockholders that opt out of our dividend reinvestment plan will experience dilution in their ownership percentage of our common stock over time.

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

Sales of substantial amounts of our common stock, or the availability of such common stock for sale (including as a result of the conversion of our Senior Convertible Notes into common stock), could adversely affect the prevailing market prices for our common stock. 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.

If we sell shares of our common stock or securities to subscribe for or are convertible into shares of our 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 2012 annual meeting of stockholders held on December 7, 2012, our stockholders approved our ability, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering, to sell shares of our common stock at any level of discount from net asset value per share during the 12 month period following December 7, 2012. It should be noted that, theoretically, we may offer up to 25% of our then outstanding common stock each day. The issuance or sale by us of shares of our common stock or securities to subscribe for or are convertible into 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 of common stock 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 of common stock 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. In addition, such sales may adversely affect the price at which our common stock trades. We have sold shares of our common stock at prices below net asset value per share in the past and may do so to the future. We have not sold any shares of our common stock at prices below net asset value per share since July 18, 2011.

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. Subject to certain limited exceptions, we are prohibited from buying or selling any security or other property from or to the 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.

We and Priority Senior Secured Income Fund, Inc., Pathway Energy Infrastructure Fund, Inc., Prospect Capital Funding LLC, Prospect Capital Management LLC, Priority Senior Secured Income Management, LLC and Pathway Energy Infrastructure Management, LLC have submitted an exemptive application to the SEC to permit us to participate in negotiated co-investments with other funds managed by Prospect Capital Management LLC, Priority Senior Secured Income Management, LLC or Pathway Energy Infrastructure Management, LLC or affiliated advisers in a manner consistent with our investment objective, strategies and restrictions as well as regulatory requirements and other pertinent factors, subject to the conditions therein. However, there is no assurance that we will obtain such exemptive relief.

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:

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- 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;
- price and volume fluctuations in the overall stock market from time to time;
- 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;
- short-selling pressure with respect to shares of our common stock or BDCs generally;
- future sales of our securities convertible into or exchangeable or exercisable for our common stock or the conversion of such securities, including the Convertible Unsecured Notes;
- uncertainty surrounding the strength of the U.S. economic recovery;
- concerns regarding European sovereign debt;
- changes in prevailing interest rates;
- litigation matters;
- general economic trends and other external factors; and
- loss of a major funding source.

In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has, from time to time, been brought against that company.

If our stock price fluctuates significantly, we may be the target of securities litigation in the future. Securities litigation could result in substantial costs and divert management's attention and resources from our business.

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 monthly 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 stockholders from being able to sell shares of our 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 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.

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%

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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. Our Board of Directors has adopted a resolution that any business combination between us and any other person is exempted from the provisions of the Business Combination Act, provided that the business combination is first approved by the Board of Directors, including a majority of the directors who are not interested persons as defined in the 1940 Act. 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. However, as noted above, the SEC has recently taken the position that the Maryland Control Share Acquisition Act is inconsistent with the 1940 Act and may not be invoked by a BDC. It is the view of the staff of the SEC that opting into the Maryland Control Share Acquisition Act would be acting in a manner inconsistent with section 18(i) of the 1940 Act.

Your interest in us may be diluted if you do not fully exercise your subscription rights in any rights offering. In addition, if the subscription price is less than our net asset value per share, then you will experience an immediate dilution of the aggregate net asset value of your shares.

In the event we issue subscription rights, stockholders who do not fully exercise their subscription rights should expect that they will, at the completion of a rights offering pursuant to this prospectus, own a smaller proportional interest in us than would otherwise be the case if they fully exercised their rights. We cannot state precisely the amount of any such dilution in share ownership because we do not know at this time what proportion of the shares will be purchased as a result of such rights offering.

In addition, if the subscription price is less than the net asset value per share of our common stock, then our stockholders would experience an immediate dilution of the aggregate net asset value of their shares as a result of the offering. The amount of any decrease in net asset value is not predictable because it is not known at this time what the subscription price and net asset value per share will be on the expiration date of a rights offering or what proportion of the shares will be purchased as a result of such rights offering. Such dilution could be substantial.

We may in the future choose to pay dividends in our own stock, in which case our stockholders 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. The IRS has issued private letter rulings on cash/stock dividends paid by RICs and real estate investment trusts if certain requirements are satisfied, and we have received such a ruling permitting us to declare such taxable cash/stock dividends, up to 80% in stock, with respect to our taxable years ending August 31, 2012 and August 31, 2013. 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 our current and accumulated earnings and profits for United States federal income tax purposes. As a result, a U.S. Stockholder (as defined in "Material U.S. Federal Income Tax Considerations") 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 its stock at the time of the sale. Furthermore, with respect to Non-U.S. Stockholders (as defined in "Material U.S. Federal Income Tax Considerations"), 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

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sell shares of our 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(All figures in this section are in thousands except share, per share and other data)

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

Note on Forward Looking Statements

Some of the statements in this section of the prospectus constitute forward-looking statements, which relate to future events or our future performance or financial condition. The forward-looking statements contained herein involve risks and uncertainties, including statements as 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;
- our expected financings and investments;
- the adequacy of our cash resources and working capital; and
- the timing of cash flows, if any, from the operations of our portfolio companies.

We generally use words such as "anticipates," "believes," "expects," "intends" and similar expressions to identify forward-looking statements. Our actual results could differ materially from those projected in the forward-looking statements for any reason, including the factors set forth in "Risk Factors" and elsewhere in this prospectus. These forward-looking statements do not meet the safe harbor for forward-looking statements pursuant to Section 27A of the Securities Act.

We have based the forward-looking statements included in herein on information available to us on the date of this document, and we assume no obligation to update any such forward-looking statements. Although we undertake no obligation to revise or update any forward-looking statements, whether as a result of new information, future events or otherwise, you are advised to consult any additional disclosures that we may make directly to you or through reports that we in the future may file with the SEC, including any annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

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 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 currently have seven origination strategies in which we make investments: (1) lending in private equity sponsored transactions, (2) lending directly to companies not owned by private equity firms, (3) control investments in corporate operating companies, (4) control investments in financial companies, (5) investments in structured credit, (6) real estate investments, and (7) investments in syndicated debt. We continue to evaluate other origination strategies in the ordinary course of business with no specific tops-down allocation to any single origination strategy.

Lending in Private Equity Sponsored Transactions—We make loans to companies which are controlled by leading private equity firms. This debt can take the form of first lien, second lien, unitranche or mezzanine loans. In making these investments, we look for a diversified customer base, recurring demand for the product or service, barriers to entry, strong historical cash flow and experienced management teams. These loans typically have significant equity subordinate to our loan position. This strategy has represented approximately 50%-60% of our business.

Lending Directly to Companies—We provide debt financing to companies owned by non-private equity firms, the company founder, a management team or a family. Here, in addition to the strengths we look for in a sponsored transaction, we also look for the alignment with the management team with significant invested capital. This strategy often has less competition than the private equity sponsor strategy because such company financing needs are not easily addressed by banks and often require more diligence preparation. Direct lending can result in higher returns and lower leverage than sponsor transactions and may include warrants or equity to us. This strategy generally has comprised approximately 10%-15% of our business.

Control Investments in Corporate Operating Companies—This strategy involves acquiring controlling stakes in non-financial operating companies. Our investments in these companies are generally structured as a combination of yield-producing debt and equity. We provide certainty of closure to our counterparties, give the seller personal liquidity and generally look for management to continue on in their current roles. This strategy has comprised approximately 10%-15% of our business.

Control Investments in Financial Companies—This strategy involves acquiring controlling stakes in financial companies, including consumer direct lending, subprime auto lending and other strategies. Our investments in these companies are generally structured as a combination of yield-producing debt and equity. These investments are often structured in a tax-efficient RIC-compliant partnership, enhancing returns. This strategy has comprised approximately 10%-15% of our business.

Investments in Structured Credit—We make investments in CLOs, generally taking a significant position in the subordinated interests (equity) of the CLOs. The CLOs include a diversified portfolio of broadly syndicated loans and do not have direct exposure to real estate, mortgages, sub-prime debt, or consumer based debt. The CLOs in which we invest are managed by top-tier collateral managers that have been thoroughly diligenced prior to investment. This strategy has represented 10%-20% of the portfolio.

Real Estate Investments—We make investments in real estate through our wholly-owned tax-efficient real estate investment trust ("REIT"), American Property Holding Corp. ("APHC"). Our real estate investments are in various classes of fully developed and occupied real estate properties that generate current yields. We seek to identify properties that have historically high occupancy and steady cash flow generation. We partner with established property managers with experience in managing the property type to manage such properties after acquisition. This is a more recent investment strategy that has represented less than 5% of our business.

Investments in Syndicated Debt—On an opportunistic basis, we make investments in loans and high yield bonds that have been sold to a syndicate of buyers. Here we look for investments with attractive risk-adjusted returns after we have completed a fundamental credit analysis. These investments are purchased with a long term, buy-and-hold outlook and we look to provide significant structuring input by providing anchoring orders. This strategy has represented approximately 5%-10% of the portfolio.

We invest primarily in first and second lien senior loans and mezzanine debt, which in some cases includes an equity component. First and second lien senior loans generally are senior debt instruments that rank ahead of subordinated debt of a given portfolio company. These loans also have the benefit of security interests on the assets of the portfolio company, which may rank ahead of or be junior to other security interests. Mezzanine debt and our investments in CLOs are subordinated to senior loans and are generally unsecured. We invest in debt and equity positions of CLOs which are a form of securitization in which the cash flows of a portfolio of loans are pooled and passed on to different classes of owners in various tranches. Our CLO investments are derived from portfolios of corporate debt securities which are generally risk rated from BB to B depending on the tranche.

We seek to be a long-term investor with our portfolio companies. The aggregate value of our portfolio investments was $4,172,852 and $2,094,221 as of June 30, 2013 and June 30, 2012, respectively. During the year ended June 30, 2013, our net cost of investments increased by $2,156,465, or 102.7%, as a result of 68 new investments, 25 follow-on investments and several revolver advances of $3,043,531, accrued of payment-in-kind interest of $10,947, structuring fees of $52,699 and amortization of discounts and premiums of $11,016, while we received full repayment on 23 investments, sold ten investments, impaired one investment, and received several partial prepayments, amortization payments and a revolver repayment, totaling $931,534.

Compared to the end of last fiscal year (ended June 30, 2012), net assets increased by $1,144,520, or 75.7% during the year ended June 30, 2013, from $1,511,974 to $2,656,494. This increase resulted from the issuance of new shares of our common stock (less offering costs) in the amount of $1,179,084, dividend reinvestments of $16,087, and $220,856 from operations. These increases, in turn, were offset by $271,507 in dividend distributions to our stockholders. The $220,856 increase in net assets resulting from operations is net of the following: net investment income of $324,924, net realized loss on investments of $26,234, and a decrease in net assets due to changes in net unrealized depreciation of investments of $77,834.

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, and these differences could be material.

Fourth Quarter Highlights

Investment Transactions

On April 1, 2013, we refinanced our existing $18,635 of subordinated loans to Ajax Rolled Ring & Machine, Inc. ("Ajax"), increasing the size of our debt investment to $38,537. Concurrent with the refinancing, we received repayment of the $18,635 subordinated loans that were previously outstanding. The subordinated unsecured term loan bears interest in cash at the greater of 11.5% or Libor plus 8.5% and interest payment in kind of 6.0% and has a final maturity of March 30, 2018.

On April 15, 2013, assets previously held by H&M were assigned to Wolf in exchange for a $66,000 term loan secured by the assets. Our cost basis in this loan of $44,632 was determined in accordance with ASC 310-40, Troubled Debt Restructurings by Creditors, and is equal to the fair value of
assets at the time of transfer and we recorded a realized loss of $19,647 in connection with the foreclosure on the assets. On May 17, 2013, Wolf sold certain of the assets that had been previously held by H&M that were located in Martin County to Hibernia for $66,000. Proceeds from the sale were primarily used to repay the loan and NPI receivable due to us and we recognized as a realized gain of $11,826 partially offsetting the previously recorded loss. We received $3,960 of structuring and advisory fees from Wolf during the year ended June 30, 2013 related to the sale and $991 under the NPI agreement which was recognized as other income during the fiscal year ended June 30, 2013.

On April 17, 2013, we made an investment of $43,650 to purchase 97% of the subordinated notes in Mountain View CLO 2013-I Ltd. ("Mountain View").

On April 22, 2013, we provided $34,375 of senior secured financing, of which $31,875 was funded at closing, to support the acquisition of Pegasus Business Intelligence, LP ("Pegasus"), the world's largest processor of commissions paid by hotels to travel agencies for room booking services. The $15,938 Term Loan A note bears interest in cash at the greater of 6.75% or Libor plus 5.5% and has a final maturity of April 18, 2018. The $15,938 Term Loan B note bears interest in cash at the greater of 13.75% or Libor plus 12.5% and has a final maturity of April 18, 2018. The $2,500 senior secured revolver, which was unfunded at closing, bears interest in cash at the greater of 9.0% or Libor plus 7.75% and has a final maturity of April 18, 2014.

On April 25, 2013, we made an investment of $26,000 to purchase 50.9% of the subordinated notes in Brookside Mill CLO Ltd. ("Brookside").

On April 30, 2013, we made a $21,247 follow-on investment in APH, to acquire Lofton Place Apartments and Vista at Palma Sola, multi-family residential properties located in Florida. We invested $3,247 of equity and $18,000 of debt in APH. The senior secured note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.50% and has a final maturity of October 24, 2020.

On April 30, 2013, we sold our investment in Fischbein, LLC ("Fischbein") for net proceeds of $3,168, recognizing a realized gain of $2,293 on the sale. In addition, there is $310 being held in escrow which will be recognized as additional gain if and when received.

On May 8, 2013, we made a $6,119 follow-on investment in APH, to acquire Arlington Park, a multi-family residential property located in Marietta, Georgia. We invested $2,119 of equity and $4,000 of debt in APH. The senior secured note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.50% and has a final maturity of October 24, 2020.

On May 9, 2013, we provided a $55,000 senior secured credit facility to support the recapitalization of Sandow Media, LLC ("Sandow"), a provider of multimedia content and services to businesses and consumers focused on the areas of design and luxury. The senior secured first lien loan bears interest in cash at the greater of 10.5% or Libor plus 8.5% and interest payment in kind of 1.5% and has a final maturity of May 8, 2018.

On May 10, 2013, we provided $150,000 of secured second lien financing to support the recapitalization of Arctic Glacier, Inc. ("Arctic Glacier"), a leading producer, marketer, and distributor of high-quality packaged ice to consumers in the United States and Canada. After the financing, we received repayment of $86,982 of subordinated unsecured term loan previously outstanding. The senior secured second lien loan bears interest in cash at the greater of 11.25% or Libor plus 10.0% and has a final maturity of November 10, 2019.

On May 14, 2013, we provided $4,000 of senior secured financing to SourceHOV, LLC ("SourceHOV"), a leading provider of business and knowledge process outsourcing. The second lien term loan bears interest in cash at the greater of 8.75% or Libor plus 7.5% and has a final maturity of April 30, 2019. On June 13, 2013, we sold our $4,000 investment in SourceHOV and realized a gain of $40 on this investment.
On May 16, 2013, Out Rage, LLC ("Out Rage") repaid the $11,836 loan receivable to us.
On May 23, 2013, Snacks Holding Corporation ("Snacks Holding") repaid the $15,366 loan receivable to us.
On May 31, 2013, we made a follow-on secured second lien debt investment of $7,190 in Injured Workers Pharmacy LLC ("IWP"), a specialty pharmacy services company. The secured second lien loan bears interest in cash at the greater of 11.5% or Libor plus 7.0% and interest payment in kind of 1.0% and has a final maturity of May 31, 2019.
On June 3, 2013, Nobel Learning Communities, Inc. ("Nobel") repaid the $15,262 loan receivable to us.
On June 4, 2013, Springs Window Fashions, LLC ("Springs") repaid the $35,000 loan receivable to us.
On June 11, 2013, we provided $115,000 of senior secured financing to CI Holdings ("Transplace"), a third-party logistics company that services many of the largest shippers in the world. The senior secured first lien loan bears interest in cash at the greater of 10.0% or Libor plus 5.0% and has a final maturity of June 11, 2019.
On June 11, 2013, we provided $7,000 of secured second lien financing to Armor Holding II LLC ("AST"), a leading North American third-party provider of share registry and associated value added services to shareholders on behalf of listed public companies. The second lien loan bears interest in cash at the greater of 9.25% or Libor plus 8.0% and has a final maturity of December 26, 2020.
On June 12, 2013, we made a $23,250 follow-on investment in R-V Industries, Inc. ("R-V"). The senior subordinated note bears interest in cash at the greater of 10.0% or Libor plus 9.0% and has a final maturity of June 12, 2018.
On June 14, 2013, we sold our $10,000 investment in Transaction Networks Services, Inc. ("TNS") and realized a gain of $117 on this investment.
On June 18, 2013, we served as sole agent and provider of $70,000 senior secured financing, of which $65,643 was funded at closing, to support the recapitalization of Traeger Pellet Grills LLC ("Traeger"), a leading designer, marketer, and distributor of wood pellet grills, flavored wood pellets, and grill accessories. The $30,000 Term Loan A note bears interest in cash at the greater of 6.5% or Libor plus 4.5% and has a final maturity of June 18, 2018. The $30,000 Term Loan B note bears interest in cash at the greater of 11.5% or Libor plus 9.5% and has a final maturity of June 18, 2018. The $10,000 senior secured revolver, of which $5,643 was drawn at closing, bears interest in cash at the greater of 9.0% or Libor plus 7.0% and has a final maturity of June 18, 2014.
On June 24, 2013, we made a $76,533 follow-on investment in APH, to acquire Arium Resort (f/k/a The Resort at Pembroke Pines), a prominent multi-family residential community located in Pembroke Pines, Florida. We invested $13,533 of equity and $63,000 of debt in APH. The senior secured note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.50% and has a final maturity of October 24, 2020.
On June 25, 2013, we made an investment of $26,500 to purchase 84.13% of the subordinated notes in LCM XIV CLO Ltd. ("LCM XIV").
On June 27, 2013, we provided $11,000 of secured second lien financing to Blue Coat Systems, Inc. ("Blue Coat"), a leading provider of web security and wide area network (WAN) optimization solutions. The second lien note bears interest in cash at the greater of 9.5% or Libor plus 8.5% and has a final maturity of June 28, 2020.
On June 27, 2013, we made a follow-on secured debt investment of $87,500 to support the recapitalization of Progrexion Holdings, Inc. ("Progrexion"). After the financing, we now hold $241,033 of senior secured debt of Progrexion. The senior secured first lien note bears interest in cash at the greater of 10.5% or Libor plus 8.5% and has a final maturity of September 14, 2017.
On June 28, 2013, Sandow repaid $30,100 of the $55,000 loan receivable to us. After the repayment, we now hold $24,900 of senior secured debt of Sandow.
On June 28, 2013, we made a $1,000 follow-on investment in Ajax. The subordinated unsecured term loan bears interest in cash at the greater of 11.5% or Libor plus 8.5% and interest payment in kind of 6.0% and has a final maturity of March 30, 2018.

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On June 28, 2013, we made an $18,000 secured debt follow-on investment in New Star Metals, Inc. ("New Star"), a provider of specialized processing services to the steel industry. The senior subordinated term loan bears interest in cash at 11.5% and interest payment in kind of 1.0% and has a final maturity of February 2, 2018.

In June 2013, we determined that the impairment of Manx was other-than-temporary and recorded a realized loss of $9,397 for the amount that the amortized cost exceeded the fair market value.

Equity Issuance

During the period from April 1, 2013 to May 31, 2013, we sold 8,836,237 shares of our common stock at an average price of $10.92 per share, and raised $96,476 of gross proceeds, under the ATM Program. Net proceeds were $95,474 after commissions to the broker-dealer on shares sold and offering costs. No additional shares were sold from June 1, 2013 to June 30, 2013.

On April 18, 2013, May 23, 2013 and June 20, 2013, we issued 138,087, 117,497 and 117,107 shares of our common stock in connection with the dividend reinvestment plan, respectively.

Dividend

On May 6, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110125 per share for May 2013 to holders of record on May 31, 2013 with a payment date of June 20, 2013;
- $0.110150 per share for June 2013 to holders of record on June 28, 2013 with a payment date of July 18, 2013;
- $0.110175 per share for July 2013 to holders of record on July 31, 2013 with a payment date of August 22, 2013; and
- $0.110200 per share for August 2013 to holders of record on August 30, 2013 with a payment date of September 19, 2013.

On June 17, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110225 per share for September 2013 to holders of record on September 30, 2013 with a payment date of October 24, 2013;
- $0.110250 per share for October 2013 to holders of record on October 31, 2013 with a payment date of November 21, 2013;
- $0.110275 per share for November 2013 to holders of record on November 29, 2013 with a payment date of December 19, 2013; and
- $0.110300 per share for December 2013 to holders of record on December 31, 2013 with a payment date of January 23, 2014.

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Debt Issuance

During the quarter ended June 30, 2013, we issued $164,376 in aggregate principal amount of our Prospect Capital InterNotes® for net proceeds of approximately $159,983, as follows:

Date of Issuance	Principal Amount	Interest Rate Range		Weighted Average Interest Rate		Maturity Date
April 4, 2013 - April 25, 2013	$ 29,528	4.50% - 5.00%		4.96	%	April 15, 2020
April 4, 2013 - April 25, 2013	264	3.78% - 3.78%		3.78	%	April 15, 2023
April 4, 2013 - April 25, 2013	5,164	4.63% - 5.50%		5.34	%	April 15, 2031
April 4, 2013 - April 25, 2013	12,280	6.00	%	6.00	%	April 15, 2043
May 2, 2013 - May 31, 2013	42,482	5.00	%	5.00	%	May 15, 2020
May 2, 2013 - May 31, 2013	10,000	5.00	%	5.00	%	May 15, 2028
May 2, 2013 - May 31, 2013	7,548	5.75	%	5.75	%	May 15, 2031
May 2, 2013 - May 31, 2013	33,641	6.25	%	6.25	%	May 15, 2043
June 6, 2013 - June 27, 2013	9,905	5.00% - 5.25%		5.04	%	June 15, 2020
June 6, 2013 - June 27, 2013	5,000	5.00	%	5.00	%	June 15, 2028
June 6, 2013 - June 27, 2013	1,707	5.75% - 6.00%		5.85	%	June 15, 2031
June 6, 2013 - June 27, 2013	6,857	6.25% - 6.50%		6.31	%	June 15, 2043
	$ 164,376					

Investment Holdings

As of June 30, 2013, we continue to pursue our diversified investment strategy. At June 30, 2013, approximately $4,172,852 or 157.1% of our net assets are invested in 124 long-term portfolio investments and CLOs and 5.4% of our net assets are invested in money market funds.

During the year ended June 30, 2013, we originated $3,103,217 of new investments. Our origination efforts are focused primarily on secured lending, to reduce the risk in the portfolio, investing primarily in first lien loans, and subordinated notes in CLOs, though we also continue to close select junior debt and equity investments. In addition to targeting investments senior in corporate capital structures with our new originations, we have also increased our origination business mix of third party private equity sponsor owned companies, which tend to have more third party equity capital supporting our debt investments than non-sponsor transactions. Our annualized current yield was 13.9% and 13.6% as of June 30, 2012 and June 30, 2013, respectively, across all performing interest bearing investments. The decrease in our current yield is primarily due to recent originations being at lower yields than the existing portfolio. Monetization of equity positions that we hold and loans on non-accrual status are not included in this yield calculation. In many 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 more than 25% 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 the investee company.

As of June 30, 2013, we own controlling interests in AIRMALL USA, Inc. ("AIRMALL"), Ajax, APH, AWCNC, LLC, Borga, Inc., CCPI Holdings, Inc. ("CCPI"), Credit Central Holdings of Delaware, LLC ("Credit Central"), Energy Solutions Holdings, Inc. (f/k/a Gas Solutions Holdings, Inc.) ("Energy Solutions"), First Tower Holdings of Delaware, LLC ("First Tower Delaware"), Manx Energy, Inc. ("Manx"), Nationwide Acceptance Holdings, LLC ("Nationwide"), NMMB Holdings, Inc. ("NMMB"), R-V Industries, Inc. ("R-V"), The Healing Staff, Inc. ("THS"), Valley Electric Holdings I, Inc. ("Valley Electric") and Wolf Energy Holdings, Inc. ("Wolf"). We also own an affiliated interest in BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork) ("Biotronic"), Boxercraft Incorporated ("Boxercraft") and Smart, LLC.

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The following is a summary of our investment portfolio by level of control at June 30, 2013 and June 30, 2012, respectively:

	June 30, 2013								June 30, 2012							
Level of Control	Cost	Percent of Portfolio		Fair Value	Percent of Portfolio		Cost		Percent of Portfolio		Fair Value		Percent of Portfolio			
Control	$830,151	19.5	%	$811,634	19.5	%	$518,015		24.7	%	$564,489		27.0	%		
Affiliate	49,189	1.2	%	42,443	1.0	%	44,229		2.1	%	46,116		2.2	%		
Non-control/Non-affiliate	3,376,438	79.3	%	3,318,775	79.5	%	1,537,069		73.2	%	1,483,616		70.8	%		
Total Portfolio	$4,255,778	100.0	%	$4,172,852	100.0	%	$2,099,313		100.0	%	$2,094,221		100.0	%		

The following is our investment portfolio presented by type of investment at June 30, 2013 and June 30, 2012, respectively:

	June 30, 2013						June 30, 2012					
Type of Investment	Cost	Percent of Portfolio		Fair Value	Percent of Portfolio		Cost	Percent of Portfolio		Fair Value	Percent of Portfolio	
Revolving Line of Credit	$9,238	0.2	%	$8,729	0.2	%	$1,145	0.1	%	$868	—	%
Senior Secured Debt	2,262,327	53.1	%	2,207,091	52.8	%	1,146,454	54.6	%	1,080,053	52.0	%
Subordinated Secured Debt	1,062,386	25.0	%	1,024,901	24.6	%	536,900	25.6	%	488,113	22.9	%
Subordinated Unsecured Debt	88,470	2.1	%	88,827	2.1	%	72,617	3.5	%	73,195	3.5	%
CLO Debt	27,667	0.7	%	28,589	0.7	%	27,258	1.3	%	27,717	1.3	%
CLO Residual Interest	660,619	15.5	%	658,086	15.8	%	214,559	10.2	%	218,009	10.4	%
Preferred Stock	25,016	0.6	%	14,742	0.4	%	31,323	1.5	%	29,155	1.4	%
Common Stock	117,678	2.7	%	108,494	2.6	%	61,459	2.9	%	137,198	6.6	%
Membership Interests	216	—	%	492	—	%	5,437	0.2	%	13,844	0.7	%
Overriding Royalty Interests	—	—		—	—		—	—		1,623	0.1	%
Net Profit Interests	—	—		20,959	0.5	%	—	—		—	—	
Escrows Receivable	—	—		4,662	0.1	%	—	—		17,686	0.8	%
Warrants	2,161	0.1	%	7,280	0.2	%	2,161	0.1	%	6,760	0.3	%
Total Portfolio	$4,255,778	100.0	%	$4,172,852	100.0	%	$2,099,313	100.0	%	$2,094,221	100.0	%

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The following is our investments in interest bearing securities presented by type of security at June 30, 2013 and June 30, 2012, respectively:

	June 30, 2013								June 30, 2012							
Type of Investment	Cost	Percent of Debt Securities		Fair Value	Percent of Debt Securities		Cost		Percent of Debt Securities		Fair Value		Percent of Debt Securities			
First Lien	$2,271,565	55.3	%	$2,215,820	55.2	%	$1,147,599		57.4	%	$1,088,887		57.6	%		
Second Lien	1,062,386	25.8	%	1,024,901	25.5	%	536,900		26.9	%	480,147		25.4	%		
Unsecured	88,470	2.2	%	88,827	2.2	%	72,617		3.6	%	73,195		3.9	%		
CLO Residual Interest	660,619	16.0	%	658,086	16.4	%	214,559		10.7	%	218,009		11.6	%		
CLO Debt	27,667	0.7	%	28,589	0.7	%	27,258		1.4	%	27,717		1.5	%		
Total Debt Securities	$4,110,707	100.0	%	$4,016,223	100.0	%	$1,998,933		100.0	%	$1,887,955		100.0	%		

The following is our investment portfolio presented by geographic location of the investment at June 30, 2013 and June 30, 2012, respectively:

	June 30, 2013						June 30, 2012					
Geographic Location	Cost	Percent of Portfolio		Fair Value	Percent of Portfolio		Cost	Percent of Portfolio		Fair Value	Percent of Portfolio	
Canada	$165,000	3.9	%	$165,000	4.0	%	$15,134	0.7	%	$17,040	0.8	%
Cayman Islands	688,286	16.2	%	686,675	16.5	%	241,817	11.5	%	245,726	11.7	%
Ireland	14,927	0.4	%	15,000	0.4	%	14,918	0.7	%	15,000	0.7	%
Midwest US	565,239	13.3	%	531,934	12.7	%	427,430	20.4	%	377,139	18.0	%
Northeast US	649,484	15.3	%	663,025	15.9	%	293,181	14.0	%	313,437	15.0	%
Puerto Rico	41,352	1.0	%	41,352	1.0	%	—	—		—	—	
Southeast US	1,111,946	26.0	%	1,081,320	25.8	%	642,984	30.6	%	634,945	30.4	%
Southwest US	345,392	8.1	%	336,362	8.1	%	193,627	9.2	%	234,433	11.2	%
Western US	674,152	15.8	%	652,184	15.6	%	270,222	12.9	%	256,501	12.2	%
Total Portfolio	$4,255,778	100.0	%	$4,172,852	100.0	%	$2,099,313	100.0	%	$2,094,221	100.0	%

The following is our investment portfolio presented by industry sector of the investment at June 30, 2013 and June 30, 2012, respectively:

	June 30, 2013						June 30, 2012					
Industry	Cost	Percent of Portfolio		Fair Value	Percent of Portfolio		Cost	Percent of Portfolio		Fair Value	Percent of Portfolio	
Aerospace and Defense	$56	—	%	$—	—		$56	—	%	$—	—	
Automobile / Auto Finance	23,214	0.6	%	22,917	0.5	%	32,806	1.6	%	32,478	1.6	%
Biotechnology	—	—		14	—	%	—	—		—	—	
Business Services	180,793	4.2	%	179,544	4.3	%	3,164	0.2	%	3,288	0.2	%
Chemicals	28,364	0.7	%	28,648	0.7	%	58,104	2.8	%	58,104	2.8	%
Commercial Services	252,073	5.9	%	252,073	6.0	%	80,418	3.8	%	80,407	3.8	%
Construction and Engineering	53,615	1.3	%	53,615	1.3	%	—	—		—	—	
Consumer Finance	413,332	9.7	%	406,964	9.8	%	305,521	14.6	%	305,521	14.6	%

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	June 30, 2013						June 30, 2012					
Industry	Cost	Percent of Portfolio		Fair Value	Percent of Portfolio		Cost	Percent of Portfolio		Fair Value	Percent of Portfolio	
Consumer Services	330,343	7.8	%	332,394	8.0	%	146,335	7.0	%	147,809	7.1	%
Contracting	2,145	0.1	%	—	—		15,949	0.8	%	—	—	
Diversified Financial Services	745,705	17.5	%	742,434	17.8	%	260,219	12.3	%	264,128	12.6	%
Diversified / Conglomerate Service	—	—		143	—	%	—	—		35	—	%
Durable Consumer Products	380,225	8.9	%	370,207	8.9	%	153,327	7.3	%	152,862	7.3	%
Ecological	141	—	%	335	—	%	141	—	%	240	—	%
Electronics	—	—		149	—	%	—	—		144	—	%
Energy	63,895	1.5	%	56,321	1.3	%	63,245	3.0	%	126,868	6.1	%
Food Products	177,423	4.2	%	177,428	4.3	%	101,975	4.9	%	96,146	4.5	%
Healthcare	275,124	6.5	%	273,838	6.6	%	141,990	6.8	%	143,561	6.9	%
Hotel, Restaurant & Leisure	11,764	0.3	%	12,000	0.3	%	—	—		—	—	
Insurance	—	—		—	—		83,461	4.0	%	83,461	4.0	%
Machinery	396	—	%	790	—	%	4,684	0.2	%	6,485	0.3	%
Manufacturing	163,431	3.8	%	167,584	4.0	%	95,191	4.5	%	127,127	6.1	%
Media	171,290	4.0	%	161,325	3.9	%	165,866	7.9	%	161,843	7.7	%
Metal Services and Minerals	60,162	1.4	%	60,274	1.4	%	—	—		—	—	
Oil and Gas Equipment Services	—	—		—	—		7,188	0.3	%	7,391	0.4	%
Oil and Gas Production	75,126	1.8	%	24,420	0.6	%	130,928	6.2	%	38,993	1.9	%
Personal and Nondurable Consumer Products	39,000	0.9	%	39,630	0.9	%	39,351	1.8	%	39,968	1.9	%
Production Services	—	—		—	—		268	—	%	2,040	0.1	%
Property Management	51,170	1.2	%	54,648	1.3	%	51,770	2.5	%	47,982	2.2	%
Real Estate	152,540	3.6	%	152,540	3.7	%	—	—		—	—	
Retail	14,190	0.3	%	14,569	0.3	%	63	—	%	129	—	%
Software & Computer Services	307,734	7.2	%	309,308	7.4	%	53,908	2.6	%	54,711	2.6	%
Specialty Minerals	38,500	0.9	%	42,558	1.0	%	37,732	1.8	%	44,562	2.1	%
	99,500	2.3	%	99,323	2.4	%	—	—		—	—	

Textiles, Apparel & Luxury Goods												
Textiles and Leather	16,760	0.4	%	9,385	0.2	%	15,123	0.7	%	17,161	0.8	%
Transportation	127,767	3.0	%	127,474	3.1	%	50,530	2.4	%	50,777	2.4	%

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	June 30, 2013				June 30, 2012			
Industry	Cost	Percent of Portfolio	Fair Value	Percent of Portfolio	Cost	Percent of Portfolio	Fair Value	Percent of Portfolio
Total Portfolio	$4,255,778	100.0 %	$4,172,852	100.0 %	$2,099,313	100.0 %	$2,094,221	100.0 %

Portfolio Investment Activity

During the year ended June 30, 2013, we acquired $2,574,755 of new investments, completed follow-on investments in existing portfolio companies, totaling approximately $496,371, funded $21,143 of revolver advances, and recorded PIK interest of $10,947, resulting in gross investment originations of $3,103,217. The more significant of these investments are described briefly in the following:

On July 5, 2012, we made a senior secured debt investment of $28,000 to support the acquisition of Material Handling Services, LLC, d/b/a/ Total Fleet Solutions ("TFS"), a provider of forklift and other material handling equipment fleet management and procurement services, by funds managed by CI Capital Partners, LLC. The senior secured term loan bears interest in cash at the greater of 10.5% or Libor plus 8.5% and has a final maturity of July 5, 2017.

On July 16, 2012, we provided $15,000 of secured second lien financing to Pelican Products, Inc., a leading provider of unbreakable, watertight protective cases and technically advanced professional lighting equipment. The second lien term loan bears interest in cash at the greater of 11.5% or Libor plus 10.0% and has a final maturity of June 14, 2019.

On July 20, 2012, we provided $12,000 of senior secured financing to EIG Investors Corp ("EIG"), a provider of an array of online services such as web presence, domain hosting, e-commerce, e-mail and other related services to small- and medium-sized businesses. The second lien term loan bears interest in cash at the greater of 11.0% or Libor plus 9.5% and has a final maturity of October 22, 2018.

On July 20, 2012, we provided $10,000 of senior secured financing to FPG, LLC ("FPG"), a supplier of branded consumer and commercial products sold to the retail, foodservice, and hospitality sectors. The note payable bears interest in cash at the greater of 12.0% or Libor plus 11.0% and has a final maturity of January 20, 2017.

On July 27, 2012, we provided $85,000 of subordinated financing to support the acquisition of substantially all the assets of Arctic Glacier Income Funds by funds affiliated with H.I.G. The new company, Arctic Glacier U.S.A., Inc., will continue to conduct business under the "Arctic Glacier" name and be a leading producer, marketer, and distributor of high-quality packaged ice to consumers in Canada and the United States. The unsecured subordinated term loan bears interest in cash at 12.0% and interest payment in kind of 3.0% and has a final maturity of July 27, 2019.

On August 2, 2012, we provided a $27,000 secured loan to support the acquisition of New Star, a provider of specialized processing services to the steel industry, by funds managed by Insight Equity Management Company. The senior subordinated note bears interest in cash at the greater of 11.5% or Libor plus 8.5% and interest payment in kind of 1.0% and has a final maturity of February 2, 2018.

On August 3, 2012, we provided $120,000 of senior secured financing, of which $110,000 was funded at closing, to support the acquisition of InterDent, Inc. ("Interdent"), a leading provider of dental practice management services to dental professional corporations and associations in the United States, by funds managed by H.I.G. The $55,000 Term Loan A note bears interest in cash at the greater of 8.0% or Libor plus 6.5% and has a final maturity of August 3, 2017. The $55,000 Term Loan B note bears interest in cash at the greater of 13.0% or Libor plus 10.0% and has a final maturity of August 3, 2017. The $10,000 senior secured revolver, which was unfunded at closing, bears interest in cash at the greater of 10.5% or Libor plus 8.25% and matured on February 3, 2013.

On August 3, 2012, we provided $44,000 of secured subordinated financing to support the refinancing of New Century Transportation, Inc., a leading transportation and logistics company.

The senior subordinated loan bears interest in cash at the greater of 12.0% or Libor plus 10.0% and interest payment in kind of 3.0% and has a final maturity of February 3, 2018.

On August 3, 2012, we provided $10,000 of senior secured financing to Pinnacle (US) Acquisition Co Limited, the largest multi-national software company focused on the delivery of analytical and information management solutions for the discovery and extraction of subsurface natural resources. The second lien term loan originally bore interest in cash at the greater of 10.5% or Libor plus 8.25%. On January 17, 2013, we amended the terms of this investment and the first lien note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.5% as of June 30, 2013. The second lien term loan has a final maturity of August 3, 2020.

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On August 6, 2012, we made an investment of $22,210 to purchase 62.9% of the subordinated notes in Halcyon Loan Advisors Funding 2012-I, Ltd.
On August 7, 2012, we made an investment of $36,798 to purchase 95.0% of the subordinated notes in ING IM CLO 2012-II, Ltd.
On August 17, 2012, we made a secured second lien investment of $38,500 to support the recapitalization of American Gilsonite Company. The secured note bears interest in cash at 11.5% and has a final maturity of September 1, 2017. After the financing, on August 28, 2012, we received repayment of the $37,732 loan previously outstanding.
On September 14, 2012, we invested an additional $10,000 in Hoffmaster Group, Inc. The second lien term loan bears interest in cash at the greater of 11.0% or Libor plus 9.5% and has a final maturity of January 3, 2019.
On September 14, 2012, we made a secured investment of $135,000 to support the recapitalization of Progrexion. Concurrent with the financing, we received repayment of the $62,680 of loans that were previously outstanding. The senior secured loan bears interest in cash at the greater of 10.5% or Libor plus 8.5% and has a final maturity of September 14, 2017.
On September 27, 2012, we made an investment of $45,746 to purchase 95% of the subordinated notes in ING IM CLO 2012-III, Ltd.
On September 28, 2012, we made an unsecured investment of $10,400 to support the acquisition of Evanta Ventures, Inc., a diversified event management company. The subordinated note bears interest in cash at 12.0% and interest payment in kind of 1.0% and has a final maturity of September 28, 2018.
On September 28, 2012, we made a secured second lien investment of $100,000 to support the recapitalization of United Sporting Companies, Inc. ("USC"), a national distributor of hunting, outdoor, marine and tackle products. The secured loan bears interest in cash at the greater of 12.75% or Libor plus 11.0% and has a final maturity of May 16, 2018.
On October 3, 2012, we made a senior secured investment of $21,500 to support the acquisition of CP Well Testing, LLC, a leading provider of flowback services to oil and gas companies operating in Western Oklahoma and the Texas Panhandle. The first lien note bears interest in cash at the greater of 13.5% or Libor plus 11.0% and has a final maturity of October 3, 2017.
On October 11, 2012, we made a secured second lien investment of $12,000 in Deltek, Inc., an enterprise software and information solutions provider for professional services firms, government contractors, and government agencies. The second lien note bears interest in cash at the greater of 10.0% or Libor plus 8.75% and has a final maturity of October 10, 2019.
On October 12, 2012, we made a senior secured investment of $42,000 to support the acquisition of Gulf Coast Machine and Supply Company, a preferred provider of value-added forging solutions to energy and industrial end markets. The first lien note bears interest in cash at the greater of 10.5% or Libor plus 8.5% and has a final maturity of October 12, 2017.
On October 18, 2012, we made a follow-on senior secured debt investment of $20,000 in First Tower Delaware, to support seasonal growth in finance receivables due to increased holiday borrowing activity among its customer base. The first lien note bears interest in cash at the greater of 20.0% or Libor plus 18.5% and has a final maturity of June 30, 2022.
On October 24, 2012, we made an investment of $7,800 in APH, to acquire an industrial real estate property occupied by Filet-of-Chicken, a chicken processor in Georgia. We invested $1,809 of equity and $6,000 of debt in APH. The first lien note originally bore interest in cash at the greater of 10.5% or Libor plus 8.5% and interest payment in kind of 2.0%. On January 17, 2013, we amended the terms of this investment and the first lien note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.5% as of June 30, 2013. The first lien note has a final maturity of October 24, 2020.
On November 5, 2012, we made an investment of $39,475 to purchase 95.0% of the income notes in ING IM CLO 2012-IV, Ltd.
On November 9, 2012, we made a secured second lien investment of $22,000 to support the recapitalization of EIG. Concurrent with the financing, we received a repayment of the $12,000 loan previously outstanding. The new note

bears interest in cash at the greater of 10.25% or Libor plus 9.0% and has a final maturity of May 9, 2020.
On November 26, 2012, we made a secured second lien investment of $22,000 in The Petroleum Place, Inc., a provider of enterprise resource planning software focused on the oil & gas industry. The second lien note bears interest in cash at the greater of 10.0% or Libor plus 8.75% and has a final maturity of May 20, 2019.

On November 30, 2012, we made a secured second lien investment of $9,500 to support the recapitalization of R-V. The second lien note bears interest in cash at the greater of 12.0% or Libor plus 9.0% and has a final maturity of May 30, 2018. As part of the recapitalization, we received a dividend of $11,073 for our investment in R-V's common stock.
On December 6, 2012, we made an investment of $38,291 to purchase 90% of the subordinated notes in Apidos CLO XI, LLC.
On December 13, 2012, we completed a $33,921 recapitalization of CCPI, an international manufacturer of refractory materials and other consumable products for industrial applications. Through the recapitalization, Prospect acquired a controlling interest in CCPI for $28,334 in cash and 467,928 unregistered shares of our common stock. The first lien note issued to CCPI bears interest in cash at a fixed rate of 10.0% and has a final maturity of December 31, 2017. The first lien note issued to CCPI bears interest in cash at a fixed rate of 12.0% and interest payment in kind of 7.0%, and has a final maturity of June 30, 2018.
On December 14, 2012, we provided $10,000 of first lien financing to support the recapitalization of Prince Mineral Holding Corp. ("Prince"), a leading global specialty mineral processor and consolidator. The first lien note bears interest in cash at a fixed rate of 11.5% and has a final maturity of December 15, 2019.
On December 14, 2012, we made a $3,000 follow-on investment in Focus Brands, Inc. The second lien note bears interest in cash at the greater of 10.25% or Libor plus 9.0% and has a final maturity of August 21, 2018.
On December 17, 2012, we made a $39,800 first lien investment in Coverall North America, Inc. ("Coverall"), a leading franchiser of commercial cleaning businesses. The first lien note bears interest in cash at the greater of 11.5% or Libor plus 8.5% and has a final maturity of December 17, 2017.
On December 17, 2012, we made a $38,150 first lien follow-on investment in TFS, to support the acquisition of Miner Holding Company, Inc. The first lien note bears interest in cash at the greater of 10.0% or Libor plus 8.0% and has a final maturity of December 21, 2017.
On December 17, 2012, we made a secured debt investment of $30,000 to support the recapitalization of Biotronic. After the financing, we received repayment of the $26,227 loan that was previously outstanding. The new note bears interest in cash at the greater of 10.0% or Libor plus 8.0% and has a final maturity of December 17, 2017.
On December 19, 2012, we provided $17,500 of senior secured second lien financing to Grocery Outlet, Inc., to support the recapitalization of a retailer of food, beverages and general merchandise. The second lien note bears interest in cash at the greater of 10.5% or Libor plus 9.25% and has a final maturity of June 17, 2019.
On December 19, 2012, we provided $23,200 of senior secured second lien financing to support the recapitalization of TB Corp., a Mexican restaurant chain. The second lien note bears interest in cash at a fixed rate of 12.0% and interest payment in kind of 1.5% and has a final maturity of December 18, 2018.
On December 20, 2012, we made an additional follow-on senior secured debt investment of $19,500 to support the recapitalization of Progrexion. After the financing, we held $154,500 of senior secured debt of Progrexion. The first lien note bears interest in cash at the greater of 10.5% or Libor plus 8.5% and has a final maturity of September 14, 2017.
On December 21, 2012, we made a $10,000 senior secured second lien follow-on investment in Seaton Corp. The second lien note bears interest in cash at the greater of 12.5% or Libor plus 9.0% and interest payment in kind of 2.0% and has a final maturity of March 14, 2015.
On December 21, 2012, we made a $37,500 senior secured first lien investment in Lasership, Inc., a leading provider of regional same day and next day distribution services for premier e-commerce and product supply businesses. The first lien note bears interest in cash at the greater of 10.25% or Libor plus 8.25% and has a final maturity of December 21, 2017.
On December 21, 2012, we made a $12,000 senior secured first lien follow-on investment in FPG, a supplier of branded consumer and commercial products sold to the retail, foodservice, and hospitality sectors. The first lien note bears interest in cash at the greater of 12.0% or Libor plus 11.0% and has a final maturity of January 20, 2017.
On December 24, 2012, we made a follow-on secured debt investment of $5,000 in New Star. The second lien note bears interest in cash at the greater of 11.5% or Libor plus 8.5% and interest payment in kind of 1.0% and has a final maturity of February 2, 2018.

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On December 24, 2012, we made a $7,000 second lien secured investment in Aderant North America, Inc., a leading provider of enterprise software solutions to professional services organizations. The second lien note bears interest in cash at the greater of 11.0% or PRIME plus 7.75% and has a final maturity of June 20, 2019.

On December 28, 2012, we made a $9,500 first lien secured investment in APH, to acquire Abbington Pointe, Inc., a multi-family property in Marietta, Georgia. We invested $3,193 of equity and $6,400 of debt in APH. The first lien note originally bore interest in cash at the greater of 10.5% or Libor plus 8.5% and interest payment in kind of 2.0%. On January 17, 2013, we amended the terms of this investment and the first lien note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.5% as of June 30, 2013. The first lien note has a final maturity of October 24, 2020.

On December 28, 2012, we made a $5,000 second lien secured investment in TransFirst Holdings, Inc., a payments processing firm that provides electronic credit card authorization to merchants located throughout the United States. The second lien note bears interest in cash at the greater of 11.0% or Libor plus 9.75% and has a final maturity of June 27, 2018.

On December 28, 2012, we completed a $47,900 recapitalization of Credit Central, a branch-based provider of installment loans. Through the recapitalization, we acquired a controlling interest in Credit Central for $38,082 in cash and 897,906 unregistered shares of our common stock. The first lien note bears interest in cash at the greater of 20.0% or Libor plus 18.5% and has a final maturity of December 31, 2020.

On December 28, 2012, we made a $3,600 follow-on subordinated unsecured investment in Ajax. The unsecured note bears interest in cash at the greater of 11.5% or Libor plus 8.5% and interest payment in kind of 6.00% and has a final maturity of December 31, 2017.

On December 28, 2012, we made a $30,000 first lien senior secured investment to support the recapitalization of Spartan Energy Services, LLC ("Spartan"), a leading provider of thru tubing and flow control services to oil and gas companies. The first lien note bears interest in cash at the greater of 10.5% or Libor plus 9.0% and has a final maturity of December 28, 2017.

On December 31, 2012, we provided $32,000 senior secured loan to support the acquisition of System One Holdings, LLC, a leading provider of professional staffing services. The first lien note bears interest in cash at the greater of 11.0% or Libor plus 9.5% and has a final maturity of December 31, 2018.

On December 31, 2012, we funded a recapitalization of Valley Electric with $42,572 of debt and $9,526 of equity financing. Through the recapitalization, we acquired a controlling interest in Valley Electric for $7,449 in cash and 4,141,547 unregistered shares of our common stock. The first lien note issued to Valley Electric bears interest in cash at the greater of 9.0% or Libor plus 6.0% and interest payment in kind of 9.0% and has a final maturity of December 31, 2018. The first lien note issued to Valley Electric Co. of Mt. Vernon Inc. bears interest in cash at the greater of 8.0% or Libor plus 5.0% and interest payment in kind of 2.5% and has a final maturity of December 31, 2017.

On December 31, 2012, we provided $70,000 of secured second lien debt financing for the acquisition of Thomson Reuters Property Tax Services by Ryan, LLC ("Ryan"). The second lien note bears interest in cash at the greater of 12.0% or Libor plus 9.0% and interest payment in kind of 3.0% and has a final maturity of June 30, 2018.

On January 11, 2013, we provided $27,100 of debt financing to Correctional Healthcare Holding Company, Inc. ("CHC"), a national provider of correctional medical and behavioral healthcare solutions. The subordinated secured second lien loan bears interest in cash at 11.25% and has a final maturity of January 11, 2020.

On January 17, 2013, we made a $30,348 follow-on investment in APH, to acquire 5100 Live Oaks Blvd, LLC, a multi-family residential property located in Tampa, Florida. We invested $2,748 of equity and $27,600 of debt in APH. The first lien note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.50% and has a final maturity of October 24, 2020.

On January 24, 2013, we made an investment of $24,870 to purchase 56.14% of the subordinated notes in Cent 17 CLO Limited.

On January 24, 2013, we made an investment of $26,901 to purchase 50.12% of the subordinated notes in Octagon Investment Partners XV, Ltd.

On January 29, 2013, we provided $8,000 of secured second lien financing to TGG Medical Transitory, Inc., a developer of technologies for extracorporeal photopheresis treatments. The senior secured second lien term loan bears interest in cash at the greater of 11.25% or Libor plus 10.0% and has a final maturity of June 27, 2018.

On January 31, 2013, we funded an acquisition of the subsidiaries of Nationwide, which operate a specialty finance business based in Chicago, Illinois, with $21,308 of debt and $3,843 of equity financing. The senior secured term loan bears interest in cash at the greater of 20.0% or Libor plus 18.5% and has a final maturity of January 31, 2023.
On February 5, 2013, we received a distribution of $3,250 related to our investment in NRG Manufacturing, Inc. ("NRG"), for which we realized a gain of the same amount. This was a partial release of the amount held in escrow.
On February 5, 2013, we made a secured debt investment of $2,000 in Healogics, Inc. ("Healogics"), a provider of outpatient wound care management services located in Jacksonville, Florida.
On February 13, 2013, we made an investment of $35,025 to purchase 50.34% of the subordinated notes in Galaxy XV CLO, Ltd.
On February 14, 2013, we made a $2,000 secured second lien debt investment in J.G. Wentworth, LLC ("J.G. Wentworth"), the largest purchaser of structured settlement and annuity payments in the United States. The second lien term loan bears interest in cash at the greater of 9.0% or Libor plus 7.5% and has a final maturity of February 8, 2019.
On February 14, 2013, we provided $15,000 of senior secured financing to Speedy Group Holdings Corp., a leading provider of short-term loans and financial services in the United States, the United Kingdom and Canada. The unsecured subordinated term loan bears interest in cash at 12.0% and has a final maturity of November 15, 2017.
On February 15, 2013, we made a $6,000 secured second lien debt investment in SESAC Holdco II LLC, a performing rights organization based in Nashville, Tennessee. The second lien term loan bears interest in cash at the greater of 10.0% or Libor plus 8.75% and has a final maturity of July 12, 2019.
On February 21, 2013, we provided $39,550 of senior secured first lien financing to Atlantis Healthcare Group (Puerto Rico), Inc., a leading owner and operator of dialysis stations. The senior secured term loan bears interest in cash at the greater of 10.0% or Libor plus 8.0% and has a final maturity date of February 21, 2018.
On February 25, 2013, we made a $10,000 secured second lien loan and a $2,000 secured first lien debt investment in TNS, an international data communications company that provides networking, data communications and other value added services. The second lien term loan bears interest in cash at the greater of 9.0% or Libor plus 8.0% and has a final maturity of August 14, 2020.
On March 1, 2013, we made a $70,000 secured term loan investment in a subsidiary of Cinedigm DC Holdings, LLC, a leading provider of digital cinema services, software and content marketing and distribution. The senior secured term loan bears interest in cash at the greater of 11.0% or Libor plus 9.0% and interest payment in kind of 2.5% and has a final maturity of March 31, 2021.
On March 6, 2013, we made a $5,000 follow-on investment in Rocket Software, Inc. The senior secured second lien term loan bears interest in cash at the greater of 10.25% or Libor plus 8.75% and has a final maturity of February 8, 2019.
On March 7, 2013, we made a secured second lien follow-on investment of $60,000 in USC. The senior secured second lien term loan bears interest in cash at the greater of 12.75% or Libor plus 11.0% and has a final maturity of May 16, 2018.
On March 8, 2013, we made an investment of $40,400 to purchase 78.60% of the subordinated notes in Halcyon Loan Advisors Funding 2013-I, Ltd.
On March 12, 2013, we provided $12,000 of secured second lien financing to ALG USA Holding, LLC, a vertically integrated travel company that focuses on providing all-inclusive vacations in Mexico and the Caribbean to U.S. customers. The senior secured second lien term loan bears interest in cash at the greater of 10.25% or Libor plus 9.0% and has a final maturity of February 28, 2020.
On March 15, 2013, we made an investment of $44,063 to purchase 95.27% of the subordinated notes in Apidos CLO XII, Ltd.
On March 18, 2013, we provided a $197,291 first lien senior secured credit facility to support the refinancing of Capstone Logistics, LLC ("Capstone"), a logistics services portfolio company. After the financing, we received repayment of $69,139 of loans previously outstanding. The $97,291 Term Loan A note bears interest in cash at the greater of 6.5% or Libor plus 5.0% and has a final maturity of September 16, 2016. The $100,000 Term Loan B note bears interest in cash at the greater of 11.5% or Libor plus 10.0% and has a final maturity of September 16, 2016.

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On March 27, 2013, we provided $100,000 of senior secured debt financing to support the recapitalization of Broder Bros., Co. ("Broder"), a leading distributor of imprintable sportswear and accessories in the United States. The senior secured term loan bears interest in cash at the greater of 10.75% or Libor plus 9.0% and has a final maturity of June 27, 2018.

On April 1, 2013, we refinanced our existing $38,472 senior and subordinated loans to Ajax, increasing the size of our debt investment to $38,537. Concurrent with the refinancing, we received repayment of the $18,635 loans that were previously outstanding. The subordinated unsecured term loan bears interest in cash at the greater of 11.5% or Libor plus 8.5% and interest payment in kind of 6.0% and has a final maturity of March 30, 2018.

On April 17, 2013, we made an investment of $43,650 to purchase 97% of the subordinated notes in Mountain View.

On April 22, 2013, we provided $34,375 of senior secured financing, of which $31,875 was funded at closing, to support the acquisition of Pegasus, the world's largest processor of commissions paid by hotels to travel agencies for room booking services. The Term Loan A note bears interest in cash at the greater of 6.75% or Libor plus 5.5% and has a final maturity of April 18, 2018. The Term Loan B note bears interest in cash at the greater of 13.75% or Libor plus 12.5% and has a final maturity of April 18, 2018. The $5,000 senior secured revolver bears interest in cash at the greater of 9.0% or Libor plus 7.75% and has a final maturity of April 18, 2014.

On April 25, 2013, we made an investment of $26,000 to purchase 50.9% of the subordinated notes in Brookside.

On April 30, 2013, we made a $21,247 follow-on investment in APH, to acquire Lofton Place Apartments and Vista at Palma Sola, multi-family residential properties located in Florida. We invested $3,247 of equity and $18,000 of debt in APH. The senior secured note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.50% and has a final maturity of October 24, 2020.

On May 8, 2013, we made a $6,119 follow-on investment in APH, to acquire Arlington Park, a multi-family residential property located in Marietta, Georgia. We invested $2,118 of equity and $4,000 of debt in APH. The senior secured note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.50% and has a final maturity of October 24, 2020.

On May 9, 2013, we provided a $60,000 senior secured credit facility, of which $55,000 was funded at closing, to support the recapitalization of Sandow, a provider of multimedia content and services to businesses and consumers focused on the areas of design and luxury. The senior secured first lien loan bears interest in cash at the greater of 10.5% or Libor plus 8.5% and interest payment in kind of 1.5% and has a final maturity of May 8, 2018.

On May 10, 2013, we provided a $150,000 senior secured term loan to support the recapitalization of Arctic Glacier, a leading producer, marketer, and distributor of high-quality packaged ice to consumers in the United States and Canada. After the financing, we received repayment of $86,982 of subordinated unsecured term loan previously outstanding. The senior secured second lien loan bears interest in cash at the greater of 11.25% or Libor plus 10.0% and has a final maturity of November 10, 2019.

On May 14, 2013, we provided $4,000 of senior secured financing to SourceHOV, a leading provider of business and knowledge process outsourcing. The senior secured second lien loan bears interest in cash at the greater of 8.75% or Libor plus 7.5% and has a final maturity of April 30, 2019.

On May 31, 2013, we made a follow-on secured second lien debt investment of $7,190 in IWP, a specialty pharmacy services company. The secured second lien loan bears interest in cash at the greater of 11.5% or Libor plus 7.0% and interest payment in kind of 1.0% and has a final maturity of May 31, 2019.

On June 11, 2013, we provided $115,000 of senior secured financing to Transplace, a third-party logistics company that services many of the largest shippers in the world. The senior secured first lien loan bears interest in cash at the greater of 10.0% or Libor plus 5.0% and has a final maturity of June 11, 2019.

On June 11, 2013, we provided $7,000 of secured second lien financing to AST, a leading North American third-party provider of share registry and associated value added services to shareholders on behalf of listed public companies. The second lien loan bears interest in cash at the greater of 9.25% or Libor plus 8.0% and has a final maturity of December 26, 2020.

On June 12, 2013, we made a $23,250 follow-on investment in R-V. The senior subordinated note bears interest in cash at the greater of 10.0% or Libor plus 9.0% and has a final maturity of June 12, 2018.

On June 18, 2013, we served as sole agent and provider of $70,000 senior secured financing, of which $65,643 was funded at closing, to support the recapitalization of Traeger, a leading designer, marketer, and distributor of wood pellet grills,

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flavored wood pellets, and grill accessories. The $30,000 Term Loan A note bears interest in cash at the greater of 6.5% or Libor plus 4.5% and has a final maturity of June 18, 2018. The $30,000 Term Loan B note bears interest in cash at the greater of 11.5% or Libor plus 9.5% and has a final maturity of June 18, 2018. The $10,000 senior secured revolver, of which $5,643 was drawn at closing, bears interest in cash at the greater of 9.0% or Libor plus 7.0% and has a final maturity of June 18, 2014.

On June 24, 2013, we made a $76,533 follow-on investment in APH, to acquire Arium Resort (f/k/a The Resort at Pembroke Pines), a prominent multi-family residential community located in Pembroke Pines, Florida. We invested $13,533 of equity and $63,000 of debt in APH. The senior secured note bears interest in cash at the greater of 6.0% or Libor plus 4.0% and interest payment in kind of 5.50% and has a final maturity of October 24, 2020.

On June 25, 2013, we made an investment of $26,500 to purchase 84.13% of the subordinated notes in LCM XIV.

On June 27, 2013, we provided $11,000 of secured second lien financing to Blue Coat, a leading provider of web security and wide area network (WAN) optimization solutions. The second lien note bears interest in cash at the greater of 9.5% or Libor plus 8.5% and has a final maturity of June 28, 2020.

On June 27, 2013, we made a follow-on secured debt investment of $87,500 to support the recapitalization of Progrexion. After the financing, we now hold $241,033 of senior secured debt of Progrexion. The senior secured first lien note bears interest in cash at the greater of 10.5% or Libor plus 8.5% and has a final maturity of September 14, 2017.

On June 28, 2013, we made a $1,000 follow-on investment in Ajax. The subordinated unsecured term loan bears interest in cash at the greater of 11.5% or Libor plus 8.5% and interest payment in kind of 6.0% and has a final maturity of March 30, 2018.

On June 28, 2013, we made an $18,000 secured debt follow-on investment in New Star, a provider of specialized processing services to the steel industry. The senior subordinated term loan bears interest in cash at 11.5% and interest payment in kind of 1.0% and has a final maturity of February 2, 2018.

During the year ended June 30, 2013, we closed-out twenty-three positions which are briefly described below.

On July 24, 2012, we sold our 3,821 shares of Iron Horse Coiled Tubing, Inc. ("Iron Horse") common stock in connection with the exercise of an equity buyout option, receiving $2,040 of net proceeds and realizing a gain of approximately $1,772 on the sale.

On August 3, 2012, Pinnacle Treatment Centers, Inc. repaid the $17,475 loan receivable to us.

On August 10, 2012, U.S. HealthWorks Holding Company, Inc. repaid the $25,000 loan receivable to us.

On September 20, 2012, Fischbein repaid the $3,425 loan receivable to us.

On October 5, 2012, Northwestern Management Services, LLC ("Northwestern") repaid the $15,092 loan receivable to us and we sold our 50 shares of Northwestern common stock for total proceeds of $2,233, realizing a gain of $1,862.

On October 16, 2012, Blue Coat repaid the $25,000 loan receivable to us.

On October 18, 2012, Hi-Tech Testing Services, Inc. and Wilson Inspection X-Ray Services, Inc. repaid the $7,200 loan receivable to us.

On October 19, 2012, Mood Media Corporation repaid the $15,000 loan receivable to us.

On October 31, 2012, Shearer's Foods, Inc. ("Shearer's") repaid the $37,999 loan receivable to us. On November 7, 2012, we redeemed our membership interests in Mistral Chip Holdings, LLC, Mistral Chip Holdings 2, LLC and Mistral Chip Holdings 3, LLC in connection with the sale of Shearer's, receiving $6,022 of net proceeds and realizing a gain of approximately $2,027 on the redemption.

On November 8, 2012, Potters Holdings II, L.P. repaid the $15,000 loan receivable to us.

On November 15, 2012, Renaissance Learning, Inc. repaid the $6,000 loan receivable to us.

On December 3, 2012, VanDeMark Chemicals, Inc. repaid the $29,658 loan receivable to us.

On December 7, 2012, Hudson Products Holdings, Inc. ("Hudson") repaid the $6,267 loan receivable to us.

On December 21, 2012, ST Products, LLC repaid the $23,162 loan receivable to us.

On December 21, 2012, SG Acquisition, Inc. repaid the $83,242 loan receivable to us.

On February 5, 2013, we sold our $2,000 investment in Healogics and realized a gain of $60 on this investment.
On February 25, 2013, we sold our $2,000 secured first lien investment in TNS and realized a gain of $20 on this investment.
On March 18, 2013, we sold our $2,000 investment in J.G. Wentworth and realized a gain of $75 on this investment.
On March 28, 2013, we sold our investment in New Meatco Provisions, LLC ("Meatco") for net proceeds of approximately $1,965, realizing a loss of $10,814 on the sale.
On March 29, 2013, we received net proceeds of $1,251 for the partial sale of our equity investment in Caleel + Hayden, LLC, realizing a gain of $900 on the sale.
On April 30, 2013, we sold our investment in Fischbein for net proceeds of $3,168, recognizing a realized gain of $2,293 on the sale. In addition, there is $310 being held in escrow which will be recognized as additional gain if and when received.
On May 16, 2013, Out Rage repaid the $11,836 loan receivable to us.
On May 23, 2013, Snacks Holding repaid the $15,366 loan receivable to us.
On June 3, 2013, Nobel repaid the $15,262 loan receivable to us.
On June 4, 2013, Springs repaid the $35,000 loan receivable to us.
On June 13, 2013, we sold our $4,000 investment in SourceHOV and realized a gain of $40 on this investment.
On June 14, 2013, we sold our $10,000 investment in TNS and realized a gain of $117 on this investment.
On June 28, 2013, Sandow repaid $30,100 of the $55,000 loan receivable to us. After the repayment, we now hold $24,900 of senior secured debt of Sandow.
In addition to the repayments noted above, during the year ended June 30, 2013, we received principal amortization payments of $19,568 on several loans, and $99,066 of partial prepayments primarily related to Byrider Systems Acquisition Corp, Capstone, Cargo Airport Services USA, LLC ("Cargo"), Energy Solutions, NMMB, Northwestern, and Sandow.
On January 4, 2012, Energy Solutions sold its gas gathering and processing assets ("Gas Solutions") for a sale price of $199,805, adjusted for the final working capital settlement, including a potential earnout of $28,000 that will be paid based on the future performance of Gas Solutions. We do not know the timing, if any, related to this potential earnout and have valued the $28,000 at zero as of June 30, 2013. After expenses, including structuring fees of $9,966 paid to us, Energy Solutions received approximately $158,687 in cash. Currently, a loan to Energy Solutions remains outstanding and is collateralized by the cash held by Energy Solutions after the sale transaction. The sale of Gas Solutions by Energy Solutions resulted in significant earnings and profits, as defined by the Internal Revenue Code, at Energy Solutions for calendar year 2012. As a result, distributions from Energy Solutions to us were required to be recognized as dividend income, in accordance with ASC 946, Financial Services—Investment Companies, as cash distributions are received from Energy Solutions to the extent there are earnings and profits sufficient to support such recognition. During the year ended June 30, 2013, Energy Solutions repaid $28,500 of senior and subordinated secured debt. We received $19,543 of make-whole fees for early repayment of the outstanding loan receivables, which was recorded as interest income during the year ended June 30, 2013. During the year ended June 30, 2013, we received distributions of $53,820 from Energy Solutions which were recorded as dividend income. Energy Solutions continues to hold $23,979 of cash for future investment and repayment of the remaining debt.
During the year ended June 30, 2013, we recognized $1,481 of interest income due to purchase discount accretion from the assets acquired from Patriot Capital Funding, Inc. ("Patriot"). Included in the $1,481 recorded during the year ended June 30, 2013 is $1,111 of normal accretion and $370 of accelerated accretion resulting from the repayment of Hudson. We expect to recognize $240 of normal accretion during the three months ended September 30, 2013.
During the year ended June 30, 2012, we recognized $6,613 of interest income due to purchase discount accretion from the assets acquired from Patriot. Included in the $6,613 is $3,083 of normal accretion and $3,530 of accelerated accretion resulting from the repayment of Mac & Massey Holdings, LLC ("Mac & Massey"), Nupla Corporation ("Nupla"), ROM Acquisition Corp and Sport Helmets Holdings, LLC ("Sport Helmets").
During the year ended June 30, 2011, we recognized $22,084 of interest income due to purchase discount accretion from the assets acquired from Patriot. Included in the $22,084 is $4,912 of normal accretion, $12,035 of accelerated accretion resulting from the repayment of Impact Products, LLC, Label Corp Holdings Inc. and Prince, and $4,968 of

accelerated

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accretion resulting from the recapitalization of our debt investments in Arrowhead General Insurance Agency, Inc. ("Arrowhead"), The Copernicus Inc. ("Copernicus"), Fischbein and Northwestern. The restructured loans for Arrowhead, Copernicus, Fischbein and Northwestern were issued at market terms comparable to other industry transactions. In accordance with ASC 320-20-35 the cost basis of the new loans were recorded at par value, which precipitated the acceleration of original purchase discount from the loan repayments which was recognized as interest income.

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

Quarter-End	Acquisitions(1)	Dispositions(2)
June 30, 2013	$798,760	$321,615
March 31, 2013	784,395	102,527
December 31, 2012	772,125	349,269
September 30, 2012	747,937	158,123
June 30, 2012	573,314	146,292
March 31, 2012	170,073	188,399
December 31, 2011	154,697	120,206
September 30, 2011	222,575	46,055
June 30, 2011	312,301	71,738
March 31, 2011	359,152	78,571
December 31, 2010	140,933	67,405
September 30, 2010	140,951	68,148
June 30, 2010	88,973	39,883
March 31, 2010	59,311	26,603
December 31, 2009(3)	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	$6,352,530	$2,089,211

(1) Includes new deals, additional fundings, refinancings and PIK interest.
(2) Includes scheduled principal payments, prepayments and refinancings.

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(3) The $210,438 of acquisitions for the quarter ended December 31, 2009 includes $207,126 of portfolio investments acquired from Patriot.

Investment Valuation

In determining the fair value of our portfolio investments at June 30, 2013, the Audit Committee considered valuations from the independent valuation firms and from management having an aggregate range of $4,081,889 to $4,354,692, excluding money market investments.

In determining the range of value for debt instruments, management and the independent valuation firms 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.

In determining the range of value for our investments in CLOs, management and the independent valuation firms used discounted cash flow models. The valuations were accomplished through the analysis of the CLO deal structures to identify the risk exposures from the modeling point of view. For each security, the most appropriate valuation approach was chosen from alternative approaches to ensure the most accurate valuation for each security. A discounted cash flow model is prepared, utilizing a waterfall engine to store the collateral data, generate collateral cash flows from the assets, and distributes the cash flow to the liability structure based on the payment priorities, and discount them back using proper discount rates that incorporate all the risk factors.

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, comparable multiples for recent sales of companies within the industry and discounted cash flow models for our investments in CLOs. The composite of all these analyses, applied to each investment, was a total valuation of $4,172,852, excluding money market investments.

Our portfolio companies are generally lower middle market companies, outside of the financial sector, with less than $150,000 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.

Control investments offer increased risk and reward over straight debt investments. Operating results and changes in market multiples can result in dramatic 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. Several control investments in our portfolio are under enhanced scrutiny by our senior management and our Board of Directors and are discussed below.

AIRMALL USA, Inc.

AIRMALL is a leading developer and manager of airport retail operations. AIRMALL has developed and presently manages all or substantially all of the retail operations and food and beverage concessions at Baltimore/Washington International Thurgood Marshall Airport (BWI), Boston Logan International Airport (BOS), Cleveland Hopkins International Airport (CLE) and Pittsburgh International Airport (PIT). AIRMALL does so pursuant to long-term, infrastructure-like contracts with the respective municipal agencies that own and operate the airports.

On July 30, 2010, we invested $52,420 of combined debt and equity as follows: $30,000 senior term loan, $12,500 senior subordinated note and $9,920 preferred equity. We own 100% of AIRMALL's equity securities. AIRMALL's financial performance has been consistent since the acquisition and we continue to monitor the medium to long-term growth prospects for the company.

As a result of improved operating results, the Board of Directors increased the fair value of our investment in AIRMALL to $54,648 as of June 30, 2013, a premium of $3,478 from its amortized cost, compared to the $3,788 unrealized depreciation recorded at June 30, 2012.

Ajax Rolled Ring & Machine, Inc.

Ajax forges large seamless steel rings on two forging mills in the company's York, South Carolina facility. The rings are used in a range of industrial applications, including in construction equipment and power turbines. Ajax also provides machining and other ancillary services.

We acquired a controlling equity interest in Ajax in a recapitalization of Ajax 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

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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. Ajax repaid $3,461 of this secured subordinated debt during the quarter ended September 30, 2010. During the quarter ended December 31, 2012, we funded an additional $3,600 of unsecured debt to refinance first lien debt held by Wells Fargo.

On April 1, 2013, we refinanced our existing $38,472 senior loans to Ajax, increasing the size of our debt investment to $38,537. Concurrent with the refinancing, we received repayment of the $18,635 loans that were previously outstanding. As of June 30, 2013, we control 78.01% of the fully-diluted common and preferred equity. The principal balance of our senior debt to Ajax was $19,737 and our subordinated debt was $19,700 as of June 30, 2013.

Due to soft operating results, the Board of Directors decreased the fair value of our investment in Ajax to $39,437 as of June 30, 2013, a reduction of $6,057 from its amortized cost, compared to the $11,151 unrealized appreciation recorded at June 30, 2012.

APH Property Holdings, LLC

We make investments in real estate through our investment in APH, a holding company that owns 100% of the common equity of APHC. APHC is a Maryland corporation and qualified REIT for federal income tax purposes. During the year ended June 30, 2013, we provided $125,892 and $26,648 of debt and equity financing, respectively, to APH for the acquisition of various industrial and multi-family residential real estate properties in Florida and Georgia. We received structuring fees of $4,511 from APH that were recorded as other income during the year ended June 30, 2013. As of June 30, 2013, APHC's real estate portfolio was comprised of seven investments. The following table shows the mortgages outstanding due to other parties for each of the seven properties:

No.	Property Name	City	Date of Acquisition	Purchase Price	Mortgage Outstanding
1	146 Forest Parkway	Forest Park, GA	10/24/2012	$7,400	$—
2	Abbington Pointe	Marietta, GA	12/28/2012	23,500	15,275
3	Amberly Place	Tampa, FL	1/17/2013	63,400	39,600
4	Lofton Place	Tampa, FL	4/30/2013	26,000	16,965
5	Vista at Palma Sola	Bradenton, FL	4/30/2013	27,000	17,550
6	Arlington Park	Marietta, GA	5/8/2013	14,850	9,650
7	Arium Resort	Pembroke Pines, GA	6/24/2013	225,000	157,500

The Board of Directors set the fair value of our investment in APH to $152,540 as of June 30, 2013, equal to its amortized cost.

Energy Solutions Holdings Inc. (f/k/a Gas Solutions Holdings, Inc.)

Energy Solutions owns interests in other companies operating in the energy sector. These include operating offshore supply vessels and ownerships of a non-operating biomass plant and several coal mines. Energy Solutions subsidiaries formerly owned interests in a gas gathering and processing system in east Texas.

In December 2011, we completed a reorganization of Gas Solutions Holdings, Inc. renaming the company Energy Solutions and transferring ownership of other operating companies owned by us and operating within the energy industry with the intent of strategically expanding Energy Solutions operations across energy sectors. As part of the reorganization, we transferred our equity interests in Change Clean Energy Holdings, Inc. ("CCEHI"), Change Clean Energy, Inc. ("CCEI"), Freedom Marine Holdings, LLC ("Freedom Marine") and Yatesville Coal Holdings, Inc. ("Yatesville") to Energy Solutions. On December 28, 2011, we made a follow-on investment of $4,750 to support the acquisition of a new vessel by Vessel Holdings LLC, a subsidiary of Freedom Marine.

On January 4, 2012, Energy Solutions sold Gas Solutions for a sale price of $199,805, adjusted for the final working capital settlement, including a potential earnout of $28,000 that will be paid based on the future performance of Gas Solutions. After expenses, including structuring fees of $9,966 paid to us, Energy Solutions received approximately $158,687 in cash. Currently, a loan to Energy Solutions remains outstanding and is collateralized by the cash held by Energy Solutions after the sale transaction. The sale of Gas Solutions by Energy Solutions has resulted in significant earnings and profits, as defined by the Internal Revenue Code, at Energy Solutions for calendar year 2012. As a result, distributions from Energy Solutions to us were required to be recognized as dividend income, in accordance with ASC

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as cash distributions are received from Energy Solutions to the extent there are current year earnings and profits sufficient to support such recognition.

In determining the value of Energy Solutions, we have utilized two valuation techniques to determine the value of the investment. Our Board of Directors has determined the value to be $26,696 for our debt and equity positions at June 30, 2013 based upon a combination of a current value method for the cash balances of Energy Solutions and a liquidation analysis for our interests in CCEHI, CCEI, Freedom Marine and Yatesville. At June 30, 2013 and June 30, 2012, Energy Solutions, including the underlying portfolio companies affected by the reorganization, was valued at $7,574 below and $63,623 above its amortized cost, respectively. We received distributions of $53,820 from Energy Solutions that were recorded as dividend income during the year ended June 30, 2013. We also received $19,543 of make-whole fees from Energy Solutions for early repayments of the outstanding loans, which was recorded as interest income in the year ended June 30, 2013.

First Tower Holdings of Delaware, LLC

First Tower is a multiline specialty finance company based in Flowood, Mississippi with over 170 branch offices.

On June 15, 2012, we acquired 80.1% of First Tower, LLC ("First Tower") businesses for $110,200 in cash and 14,518,207 unregistered shares of our common stock. Based on our share price of $11.06 at the time of issuance, we acquired our 80.1% interest in First Tower for approximately $270,771. As consideration for our investment, First Tower Delaware, which is 100% owned by us, recorded a secured revolving credit facility to us of $244,760 and equity of $43,193. First Tower Delaware owns 80.1% of First Tower Holdings LLC, the holding company of First Tower. The assets of First Tower acquired include, among other things, the subsidiaries owned by First Tower, which hold finance receivables, leaseholds, and tangible property associated with First Tower's businesses. During the three months ended June 30, 2012, we received $8,075 in structuring fee income.

During the three months ended December 31, 2012, we funded an additional $20,000 of senior secured debt to support seasonally high demand during the holiday season. As of June 30, 2013, First Tower had total assets of approximately $605,783 including $378,327 of finance receivables net of unearned charges. As of June 30, 2013, First Tower's total debt outstanding to parties senior to us was $264,760.

Due to a reduction in public market comparables in the consumer finance industry, the Board of Directors set the fair value of our investment in First Tower at $298,084 as of June 30, 2013, a discount of $9,869 to its amortized cost, compared to $287,953 as of June 30, 2012, equal to its amortized cost at that time.

Manx Energy, Inc.

Manx was formed for the purpose of rolling up the assets of two existing Prospect portfolio companies, Coalbed, LLC ("Coalbed") and Appalachian Energy Holdings, LLC ("AEH"), bringing them under new management, restructuring the outstanding debt, and infusing additional capital to allow for future growth. Coalbed is the owner of 100% of the outstanding equity interests of Coalbed Pipelines, LLC and Coalbed Operator, LLC. Coalbed was formed in October 2009 to acquire our outstanding senior secured loan and assigned interests in Conquest Cherokee, LLC ("Conquest"). Conquest's assets consisted primarily of coalbed methane reserves in the Cherokee Basin. AEH was formed in 2006 and is the owner of 100% of the outstanding equity interests of East Cumberland L.L.C., a provider of outsourced mine site development and construction services for coal production companies operating in Southern Appalachia, and C&S Oilfield and Pipeline Construction, a provider of support services to companies engaged in the exploration and production of oil and natural gas.

On January 19, 2010, we modified the terms of our senior secured debt in AEH and Coalbed in conjunction with the formation of Manx, a new entity consisting of the assets of AEH, Coalbed and Kinley Exploration LLC. 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. During the year ended June 30, 2011, we made a follow-on secured debt investments of $750 in Manx to support ongoing operations. On June 30, 2012, Manx assigned the membership interests and associated operating company debt of Coalbed and AEH to Wolf Energy Holdings, Inc. ("Wolf"), a newly-formed company owned by us.

During the quarter ended June 30, 2013, we determined that the impairment of Manx was other-than-temporary and recorded a realized loss of $9,397 for the amount that the amortized cost exceeded the fair market value. The Board of Directors set the fair value of our investment in Manx at $346 as of June 30, 2013, a reduction of $154 from its amortized cost, compared to the $11,028 unrealized depreciation recorded at June 30, 2012.

The Healing Staff, Inc.

During the three months ended December 31, 2012, we determined that the impairment of Integrated Contract Services, Inc. ("ICS") was other-than-temporary and recorded a realized loss of $12,198 for the amount that the amortized cost exceeded the fair market value. Our remaining investments are in THS and Vets Securing America ("VSA"), wholly owned subsidiaries of ICS with ongoing operations. THS provides outsourced medical staffing services to governmental and
commercial enterprises. VSA provides out-sourced security guards staffed primarily using retired military and police department veterans.

During September and October 2007, we provided $1,170 to THS for working capital through our investment in ICS. In January 2009, we foreclosed on the real and personal property of ICS. Through this foreclosure process, we gained 100% ownership of THS. As part of its strategy to diversify its revenues THS started VSA as a new business in the latter part of 2009. During the year ended June 30, 2011 and the six months ended December 31, 2011, we made follow-on secured debt investments of $1,708 and $874, respectively, to support the ongoing operations of THS and VSA. Effective October 19, 2011, the closing date of the sale by VSA of a commercial real estate asset, $893 of the follow-on secured debt investments were repaid. In early May 2012, we made short-term secured debt investments of $118 and $42, respectively, to support the operations of THS and VSA, which short term debt was repaid in early June 2012. We made no additional fundings during the six months ended June 30, 2012 and the fiscal year ended June 30, 2013. In May 2012, in connection with the implementation of accounts receivable based funding programs for THS and VSA with a third party provider we agreed to subordinate our first priority security interest in all of the accounts receivable and other assets of THS and VSA to the third party provider of that accounts receivable based funding.

Based upon an analysis of the liquidation value of assets, our Board of Directors determined the fair value of our investment in THS and VSA to be zero at June 30, 2013 and June 30, 2012, respectively, a reduction of $3,831 and $3,750 from its amortized cost, respectively.

Wolf Energy Holdings, Inc.

Wolf is a holding company formed to hold 100% of the outstanding membership interests of each of Coalbed and AEH. The membership interests of Coalbed and AEH, which were previously owned by Manx, were assigned to Wolf effective June 30, 2012. The purpose of assignment was to remove those activities from Manx deemed non-core by the Manx convertible debt investors who were not interested in funding those operations. In addition, effective June 29, 2012 C&J Cladding Holding Company, Inc. ("C&J") merged with and into Wolf, with Wolf as the surviving entity. At the time of the merger, C&J held the remaining undistributed proceeds from the sale of its membership interests in C&J Cladding, LLC. The merger was effectuated in connection with the broader simplification of our energy investment holdings.

On April 15, 2013, assets previously held by H&M were assigned to Wolf in exchange for a $66,000 term loan secured by the assets. Our cost basis in this loan of $44,632 was determined in accordance with ASC 310-40, Troubled Debt Restructurings by Creditors, and is equal to the fair value of assets at the time of transfer and we recorded a realized loss of $19,647 in connection with the foreclosure on the assets. On May 17 2013, Wolf sold certain of the assets that had been previously held by H&M that were located in Martin County to Hibernia for $66,000. Proceeds from the sale were primarily used to repay the loan and NPI receivable due to us and we recognized as a realized gain of $11,826 partially offsetting the previously recorded loss. We received $3,960 of structuring and advisory fees from Wolf during the year ended June 30, 2013 related to the sale and $991 under the NPI agreement which was recognized as other income during the fiscal year ended June 30, 2013.

Based on an increase in the liquidation value of Wolf due to the acquisition of assets previously held by H&M, the Board of Directors increased the fair value of our investment in Wolf to $4,949 as of June 30, 2013, a reduction of $3,091 from its amortized cost, compared to the $7,991 unrealized depreciation recorded at June 30, 2012.

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. Two of our portfolio companies, Ajax and First Tower Delaware, experienced such volatility and experienced fluctuations in valuation during the year ended June 30, 2013. The valuation of Ajax decreased due to declining operating results. The value of our equity position in Ajax decreased to zero as of June 30, 2013, a discount of $6,057 to its cost, compared to the $11,134 unrealized gain recorded at June 30, 2012. The valuation of First Tower Delaware decreased due to change in current market conditions. The value of our equity position in First Tower decreased to $33,324 as of June 30, 2013, a discount of $9,869 to its cost, compared to the value of $43,193 recorded at June 30, 2012, equal to its cost. Six of the other controlled investments have been valued at discounts to the original investment. Eight of the control investments are valued at the original investment amounts or higher. Overall, at June 30, 2013, the control investments are valued at $18,517 below their amortized cost.

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We hold three affiliate investments at June 30, 2013. One of our affiliate portfolio companies, Boxercraft, experienced a meaningful decrease in valuation during the year ended June 30, 2013 due to declining operating results. As of June 30, 2013, Boxercraft is valued at $9,385, a reduction of $7,375 to its amortized cost. Overall, at June 30, 2013, affiliate investments are valued at $6,746 below their amortized cost.

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. Non-control/Non-affiliate investments did not experience significant changes in valuation and are generally performing as expected or better than expected. As of June 30, 2013 and June 30, 2012, four of our Non-control/Non-affiliate investments, ICON Health & Fitness, Inc. ("ICON"), Gulf Coast Machine & Supply Company ("Gulf Coast"), Stryker Energy, LLC ("Stryker") and Wind River Resources Corp. and Wind River II Corp. ("Wind River"), are valued at a significant discount to amortized cost, due to significant decreases in the operating results of the operating companies. Overall, at June 30, 2013, other Non-control/Non-affiliate investments are valued at $8,427 above their amortized cost, excluding our investments in ICON, Gulf Coast, Stryker and Wind River, as the remaining companies are generally performing as or better than expected.

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 currently consists of a revolving credit facility availing us of the ability to borrow debt subject to borrowing base determinations and Senior Convertible Notes which we issued in December 2010, February 2011, April 2012, August 2012 and December 2012, Senior Unsecured Notes, and Prospect Capital InterNotes®, which we may issue from time to time, and our equity capital, which is comprised entirely of common equity. The following table shows the Revolving Credit Facility, Senior Convertible Notes, Senior Unsecured Notes and InterNotes® amounts and outstanding borrowings at June 30, 2013 and June 30, 2012:

	As of June 30, 2013		As of June 30, 2012	
	Maximum Draw Amount	Amount Outstanding	Maximum Draw Amount	Amount Outstanding
Revolving Credit Facility	$552,500	$124,000	$492,500	$96,000
Senior Convertible Notes	$847,500	$847,500	$447,500	$447,500
Senior Unsecured Notes	$347,725	$347,725	$100,000	$100,000
InterNotes®	$363,777	$363,777	$20,638	$20,638

The following table shows the contractual maturity of our Revolving Credit Facility, Senior Convertible Notes, Senior Unsecured Notes and InterNotes® at June 30, 2013:

	Payments Due by Period				
	Total	Less than 1 year	1 - 3 Years	3 - 5 Years	After 5 Years
Revolving Credit Facility	$124,000	$—	$—	$124,000	$—
Senior Convertible Notes	847,500	—	150,000	297,500	400,000
Senior Unsecured Notes	347,725	—	—	—	347,725
InterNotes®	363,777	—	—	—	363,777
Total contractual obligations	$1,683,002	$—	$150,000	$421,500	$1,111,502

We have and expect to continue to fund a portion of our cash needs through borrowings from banks, issuances of senior securities, including secured, unsecured and convertible debt securities, or issuances of common equity. For flexibility, we maintain a universal shelf registration statement that allows for the public offering and sale of our debt securities, common stock, preferred stock, subscription rights, and warrants and units to purchase such securities in an amount up to $3,000,000 less issuances to date. As of June 30, 2013, we can issue up to $1,743,217 of additional debt and equity securities in the public market under this shelf registration. We may from time to time issue securities pursuant to the shelf registration statement or otherwise pursuant to private offerings. The issuance of debt or equity securities will depend on future market conditions, funding needs and other factors and there can be no assurance that any such issuance will occur or be successful.

Revolving Credit Facility

On June 11, 2010, we closed an extension and expansion of our existing credit facility with a syndicate of lenders through PCF (the "2010 Facility"). The 2010 Facility, which had $325,000 total commitments as of June 30, 2011, included an accordion feature which allowed the 2010 Facility to accept up to an aggregate total of $400,000 of commitments, a limit which was met on September 1, 2011. Interest on borrowings under the 2010 Facility was one-month Libor plus 325 basis points, subject to a minimum Libor floor of 100 basis points. Additionally, the lenders charged a fee on the unused portion of the 2010 Facility equal to either 75 basis points if at least half of the credit facility was used or 100 basis points otherwise.

On March 27, 2012, we renegotiated the 2010 Facility and closed on an expanded five-year $650,000 revolving credit facility (the "2012 Facility"). The lenders have extended commitments of $552,500 under the 2012 Facility as of June 30, 2013. The 2012 Facility includes an accordion feature which allows commitments to be increased up to $650,000 in the aggregate. The revolving period of the 2012 Facility extends through March 2015, with an additional two year amortization period (with distributions allowed) after the completion of the revolving period. During such two year amortization period, all principal payments on the pledged assets will be applied to reduce the balance. At the end of the two year amortization period, the remaining balance will become due, if required by the lenders.

The 2012 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 2012 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 2012 Facility. The 2012 Facility also requires the maintenance of a minimum liquidity requirement. At June 30, 2013, we were in compliance with the applicable covenants.

Interest on borrowings under the 2012 Facility is one-month Libor plus 275 basis points with no minimum Libor floor. Additionally, the lenders charge a fee on the unused portion of the 2012 Facility equal to either 50 basis points if at least half of the credit facility is drawn or 100 basis points otherwise. The 2012 Facility requires us to pledge assets as collateral in order to borrow under the credit facility. As of June 30, 2013 and June 30, 2012, we had $473,508 and $418,980, respectively, available to us for borrowing under our 2012 Facility, of which the amount outstanding was $124,000 and $96,000, respectively. As additional investments that are eligible are transferred to PCF and pledged under the 2012 Facility, PCF will generate additional availability up to the commitment amount of $552,500. At June 30, 2013, the investments used as collateral for the 2012 Facility had an aggregate market value of $833,310, which represents 31.4% of our net assets. These assets have been transferred to PCF, a bankruptcy remote special purpose entity, which owns these investments and as such, these investments are not available to our general creditors. PCF, a bankruptcy remote special purpose entity and our wholly-owned subsidiary, holds all of these investments at market value as of June 30, 2013. The release of any assets from PCF requires the approval of the facility agent.

In connection with the origination and amendments of the 2012 Facility, we incurred $11,150 of fees, including $1,319 of fees carried over from the previous facility, which are being amortized over the term of the facility in accordance with ASC 470-50, Debt Modifications and Extinguishments, of which $6,722 remains to be amortized as of June 30, 2013.

During the years ended June 30, 2013, June 30, 2012 and June 30, 2011, we recorded $9,082, $14,883 and $8,507 of interest costs, unused fees and amortization of financing costs on our credit facility as interest expense, respectively.

Senior Convertible Notes

On December 21, 2010, we issued $150,000 in aggregate principal amount of our 6.25% senior convertible notes due 2015 ("2015 Notes") for net proceeds following underwriting expenses of approximately $145,200. Interest on the 2015 Notes is paid semi-annually in arrears on June 15 and December 15, at a rate of 6.25% per year, commencing June 15, 2011. The 2015 Notes mature on December 15, 2015 unless converted earlier. The 2015 Notes are convertible into shares of common stock at an initial conversion rate and conversion rate at June 30, 2013 of 88.0902 and 88.1429 shares of common stock, respectively, per $1 principal amount of 2015 Notes, which is equivalent to a conversion price of approximately $11.35 per share of common stock, subject to adjustment in certain circumstances. The conversion price in effect at June 30, 2013 was last calculated on the anniversary of the issuance (December 21, 2012) and will next be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1%

before the anniversary. The conversion rate for the 2015 Notes is increased if monthly cash dividends paid to common shares exceed the rate of $0.101125 per share, subject to adjustment.
On February 18, 2011, we issued $172,500 in aggregate principal amount of our 5.50% senior convertible notes due 2016 ("2016 Notes") for net proceeds following underwriting expenses of approximately $167,325. Between January 30, 2012 and February 2, 2012, we repurchased $5,000 of our 2016 Notes at a price of 97.5, including commissions. The transactions resulted in our recognizing $10 of loss in the year ended June 30, 2012. Interest on the remaining $167,500 of 2016 Notes is

paid semi-annually in arrears on February 15 and August 15, at a rate of 5.50% per year, commencing August 15, 2011. The 2016 Notes mature on August 15, 2016 unless converted earlier. The 2016 Notes are convertible into shares of common stock at an initial conversion rate and conversion rate at June 30, 2013 of 78.3699 and 78.5395 shares, respectively, of common stock per $1 principal amount of 2016 Notes, which is equivalent to a conversion price of approximately $12.73 per share of common stock, subject to adjustment in certain circumstances. The conversion price in effect at June 30, 2013 was last calculated on the anniversary of the issuance (February 14, 2012) and will next be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary. The conversion rate for the 2016 Notes is increased when monthly cash dividends paid to common shares exceed the monthly dividend rate of $0.101150 per share.

On April 16, 2012, we issued $130,000 in aggregate principal amount of our 5.375% senior convertible notes due 2017 ("2017 Notes") for net proceeds following underwriting expenses of approximately $126,035. Interest on the 2017 Notes is paid semi-annually in arrears on October 15 and April 15, at a rate of 5.375% per year, commencing October 15, 2012. The 2017 Notes mature on October 15, 2017 unless converted earlier. The 2017 Notes are convertible into shares of common stock at an initial conversion rate and conversion rate at June 30, 2013 of 85.8442 and 86.1162 shares of common stock, respectively, per $1 principal amount of 2017 Notes, which is equivalent to a conversion price of approximately $11.61 per share of common stock, subject to adjustment in certain circumstances. The conversion price in effect at June 30, 2013 was last calculated on the anniversary of the issuance (April 16, 2012) and will next be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary. The conversion rate for the 2017 Notes is increased when monthly cash dividends paid to common shares exceed the monthly dividend rate of $0.10150 per share.

On August 14, 2012, we issued $200,000 in aggregate principal amount of our 5.75% senior convertible notes due 2018 ("2018 Notes") for net proceeds following underwriting expenses of approximately $193,600. Interest on the 2018 Notes is paid semi-annually in arrears on March 15 and September 15, at a rate of 5.75% per year, commencing March 15, 2013. The 2018 Notes mature on March 15, 2018 unless converted earlier. The 2018 Notes are convertible into shares of common stock at an initial conversion rate and conversion rate at June 30, 2013 of 82.3451 shares of common stock per $1 principal amount of 2018 Notes, which is equivalent to a conversion price of approximately $12.07 per share of common stock, subject to adjustment in certain circumstances. The conversion price has not been adjusted since the issuance (August 14, 2012) and will next be adjusted on the first anniversary, unless the exercise price shall have changed by more than 1% before the anniversary. The conversion rate for the 2018 Notes is increased when monthly cash dividends paid to common shares exceed the monthly dividend rate of $0.101600 per share.

On December 21, 2012, we issued $200,000 in aggregate principal amount of 5.875% senior convertible notes due 2019 (the "2019 Notes") for net proceeds following underwriting and other expenses of approximately $193,600. Interest on the 2019 Notes is paid semi-annually in arrears on January 15 and July 15, at a rate of 5.875% per year, commencing July 15, 2013. The 2019 Notes mature on January 15, 2019 unless converted earlier. The 2019 Notes are convertible into shares of common stock at an initial conversion rate and conversion rate at June 30, 2013 of 79.7766 shares of common stock per $1 principal amount of 2019 Notes, which is equivalent to a conversion price of approximately $12.54 per share of common stock, subject to adjustment in certain circumstances. The conversion price has not been adjusted since the issuance (December 21, 2012) and will next be adjusted on the first anniversary, unless the exercise price shall have changed by more than 1% before the anniversary. The conversion rate for the 2019 Notes is increased when monthly cash dividends paid to common shares exceed the monthly dividend rate of $0.110025 per share.

In no event will the total number of shares of common stock issuable upon conversion exceed 96.8992 per $1 principal amount of the 2015 Notes (the "conversion rate cap"), except that, to the extent we receive written guidance or a no-action letter from the staff of the Securities and Exchange Commission (the "Guidance") permitting us to adjust the conversion rate in certain instances without regard to the conversion rate cap and to make the 2015 Notes convertible into certain reference property in accordance with certain reclassifications, business combinations, asset sales and corporate events by us without regard to the conversion rate cap, we will make such adjustments without regard to the conversion rate cap and will also, to the extent that we make any such adjustment without regard to the conversion rate cap pursuant to the Guidance, adjust the conversion rate cap accordingly. We will use our commercially reasonable efforts to obtain such Guidance as promptly as practicable.

Prior to obtaining the Guidance, we will not engage in certain transactions that would result in an adjustment to the conversion rate of the 2015 Notes increasing the conversion rate beyond what it would have been in the absence of such transaction unless we have engaged in a reverse stock split or share combination transaction such that in our reasonable best estimation, the conversion rate following the adjustment for such transaction will not be any closer to the conversion rate cap than it would have been in the absence of such transaction.

Upon conversion, unless a holder converts after a record date for an interest payment but prior to the corresponding interest payment date, the holder will receive a separate cash payment with respect to the Notes surrendered for conversion representing accrued and unpaid interest to, but not including the conversion date. Any such payment will be made on the settlement date applicable to the relevant conversion on the 2015 Notes and 2016 Notes (collectively, "Senior Convertible Notes").

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

Subject to certain exceptions, holders may require us to repurchase, for cash, all or part of their Notes upon a fundamental change at a price equal to 100% of the principal amount of the Notes being repurchased plus any accrued and unpaid interest up to, but excluding, the fundamental change repurchase date. In addition, upon a fundamental change that constitutes a non-stock change of control we will also pay holders an amount in cash equal to the present value of all remaining interest payments (without duplication of the foregoing amounts) on such Senior Convertible Notes through and including the maturity date.

In connection with the issuance of the Senior Convertible Notes, we incurred $27,032 of fees which are being amortized over the terms of the notes in accordance with ASC 470-50, Debt Modifications and Extinguishments, of which $20,254 remains to be amortized and is included within deferred financing costs on the consolidated statements of assets and liabilities as of June 30, 2013.

During the years ended June 30, 2013, June 30, 2012 and June 30, 2011, we recorded $45,878, $22,197 and $9,090 of interest costs and amortization of financing costs on the Senior Convertible Notes as interest expense, respectively.

Senior Unsecured Notes

On May 1, 2012, we issued $100,000 in aggregate principal amount of 6.95% senior unsecured notes due 2022 for proceeds net of offering expenses of $97,000 (the "2022 Notes"). Interest on the 2022 Notes is paid quarterly in arrears on August 15, November 15, February 15 and May 15, at a rate of 6.95% per year, commencing on August 15, 2012. The 2022 Notes mature on November 15, 2022. These notes will be our direct unsecured obligations and rank equally with all of our unsecured senior indebtedness from time to time outstanding.

On March 15, 2013, we issued $250,000 in aggregate principal amount of 5.875% senior unsecured notes due 2023 (the "2023 Notes") for net proceeds following underwriting and other expenses of approximately $245,885. Interest on the 2023 Notes is paid semi-annually. The 2023 Notes mature on March 15, 2023. These notes will be our direct unsecured obligations and rank equally with all of our unsecured senior indebtedness from time to time outstanding.

In connection with the issuance of the 2022 Notes and 2023 Notes (collectively the "Senior Unsecured Notes"), we incurred $7,480 of fees which are being amortized over the term of the notes in accordance with ASC 470-50, Debt Modifications and Extinguishments, of which $7,114 remains to be amortized and is included within deferred financing costs on the consolidated statements of assets and liabilities.

During the years ended June 30, 2013 and June 30, 2012, we recorded $11,672 and $1,178 of interest costs and amortization of financing costs on the Senior Unsecured Notes as interest expense, respectively.

Prospect Capital InterNotes®

On February 16, 2012, we entered into a Selling Agent Agreement (the "Selling Agent Agreement") with Incapital LLC, as purchasing agent for our issuance and sale from time to time of up to $500,000 of Prospect Capital InterNotes® (the "InterNotes® Offering"), which was subsequently increased to $1,000,000. Additional agents appointed by us from time to time in connection with the InterNotes Offering may become parties to the Selling Agent Agreement.

These notes are direct unsecured senior obligations and will rank equally with all of our unsecured senior indebtedness outstanding. Each series of notes will be issued by a separate trust. These notes bear interest at fixed interest rates and offer a variety of maturities no less than twelve months from the original date of issuance.

During the year ended June 30, 2013, we issued $343,139 in aggregate principal amount of our Prospect Capital InterNotes® for net proceeds of approximately $334,243. These notes were issued with stated interest rates ranging from 3.28% to 6.63% with a weighted average rate of 5.59%. These notes mature between July 15, 2019 and June 15, 2043.

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The bonds outstanding as of June 30, 2013 are:

Date of Issuance	Principal Amount	Interest Rate Range		Weighted Average Interest Rate		Maturity Date
March 1, 2012 - March 8, 2012	$ 5,465	6.90% - 7.00%		6.97	%	March 15, 2022
April 5, 2012 - April 26, 2012	8,516	6.50% - 6.85%		6.72	%	April 15, 2022
June 14, 2012	2,657	6.95	%	6.95	%	June 15, 2022
June 28, 2012	4,000	6.55	%	6.55	%	June 15, 2019
July 6, 2012 - July 26, 2012	20,928	6.20% - 6.45%		6.31	%	July 15, 2019
August 2, 2012 - August 23, 2012	17,545	6.05% - 6.15%		6.09	%	August 15, 2019
September 7, 2012 - September 27, 2012	29,406	5.85% - 6.00%		5.92	%	September 15, 2019
October 4, 2012	7,172	5.70	%	5.70	%	October 19, 2019
November 23, 2012 - November 29, 2012	13,754	5.00% - 5.13%		5.09	%	November 15, 2019
November 29, 2012	1,979	5.75	%	5.75	%	November 15, 2032
November 23, 2012 - November 29, 2012	16,437	6.50% - 6.63%		6.58	%	November 15, 2042
December 6, 2012 - December 28, 2012	9,339	4.50% - 4.86%		4.73	%	December 15, 2019
December 6, 2012	1,127	5.63	%	5.63	%	December 15, 2032
December 13, 2012 - December 28, 2012	3,702	5.00% - 5.13%		5.11	%	December 15, 2030
December 6, 2012 - December 28, 2012	22,966	6.00% - 6.38%		6.21	%	December 15, 2042
January 4, 2013 - January 31, 2013	4,427	4.00% - 4.375%		4.15	%	January 15, 2020
January 4, 2013 - January 31, 2013	2,388	4.50% - 4.875%		4.74	%	January 15, 2031
January 4, 2013 - January 31, 2013	9,338	5.50% - 5.875%		5.63	%	January 15, 2043
February 4, 2013 - February 28, 2013	2,619	4.00	%	4.00	%	February 15, 2031
February 4, 2013 - February 28, 2013	664	4.50	%	4.50	%	February 15, 2031
February 4, 2013 - February 28, 2013	4,623	5.50	%	5.50	%	February 15, 2043
March 4, 2013 - March 28, 2013	3,832	4.00	%	4.00	%	March 15, 2020
March 4, 2013 - March 28, 2013	984	4.125% - 4.50%		4.24	%	March 15, 2031
March 4, 2013 - March 28, 2013	4,308	5.50	%	5.50	%	March 15, 2043
March 14, 2013 - March 28, 2013	1,225	L+3.00%		3.27	%	March 15, 2023
April 4, 2013 - April 25, 2013	29,528	4.50% - 5.00%		4.96	%	April 15, 2020
April 4, 2013 - April 25, 2013	264	L+3.50%		3.78	%	April 15, 2023
April 4, 2013 - April 25, 2013	5,164	4.63% - 5.50%		5.34	%	April 15, 2031
April 4, 2013 - April 25, 2013	12,280	6.00	%	6.00	%	April 15, 2043
May 2, 2013 - May 31, 2013	42,482	5.00	%	5.00	%	May 15, 2020
May 2, 2013 - May 31, 2013	10,000	5.00	%	5.00	%	May 15, 2028
May 2, 2013 - May 31, 2013	7,548	5.75	%	5.75	%	May 15, 2031
May 2, 2013 - May 31, 2013	33,641	6.25	%	6.25	%	May 15, 2043
June 6, 2013 - June 27, 2013	9,905	5.00% - 5.25%		5.04	%	June 15, 2020
June 6, 2013 - June 27, 2013	5,000	5.00	%	5.00	%	June 15, 2028
June 6, 2013 - June 27, 2013	1,707	5.75% - 6.00%		5.85	%	June 15, 2031
June 6, 2013 - June 27, 2013	6,857	6.25% - 6.50%		6.31	%	June 15, 2043
	$ 363,777					

In connection with the issuance of the Prospect Capital InterNotes®, we incurred $10,598 of fees which are being amortized over the term of the notes in accordance with ASC 470-50, Debt Modifications and Extinguishments, of which $10,248 remains to be amortized and is included within deferred financing costs on the consolidated statements of assets and liabilities.

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During the years ended June 30, 2013 and June 30, 2012, we recorded $9,707 and $276 of interest costs and amortization of financing costs on the Prospect Capital InterNotes® as interest expense, respectively.

Net Asset Value

During the year ended June 30, 2013, we raised $1,179,084 of additional equity, net of offering costs, by issuing 106,752,517 shares of our common stock. The following table shows the calculation of net asset value per share as of June 30, 2013 and June 30, 2012:

	As of June 30, 2013	As of June 30, 2012
Net Assets	$ 2,656,494	$ 1,511,974
Shares of common stock outstanding	247,836,965	139,633,870
Net asset value per share	$ 10.72	$ 10.83

Results of Operations

Net increase in net assets resulting from operations for the years ended June 30, 2013, 2012 and 2011 was $220,856, $190,904 and $118,238, respectively, representing $1.07, $1.67 and $1.38 per weighted average share, respectively. During the year ended June 30, 2013, we experienced net unrealized and realized losses of $104,068 or approximately $0.50 per weighted average share primarily due to the reduction in the fair value of our investments in Ajax, Boxercraft and First Tower because of changes in current market conditions and Energy Solutions for which we received $19,543 of make-whole fees for early repayment of the outstanding loan and dividends of $53,820 during the year, which were recorded as interest and dividend income, respectively, reducing the amount previously recorded as unrealized appreciation. These losses were partially offset by net realized gains from the sale of assets in Wolf, assets formerly held by H&M, and distributions received from our escrow receivable account, primarily from NRG. During the year ended June 30, 2012, we experienced net unrealized and realized gains of $4,220 or approximately $0.04 per weighted average share primarily from significant write-ups of our investments in Ajax, Energy Solutions and R-V, and our sale of NRG for which we realized a gain of $36,940. These instances of appreciation were partially offset by unrealized depreciation in Biotronic, H&M, Meatco, NMMB, Stryker and Wind River.

Net investment income decreased on a weighted average per share basis from $1.63 to $1.57 for the years ended June 30, 2012 and 2013, respectively. The decrease is primarily due to an increase of $6,500 in accrued excise as the result of undisturbed ordinary income at December 31, 2012 and expected at December 31, 2013, and higher levels of cash awaiting deployment during the year ended June 30, 2013. Net investment income increased on a weighted average per share basis from $1.10 to $1.63 for the years ended June 30, 2011 and 2012, respectively. This increase is primarily due to the sale of NRG, for which we received a $26,936 make-whole fee for early repayment of the outstanding loan, which was recorded as interest income in the year ended June 30, 2012, and an increase in dividend income received from Energy Solutions and NRG of $38,000 and $11,411, respectively. These increases were partially offset by a $15,471 decline in interest income from purchase discount accretion from the assets acquired from Patriot.

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 fees generated from 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 net profits interests revenue, overriding royalty interests and structuring fees, was $576,336, $320,910, and $169,476, for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively. During the year ended June 30, 2013, the increase in investment income is primarily the result of a larger income producing portfolio, increased structuring, advisory and amendment fees from the deployment of additional capital in revenue-producing assets, make-whole fees from Energy Solutions for early repayment of our outstanding loan, and increased dividends received from Energy Solutions and R-V.

The following table describes the various components of investment income and the related levels of debt investments:

	Year Ended June 30, 2013	Year Ended June 30, 2012	Year Ended June 30, 2011
Interest income	$435,455	$219,536	$134,454
Dividend income	82,705	64,881	15,092
Other income	58,176	36,493	19,930
Total investment income	$576,336	$320,910	$169,476
Average debt principal of performing investments	$2,878,421	$1,466,703	$871,400
Weighted average interest rate earned on performing assets	15.1 %	15.0 %	15.2 %

Average interest income producing assets have increased from $871,400 for the year ended June 30, 2011 to $1,466,703 for the year ended June 30, 2012 to $2,878,421 for the year ended June 30, 2013. The average yield on performing interest bearing assets remained relatively consistent over the three year period.

Investment income is also generated from dividends and other income. Dividend income increased from $64,881 for the year ended June 30, 2012 to $82,705 for the year ended June 30, 2013. This $17,824 increase in dividend income is primarily attributed to an increase in the level of dividends received from our investments in Energy Solutions and R-V due to increased profits generated by the portfolio companies. We received dividends from Energy Solutions of $53,820 and $47,850 during the years ended June 30, 2013 and June 30, 2012, respectively. The sale of Gas Solutions by Energy Solutions has resulted in significant earnings and profits, as defined by the Internal Revenue Code, at Energy Solutions for calendar year 2012. As a result, distributions from Energy Solutions to us were recognized as dividend income, in accordance with ASC 946, Financial Services—Investment Companies, as cash distributions are received from Energy Solutions to the extent there are earnings and profits sufficient to support such recognition. We received dividends from R-V of $24,462 and $283 during the years ended June 30, 2013 and June 30, 2012, respectively. The $24,462 of dividends received from R-V during the year ended June 30, 2013 include a $11,073 distribution as part of R-V's recapitalization in November 2012 for which we provided an additional $9,500 of senior secured financing. The increases in dividend income from our investments in Energy Solutions and R-V were offset by a reduction in dividends received from NRG. We received dividends from NRG of $15,011 during the year ended June 30, 2012. There were no dividends from NRG received during the year ended June 30, 2013 as NRG has been sold.

Dividend income increased from $15,092 for the year ended June 30, 2011 to $64,881 for the year ended June 30, 2012. This $49,789 increase in dividend income is primarily attributed to an increase in the dividends received from our investments in Energy Solutions and NRG due to increased profits generated by the portfolio companies. We received dividends from NRG of $15,011 and $3,600 during the years ended June 30, 2012 and June 30, 2011, respectively. We received dividends from Energy Solutions of $47,850 and $9,850 during the years ended June 30, 2012 and June 30, 2011, respectively. The sale of Gas Solutions by Energy Solutions has resulted in significant earnings and profits, as defined by the Internal Revenue Code, at Energy Solutions for calendar year 2012. As a result, distributions from Energy Solutions to us were recognized as dividend income, in accordance with ASC 946, Financial Services—Investment Companies, as cash distributions are received from Energy Solutions to the extent there are earnings and profits sufficient to support such recognition.

Other income has come primarily from structuring fees, overriding royalty interests, and settlement of net profits interests. Comparing the year ended June 30, 2012 to the year ended June 30, 2013, income from other sources increased from $36,493 to $58,176, respectively. This $21,683 increase is primarily due to $52,699 of structuring fees recognized during the year ended June 30, 2013 primarily from our investments in APH, Arctic Glacier, Broder, InterDent, Progrexion, Ryan, TransPlace, USC and Wolf originations, in comparison to $26,443 of structuring fees recognized during the year ended June 30, 2012. This $26,256 increase in structuring fees is partially offset by a decrease in advisory fees recognized during the year ended June 30, 2013 from our investments in Energy Solutions and NRG. We received $8,783 of advisory fees from Energy Solutions and NRG during the year ended June 30, 2012.

No such fee was received during the year ended June 30, 2013. The remaining $4,210 increase is primarily due to $4,122 of royalty income recognized during the year ended June 30, 2013 primarily from First Tower and Wolf, in comparison to $224 of royalty income recognized during the year ended June 30, 2012.

Comparing the year ended June 30, 2011 to the year ended June 30, 2012, income from other sources increased from $19,930 to $36,493. This $16,563 increase is primarily due to $14,137 of structuring and advisory fees recognized during the year ended June 30, 2012 from our investments in Energy Solutions and NRG. The remaining $2,426 increase is primarily due to $21,088 of structuring fees recognized, excluding those received from our investments in Energy Solutions and NRG, during the year ended June 30, 2012 primarily from the Capstone, First Tower, Naylor, LLC and Totes Isotoner Corporation ("Totes") originations, in comparison to $18,494 of structuring fees recognized during the year ended June 30, 2011.

Operating Expenses

Our primary operating expenses consist of investment advisory fees (base management and income incentive fees), borrowing 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 Prospect Capital Management (the "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 $251,412, $134,226 and $75,255 for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively.

The base investment advisory expenses were $69,800, $35,836 and $22,496 for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively. These increases are directly related to our growth in total assets. For the years ended June 30, 2013, June 30, 2012 and June 30, 2011, income incentive fees incurred were $81,231, $46,761 and $23,555, respectively. The $34,470 increase in the income incentive fee for the year ended June 30, 2013 is driven by an increase in pre-incentive fee net investment income of $172,800 primarily due to an increase in interest income from a larger asset base. No capital gains incentive fee has yet been incurred pursuant to the Investment Advisory Agreement.

During the years ended June 30, 2013, June 30, 2012 and June 30, 2011, we incurred $76,341, $38,534 and $17,598, respectively, of expenses related to our 2012 Facility, InterNotes®, Senior Unsecured Notes and Senior Convertible Notes. 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 expenses of our 2012 Facility, InterNotes®, Senior Unsecured Notes and Senior Convertible Notes and the related indicators of leveraging capacity and indebtedness during these years.

	Year Ended June 30, 2013	Year Ended June 30, 2012	Year Ended June 30, 2011
Interest on borrowings	$62,657	$27,346	$9,861
Amortization of deferred financing costs	8,283	8,510	5,366
Commitment and other fees	5,401	2,678	2,371
Total	$76,341	$38,534	$17,598
Weighted-average debt outstanding	$1,066,368	$502,038	$176,277
Weighted average interest rate on borrowings (excluding amortization and undrawn facility fees)	5.88 %	5.45 %	5.59 %
Facility amount at beginning of year	$492,500	$325,000	$210,000

The increase in interest expense for the year ended June 30, 2013 is primarily due to the issuance of the 2022 Notes, 2023 Notes and the Senior Convertible Notes on April 16, 2012, August 14, 2012 and December 21, 2012, for which we incurred $34,551 of collective interest expense. The weighted average interest rate on borrowings (excluding amortization and undrawn facility fees) increased from 5.45% to 5.88% as of June 30, 2012 and June 30, 2013, respectively. This increase is primarily due to a decrease in utilization of our credit facility in favor of longer term financing.

The allocation of overhead expense from Prospect Administration was $8,737, $6,848 and $4,979 for the years ended June 30, 2013, 2012 and 2011, respectively. As our portfolio continues to grow, we expect Prospect Administration to continue to increase the size of its administrative and financial staff.

Total operating expenses, net of investment advisory fees, interest costs, excise tax and allocation of overhead from Prospect Administration ("Other Operating Expenses"), were $8,803, $6,337 and $6,627 for the years ended June 30, 2013, 2012 and 2011, respectively. The increase in Other Operating Expenses during the year ended June 30, 2013 when compared to the year ended June 30, 2012 is primarily the result of a $1,000 insurance claim settlement for legal fees expensed in previous periods that was received during the year ended June 30, 2012. The decrease in Other

Operating Expenses during the year ended June 30, 2012 when compared to the year ended June 30, 2011 is primarily the result of a $1,000 insurance claim settlement for legal fees expensed in previous periods that was received during the year ended June 30, 2012.

Net Investment Income

Net investment income represents the difference between investment income and operating expenses. Our net investment income was $324,924, $186,684 and $94,221 for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively, or $1.57 per share, $1.63 per share and $1.10 per share, respectively. The $138,240 increase for the year ended June 30, 2013 is primarily due to an increase of $215,919 in interest income, due to the increased size of our portfolio for which we have recognized additional interest income. The $255,426 increase in investment income is offset by an increase in operating expenses of $117,186, primarily due to a $68,524 increase in advisory fees due to the growing size of our portfolio and related income, and $37,807 of additional interest and credit facility expenses. For the calendar year ended December 31, 2012, we elected to retain a portion of our annual taxable income and have paid $4,500 for the excise tax due with the filing of the return. As of June 30, 2013, we have $2,000 accrued as an estimate of two quarters of the excise tax due for the calendar year ending December 31, 2013. The per share decrease is primarily due to an increase of $6,500 in excise taxes and higher levels of cash awaiting deployment during the year ended June 30, 2013.

The $92,463 increase for the year ended June 30, 2012 is primarily due to a $151,434 increase in investment income offset by an increase in operating expenses of $58,971. The $151,434 increase in investment income is due to increases of $85,082, $49,789 and $16,563 in interest income, dividend income and other income, respectively, due to the increased size of our portfolio for which we have recognized additional interest income, dividends, structuring fees and advisory fees recognized primarily from our investments in Energy Solutions, First Tower and NRG. In conjunction with the sale of NRG we also received a $26,936 make-whole fee for early repayment of the outstanding loan, which was recorded as interest income in the year ended June 30, 2012. The offsetting $58,971 increase in operating expenses is primarily due to a $36,456 increase in advisory fees due to the growing size of our portfolio and related income, $20,936 of additional interest and credit facility expenses and a $1,869 increase in overhead allocated from Prospect Administration.

Net Realized (Losses) Gains, (Decrease) Increase in Net Assets from Net Changes in Unrealized Appreciation/Depreciation

Net realized (losses) gains were ($26,234), $36,588 and $16,465 for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively. The net realized loss for the year ended June 30, 2013 was primarily due to the sale of Meatco (realized loss of $10,814), the other-than-temporary impairment of ICS (realized loss of $12,117) and restructuring of the H&M debt in conjunction with the foreclosure on the assets of H&M (realized loss of $19,647). These losses were partially offset by net realized gains from the sale of our assets in Wolf (realized gain of $11,826), assets formerly held by H&M, and distributions received from our escrow receivable account, primarily NRG (resulting in realized gains of $3,252). The net realized gain for the year ended June 30, 2012 was due primarily to the sale of NRG common stock for which we realized a gain of $36,940 and the sale of our equity interests in Copernicus, C&J, Fairchild Industrial Products, Co., Fischbein, Mac & Massey, Nupla and Sport Helmets for which we realized a total gain of $14,317. These gains were offset by our impairment of Deb Shops. During the year ended June 30, 2012, Deb Shops filed for bankruptcy and a plan for reorganization was proposed. The plan was approved by the bankruptcy court and our debt position was eliminated with no payment to us. We determined that the impairment of Deb Shops was other-than-temporary on September 30, 2011 and recorded a realized loss of $14,607 for the full amount of the amortized cost. The asset was completely written off when the plan of reorganization was approved. The net realized gain for the year ended June 30, 2011 was due primarily to gains from the sales of our common equity in Fischbein and Miller of $9,893 and $7,977, respectively.

Net (decrease) increase in net assets from changes in unrealized (depreciation) appreciation was ($77,834), ($32,368), and $7,552 for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively, or ($0.37) per share, ($0.28) per share and $0.09 per share, respectively. For the year ended June 30, 2013, the $77,834 decrease in net assets from the net change in unrealized depreciation was driven by reduction in the fair value of our investments in Ajax, Boxercraft and First Tower because of changes in current market conditions and Energy Solutions for which we received $19,543 of make-whole fees for early repayment of the outstanding loan and distributions of $53,820 during the year, which were recorded as interest and dividend income, respectively, reducing the amount previously recorded as unrealized appreciation. These instances of unrealized depreciation were partially offset by the elimination of the unrealized depreciation resulting from the H&M foreclosure mentioned above. For the year ended June 30, 2012, the $32,368 decrease in net assets from the net change in unrealized appreciation/depreciation was driven by write-downs of $68,197 related to our investments in H&M, Meatco and Stryker, as well as the elimination of the unrealized appreciation resulting from the sale of NRG mentioned above. The unrealized depreciation was partially offset by unrealized appreciation of approximately $34,712 related to our investments in Ajax and R-V. For the year ended June 30, 2011, the $7,552 increase in net assets from the net change in unrealized appreciation was driven by significant write-ups of $54,916 related to our investments in Ajax, Biotronic, ESHI, Iron Horse, NRG and Sport Helmets. The unrealized appreciation were partially offset by unrealized depreciation of approximately $35,689 related to our investments in H&M, ICS, Manx, Shearer's, Stryker, and $10,840 related to the repayment of Prince.

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Financial Condition, Liquidity and Capital Resources

For the years ended June 30, 2013, June 30, 2012 and June 30, 2011, our operating activities used $1,811,101, $287,881 and $581,609 of cash, respectively. There were no investing activities for the years ended June 30, 2013, June 30, 2012 and June 30, 2011. Financing activities provided cash flows of $1,868,250, $289,214 and $582,020 for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively. Dividends paid were $242,301, $127,564 and $91,247 for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively.

Our primary uses of funds have been to continue to invest in portfolio companies, through both debt and equity investments, repay outstanding borrowings and to make cash distributions to holders of our common stock.

Our primary sources of funds have been issuances of debt and equity. 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. During the year ended June 30, 2013, we borrowed $223,000 and made repayments totaling $195,000 under our 2012 Facility. As of June 30, 2013, we had $124,000 outstanding on our revolving credit facility, $847,500 outstanding on our Senior Convertible Notes, $347,725 outstanding on our Senior Unsecured Notes and $363,777 outstanding on InterNotes®. (See Capitalization.)

Undrawn committed revolvers incur commitment fees ranging from 0.50% to 2.00%. As of June 30, 2013 and June 30, 2012, we have $202,518 and $180,646 of undrawn revolver commitments to our portfolio companies, respectively.

Our Board of Directors, pursuant to the Maryland General Corporation Law, executed Articles of Amendment to increase the number of shares authorized for issuance from 200,000,000 to 500,000,000 in the aggregate. The amendment became effective July 30, 2012.

On October 29, 2012, our Registration Statement on Form N-2 was declared effective by the SEC. Under this Shelf Registration Statement, we can issue up to an additional $1,743,217 of debt and equity securities in the public market at June 30, 2013.

We also continue to generate liquidity through public and private stock offerings.

On June 1, 2012, we entered into an ATM Program with KeyBanc through which we could sell, by means of at-the-market offerings from time to time, of up to 9,500,000 shares of our common stock. During the period from July 2, 2012 to July 12, 2012, we sold 2,247,275 shares of our common stock at an average price of $11.59 per share, and raised $26,040 of gross proceeds, under the ATM Program. Net proceeds were $25,779 after commission to KeyBanc on shares sold.

On July 16, 2012, we issued 21,000,000 shares of our common stock at $11.15 per share (or $11.05 per share net proceeds excluding expenses), raising $234,150 of gross proceeds.

On July 27, 2012, we issued 3,150,000 shares in connection with the exercise of an option granted with the July 12, 2012 offering of 21,000,000 shares which were delivered July 16, 2012, raising an additional $35,123 of gross proceeds and $34,808 of net proceeds.

On September 10, 2012, we entered into an ATM Program with KeyBanc through which we could sell, by means of at-the-market offerings from time to time, of up to 9,750,000 shares of our common stock. During the period from October 1, 2012 to October 9, 2012, we sold 1,245,655 shares of our common stock at an average price of $11.53 per share, and raised $14,361 of gross proceeds, under this program. Net proceeds were $14,217 after commission to the broker-dealer on shares sold and offering costs.

On November 7, 2012, we issued 35,000,000 shares of our common stock at $11.10 per share (or $10.96 per share net proceeds excluding expenses), raising $383,600 of net proceeds.

On December 21, 2012, we entered into an ATM Program with KeyBanc through which we could sell, by means of at-the-market offerings from time to time, of up to 17,500,000 shares of our common stock. During the period from January 7, 2013 to February 5, 2013, we sold 10,248,051 shares of our common stock at an average price of $11.25 per share, and raised $115,315 of gross proceeds, under this program. Net proceeds were $114,162 after commission to KeyBanc on shares sold.

On February 11, 2013, we entered into an ATM Program with KeyBanc through which we could sell, by means of at-the-market offerings from time to time, of up to 45,000,000 shares of our common stock. During the period from

February 14, 2013 to May 3, 2013, we sold 17,230,253 shares of our common stock at an average price of $11.14 per share, and raised $191,897 of gross proceeds, under the ATM Program. Net proceeds were $190,109 after commissions to KeyBanc on shares sold.

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On May 8, 2013, we entered into an ATM Program with BB&T Capital Markets, BMO Capital Markets, and KeyBanc through which we could sell, by means of at-the-market offerings from time to time, of up to 45,000,000 shares of our common stock. During the period from May 14, 2013 to June 30, 2013, we sold 4,359,200 shares of our common stock at an average price of $10.90 per share, and raised $47,532 of gross proceeds, under the ATM Program. Net proceeds were $47,133 after commissions to BB&T Capital Markets, BMO Capital Markets, and KeyBanc on shares sold. During the period from July 1, 2013 to August 21, 2013, we sold 9,818,907 shares of our common stock at an average price of $10.97 per share, and raised $107,725 of gross proceeds, under the ATM Program. Net proceeds were $106,822 after commissions to BB&T Capital Markets, BMO Capital Markets, and KeyBanc on shares sold. (See Recent Developments.)

On August 23, 2013, we entered into an ATM Program with BMO Capital Markets, Goldman, Sachs & Co., RBC Capital Markets and KeyBanc through which we could sell, by means of at-the-market offerings from time to time, of up to 45,000,000 shares of our common stock. During the period from August 26, 2013 to October 10, 2013 (with settlements August 29, 2013 through October 16, 2013), we sold 16,914,710 shares of our common stock at an average price of $11.27 per share, and raised $190,609 of gross proceeds, under the ATM Program. Net proceeds were $188,735 after commissions to BMO Capital Markets, Goldman, Sachs & Co., RBC Capital Markets and KeyBanc on shares sold.

Off-Balance Sheet Arrangements

At June 30, 2013, 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.

Recent Developments

During the period from July 1, 2013 to October 10, 2013, we issued $115,110 in aggregate principal amount of our Prospect Capital InterNotes® for net proceeds of $112,713.

During the period from July 1, 2013 to August 21, 2013, we sold 9,818,907 shares of our common stock at an average price of $10.97 per share, and raised 107,725, under the ATM Program. Net proceeds were $106,822 after commissions to the broker-dealer on shares sold and offering costs.

On August 23, 2013, we entered into an ATM Program with BMO Capital Markets, Goldman, Sachs & Co., RBC Capital Markets and KeyBanc through which we could sell, by means of at-the-market offerings from time to time, of up to 45,000,000 shares of our common stock. During the period from August 26, 2013 to October 10, 2013 (with settlements August 29, 2013 through October 16, 2013), we sold 16,914,710 shares of our common stock at an average price of $11.27 per share, and raised $190,609 of gross proceeds, under the ATM Program. Net proceeds were $188,735 after commissions to BMO Capital Markets, Goldman, Sachs & Co., RBC Capital Markets and KeyBanc on shares sold.

On July 1, 2013, Pre-Paid Legal Services, Inc. repaid the $5,000 loan receivable to us.

On July 9, 2013, Southern Management Corporation repaid the $17,565 loan receivable to us.

On July 12, 2013, we provided $11,000 of secured second lien financing to Water PIK, Inc., a leader in developing innovative personal and oral healthcare products.

On July 12, 2013, we provided $11.0 million of secured second lien financing to Blue Coat Systems, Inc., a leading provider of web security and wide area network (WAN) optimization solutions.

On July 23, 2013, we made a $2,000 investment in Carolina Beverage Group, LLC ("Carolina Beverage"), a contract beverage manufacturer.

On July 24, 2013, we sold our $2,000 investment in Carolina Beverage and realized a gain of $45 on this investment.

On July 26, 2013, we made a $2,000 follow-on senior secured debt investment in Spartan, a leading provider of thru tubing and flow control services to oil and gas companies.

On July 26, 2013, we made a $20,000 follow-on secured second lien investment in Royal Adhesives & Sealants, LLC ("Royal"), a leading producer of proprietary, high-performance adhesives and sealants.

On July 31, 2013, we made a $5,100 follow-on investment in Coverall, a leading franchiser of commercial cleaning businesses.

On July 31, 2013, Royal repaid the $28,364 subordinated unsecured loan receivable to us.
On July 31, 2013, Cargo repaid the $43,399 loan receivable to us.
On August 1, 2013, Medical Security Card Company, LLC repaid the $13,214 loan receivable to us.
On August 2, 2013, we made an investment of $44,100 to purchase 90% of the subordinated notes in CIFC Funding 2013-III, Ltd.
On August 2, 2013, we funded a recapitalization of CP Energy Services, Inc. ("CP Energy") with $81,273 of debt and $12,741 of equity financing. Through the recapitalization, we acquired a controlling interest in CP Energy for $73,009 in cash and 1,918,342 unregistered shares of our common stock. After the financing, we received repayment of the $18,991 loan previously outstanding.
On August 12, 2013, we provided $80,000 in senior secured loans and a senior secured revolving loan facility, of which $70,000 was funded at closing, for the recapitalization of Matrixx Initiatives, Inc., owner of Zicam, a leading developer and marketer of OTC cold remedy products under the Zicam brand.
On August 14, 2013, we announced the revised conversion rate on the 2018 Notes of 82.8631 shares of common stock per $1 principal amount of 2018 Notes, which is equivalent to a conversion price of approximately $12.07.
On August 15, 2013, we announced an increase of $15,000 to our commitments to our credit facility. The commitments to the credit facility now stand at $567,500.
On August 15, 2013, we made a $14,000 follow-on investment in Totes, a leading designer, distributer and retailer of high quality, branded functional accessories.
On August 21, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110325 per share for January 2014 to holders of record on January 31, 2014 with a payment date of February 20, 2014;
- $0.110350 per share for February 2014 to holders of record on February 28, 2014 with a payment date of March 20, 2014; and
- $0.110375 per share for March 2014 to holders of record on March 31, 2014 with a payment date of April 17, 2014.

On August 30, 2013, we made a $16,000 follow-on investment in System One Holdings, LLC, a leading provider of professional staffing services.
On September 5, 2013, we provided $50,000 of floating rate senior secured financing to a leading payments processor.
On September 10, 2013, we made a $12,500 first lien secured investment in Photonis SAS, a world leader in the development, manufacture and sale of electro-optic components for the detection and intensification of very faint light sources.
On September 11, 2013, Seaton Corp. repaid the $13,310 loan receivable to us.
On September 12, 2013, we provided a $75,000 floating-rate senior secured term loan to support the recapitalization of American Broadband Communications, LLC, a leading provider of voice, video, and high-speed internet services.
On September 13, 2013, we made an investment of $36,515 to purchase 83.56% of the subordinated notes in Apidos CLO XV, Ltd.
On September 19, 2013, we provided $47,985 of combined senior secured floating rate debt and equity to support the recapitalization of Mity Enterprises, Inc., a leading designer, manufacturer and seller of multipurpose room furniture and specialty healthcare seating products.
On September 25, 2013, we made a $12,000 senior secured investment in NCP Finance, a lender to short term loan providers in the alternative financial services industry.
On September 25, 2013, we received payment of $5,000 in settlement of a lawsuit related to the loan to Integrated Contract Services, Inc., which was previously written off.
On September 30, 2013, we made an investment of $22,575 to purchase 51.02% of the subordinated notes in Galaxy XVI CLO, Ltd.

On September 30, 2013, we sold our investment in ADAPCO, Inc. for net proceeds of $553, recognizing a realized gain of $413 on the sale.
On September 30, 2013, we made an $18,818 follow-on investment in JHH Holdings, Inc., a leading provider of home healthcare services in Texas.
On October 1, 2013, we made a $2,600 follow-on investment in AIRMALL USA, Inc., a leading developer and manager of airport retail operations.
On October 7, 2013, Evanta Ventures, Inc. repaid the $10,506 loan receivable to us.
On October 11, 2013, we made a $5,846 follow-on senior debt and equity investment in CP Energy Services, Inc., an energy services company based in western Oklahoma.
On October 11, 2013, we provided $25,000 in preferred equity for the recapitalization of Ajax Rolled Ring & Machine, Inc. After the financing, we received repayment of the $20,009 loan previously outstanding.

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. Our financial statements include our accounts and the accounts of PCF, 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.
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

To value our assets, we follow the guidance of ASC 820 that defines fair value, establishes a framework for measuring fair value in conformity with accounting principles generally accepted in the United States or America, or GAAP, and requires disclosures about fair value measurements.
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.

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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.

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.

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 an independent valuation firm engaged by our Board of Directors;
2) the independent valuation firms conduct independent appraisals and make their own independent assessment;
3) the Audit Committee of our Board of Directors reviews and discusses the preliminary valuation of the Investment Adviser and that of the independent valuation firms; 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 the Investment Adviser, the respective independent valuation firm and the Audit Committee.

Investments are valued utilizing a shadow bond approach, a market approach, an income approach, a liquidation approach, or a combination of approaches, as appropriate. The shadow bond and market approaches use 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.

Our investments in CLOs are classified as ASC 820 level 3 securities, and are valued using discounted cash flow model. The valuations have been accomplished through the analysis of the CLO deal structures to identify the risk exposures from the modeling point of view. For each security, the most appropriate valuation approach has been chosen from alternative approaches to ensure the most accurate valuation for each security. To value a CLO, both the assets and liabilities of the CLO capital structure need be modeled. We use a waterfall engine to store the collateral data, generate collateral cash flows from the assets, and distributes the cash flow to the liability structure based on the payment priorities, and discount them back using proper discount rates that incorporate all the risk factors. The main risk factors are: default risk, interest rate risk, downgrade risk, and credit spread risk.

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 under the direction of our Board of Directors and, as a result, there is uncertainty as to the value of our portfolio investments."

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Valuation of Other Financial Assets and Financial Liabilities
ASC Subtopic 820-10-05-1, The Fair Value Option for Financial Assets and Financial Liabilities ("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 elected not to value some assets and liabilities at fair value as would be permitted by ASC 820-10-05-1.
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 at least 98% of our annual income and 98.2% of our capital gains 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 ordinary income and 98.2% of our capital gains 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. For the calendar year ended December 31, 2012, we elected to retain a portion of our annual taxable income and have paid $4,500 for the excise tax due with the filing of the return. As of June 30, 2013, we have $2,000 accrued as an estimate of two quarters of the excise tax due for the calendar year ending December 31, 2013.
If we fail to satisfy the Annual Distribution Requirement or otherwise fail to qualify as a RIC in any taxable year, 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 we be required to make distributions. Distributions would generally be taxable to our individual and other non-corporate taxable stockholders as ordinary dividend income eligible for the reduced maximum rate applicable to qualified dividend income to the extent of our current and accumulated earnings and profits, provided certain holding period and other requirements are met. Subject to certain limitations under the Code, corporate distributions would be eligible for the dividends-received deduction. To qualify again to be taxed as a RIC in a subsequent year, we would be required to distribute to our shareholders our accumulated earnings and profits attributable to non-RIC years reduced by an interest charge of 50% of such earnings and profits payable by us as an additional tax. In addition, if we failed to qualify as a RIC for a period greater than two taxable years, then, in order to qualify as a RIC in a subsequent year, we would be required to elect to recognize and pay tax on any net built-in gain (the excess of aggregate gain, including items of income, over aggregate loss that would have been realized if we had been liquidated) or, alternatively, be subject to taxation on such built-in gain recognized for a period of ten years.
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, 2013 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.

Interest income from investments in the "equity" class of security of CLO Funds (typically income notes or subordinated notes) is recorded based upon an estimation of an effective yield to expected maturity utilizing assumed cash flows in accordance with ASC 325-40-35, Beneficial Interests in Securitized Financial Assets. We monitor the expected cash inflows from our CLO equity investments, including the expected residual payments and the effective yield is determined and updated periodically.

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, 2013, approximately 0.3% of our net assets are in non-accrual status.

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 and Senior Notes as deferred financing costs. These expenses are deferred and amortized as part of interest expense using the straight-line method for our revolving credit facility and the effective interest method for our Senior Notes, over the respective expected life.

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 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.

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. In accordance with ASC 946, Financial Services—Investment Companies, convertible securities are not considered in the calculation of net assets per share.

Recent Accounting Pronouncements

In May 2011, the FASB issued Accounting Standards Update 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS ("ASU 2011-04"). ASU 2011-04 amends Topic 820, Fair Value Measurements, ("ASC 820") by: (1) clarifying that the highest-and-best-use and valuation-premise concepts only apply to measuring the fair value of non-financial assets; (2) allowing a reporting entity to measure the fair value of the net asset or net liability position in a manner consistent with how market participants would price the net risk position, if certain criteria are met; (3) providing a framework for considering whether a premium or discount can be applied in a fair value measurement; (4) providing that the fair value of an instrument classified in a reporting entity's shareholders' equity is estimated from the perspective of a market participant that holds the identical item as an asset; and (5) expanding the qualitative and quantitative fair value disclosure requirements. The expanded disclosures include, for Level 3 items, a description of the valuation process and a narrative description of the sensitivity of the fair value to changes in unobservable inputs and interrelationships between those inputs if a change in those inputs would result in a significantly different fair value measurement. ASU 2011-4 also requires disclosures about the highest-and-best-use of a non-financial asset when this use differs from the asset's current use and the reasons for such a difference. In addition, this ASU amends ASC 820, Fair Value Measurements, to require disclosures to include any transfers between Level 1 and Level 2 of the fair value hierarchy. These amendments were effective for fiscal years beginning after December 15, 2011 and for interim periods within those fiscal years. The adoption of the amended guidance in ASU 2011-04 did not have a significant effect on our financial statements. See Note 3 for the disclosure required by ASU 2011-04.

In August 2012, the FASB issued Accounting Standards Update 2012-03, Technical Amendments and Corrections to SEC Sections: Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 114 ("SAB No. 114"), Technical Amendments Pursuant to SEC Release No. 33-9250, and Corrections Related to FASB Accounting Standards Update 2010-22 ("ASU 2012-03"). The update amends various SEC paragraphs pursuant to the issuance of SAB No. 114 and is effective upon issuance. The adoption of the amended guidance in ASU 2012-03 did not have a significant effect on our financial statements.

In October 2012, the FASB issued Accounting Standards Update 2012-04, Technical Corrections and Improvements ("ASU 2012-04"). The amendments in this update cover a wide range of Topics in the ASC. These amendments include technical corrections and improvements to the ASC and conforming amendments related to fair value measurements. The adoption of the amended guidance in ASU 2012-04 did not have a significant effect on our financial statements.

In June 2013, the FASB issued Accounting Standards Update 2013-08, Financial Services—Investment Companies (Topic 946)—Amendments to the Scope, Measurement, and Disclosure Requirements ("ASU 2013-08"). ASU 2013-08 clarifies the approach to be used for determining whether an entity is an investment company and provides new measurement and disclosure requirements. ASU 2013-08 is effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013. Earlier application is prohibited. The adoption of ASU 2013-08 is not expected to materially effect on our financial statements.

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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 year ended June 30, 2013, we did not engage in hedging activities.

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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, 2013. 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, 2013 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, 2013 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, 2013 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, 2013 has been audited by our independent registered public accounting firm, as stated in their report which appears in the 10-K.

USE OF PROCEEDS

Unless otherwise specified in a prospectus supplement, we intend to use the net proceeds from selling Securities pursuant to this prospectus initially to maintain balance sheet liquidity, involving repayment of debt under our credit facility, if any, investments in high quality short-term debt instruments or a combination thereof, and thereafter to make long-term investments in accordance with our investment objective. Interest on borrowings under the credit facility is one-month LIBOR plus 275 basis points, with no minimum LIBOR floor. Additionally, the lenders charge a fee on the unused portion of the credit facility equal to either 50 basis points if at least half of the credit facility is drawn or 100 basis points otherwise. A supplement to this prospectus relating to each offering will provide additional detail, to the extent known at the time, regarding the use of the proceeds from such offering including any intention to utilize proceeds to pay expenses in order to avoid sales of long-term assets.

We anticipate that substantially all of the net proceeds of an offering of Securities pursuant to this prospectus will be used for the above purposes within six months, depending on the availability of appropriate investment opportunities consistent with our investment objective and market conditions. In addition, we expect that there will be several offerings pursuant to this prospectus; we expect that substantially all of the proceeds from all offerings will be used within three years. Pending our new investments, we plan to invest a portion of net proceeds in cash equivalents, U.S. government securities and other high-quality debt investments that mature in one year or less from the date of investment and other general corporate purposes. The management fee payable by us will not be reduced while our assets are invested in such securities, which may generate a loss to the Company. See "Regulation—Temporary Investments" for additional information about temporary investments we may make while waiting to make longer-term investments in pursuit of our investment objective.

FORWARD-LOOKING STATEMENTS

Our annual report on Form 10-K for the year ended June 30, 2013, 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 including this prospectus may contain forward looking statements within the meaning of the Section 21E of the Securities Exchange Act of 1934, as amended, which involve substantial 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 not historical facts, but rather are based on current expectations, estimates and projections about our industry, our beliefs, and our assumptions. Words such as "intends," "intend," "intended," "goal," "estimate," "estimates," "expects," "expect," "expected," "project," "projected," "projections," "plans," "seeks," "anticipates," "anticipated," "should," "could," "may," "will," "designed to," "foreseeable future," "believe," "believes" and "scheduled" and variations of these words and similar expressions are intended to identify forward-looking statements. Our 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. These forward-looking statements do not meet the safe harbor for forward-looking statements pursuant to Section 27A of the Securities Act. These statements are not guarantees of future performance and are subject to risks, uncertainties, and other factors, some of which are beyond our control and difficult to predict and could cause actual results to differ materially from those expressed or forecasted in the forward-looking statements, including without limitation:

- our future operating results;
- our business prospects and the prospects of our portfolio companies;
- the impact of investments that we expect to make;
- 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;
- 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 NASDAQ Global Select Market, and other authorities that we are subject to, as well as their counterparts in any foreign jurisdictions where we might do business; and
- the risks, uncertainties and other factors we identify in "Risk Factors" and elsewhere in this prospectus and in our filings with the SEC.

Although we believe that the assumptions on which these forward-looking statements are based are reasonable, any of those assumptions could prove to be inaccurate, and as a result, the forward-looking statements based on those assumptions also could be inaccurate. Important assumptions include our ability to originate new loans and investments, certain margins and levels of profitability and the availability of additional capital. In light of these and other uncertainties, the inclusion of a projection or forward-looking statement in this prospectus should not be regarded as a representation by us that our plans and objectives will be achieved. These risks and uncertainties include those described or identified in "Risk Factors" and elsewhere in this prospectus. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this prospectus.

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.

As a RIC, we generally are not subject to U.S. federal income tax on income and gains we distribute each taxable year to our stockholders, provided that in such taxable year we distribute at least 90% of our ordinary income and net short-term capital gains in excess of realized net long-term capital losses. In order to avoid certain excise taxes imposed on RICs, we are required to timely distribute with respect to each calendar year an amount at least equal to the sum of

- 98% of our ordinary income for the calendar year,
- 98.2% 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.

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At December 31, 2012, we accrued, and subsequently paid, $4,500 for the undistributed ordinary income retained at December 31, 2012. Through June 30, 2013, we have accrued an additional $2,000 as we expect to again retain undistributed ordinary income at December 31, 2013.

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 distribution, then stockholders' cash distributions 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 distributions. Stockholders who receive distributions 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 distributions in cash. See "Dividend Reinvestment Plan".

To the extent prudent and practicable, we intend to declare and pay dividends on a monthly basis.

With respect to the distributions 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, 2013, we declared total distributions of approximately $271.5 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.

The following table reflects the distributions per share that we have declared on our common stock to date. In June 2010, we changed our distribution policy from a quarterly payment to a monthly payment.

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Declaration Date	Record Date	Pay Date	Rate	Amount (in thousands)
8/20/2013	3/31/2014	4/17/2014	0.110375	*
8/20/2013	2/28/2014	3/20/2014	0.110350	*
8/20/2013	1/31/2014	2/20/2014	0.110325	*
6/17/2013	12/31/2013	1/23/2014	0.110300	*
6/17/2013	11/29/2013	12/19/2013	0.110275	*
6/17/2013	10/31/2013	11/21/2013	0.110250	*
6/17/2013	9/30/2013	10/24/2013	0.110225	*
5/6/2013	8/30/2013	9/19/2013	0.110200	*
5/6/2013	7/31/2013	8/22/2013	0.110175	$28,001
5/6/2013	6/28/2013	7/18/2013	0.110150	27,299
5/6/2013	5/31/2013	6/19/2013	0.110125	27,280
2/7/2013	4/30/2013	5/23/2013	0.110100	26,619
2/7/2013	3/29/2013	4/18/2013	0.110075	26,267
2/7/2013	2/28/2013	3/21/2013	0.110050	25,307
11/7/2012	1/31/2013	2/20/2013	0.110025	24,641
11/7/2012	12/31/2012	1/23/2013	0.110000	23,669
11/7/2012	11/30/2012	12/20/2012	0.101675	21,308
8/21/2012	10/31/2012	11/22/2012	0.101650	17,736
8/21/2012	9/30/2012	10/24/2012	0.101625	17,597
5/7/2012	8/31/2012	9/21/2012	0.101600	16,897
5/7/2012	7/31/2012	8/24/2012	0.101575	16,886
5/7/2012	6/29/2012	7/24/2012	0.101550	14,180
5/7/2012	5/31/2012	6/22/2012	0.101525	12,395
2/6/2012	4/30/2012	5/24/2012	0.101500	12,384
2/6/2012	3/30/2012	4/20/2012	0.101475	12,372
2/6/2012	2/29/2012	3/23/2012	0.101450	12,361
11/7/2011	1/31/2012	2/17/2012	0.101425	11,134
11/7/2011	12/31/2011	1/25/2012	0.101400	11,122
11/7/2011	11/30/2011	12/22/2011	0.101375	11,111
8/24/2011	10/31/2011	11/22/2011	0.101350	11,098
8/24/2011	9/30/2011	10/25/2011	0.101325	11,087
5/9/2011	8/31/2011	9/23/2011	0.101300	11,074
5/9/2011	7/29/2011	8/26/2011	0.101275	11,060
5/9/2011	6/30/2011	7/22/2011	0.101250	10,896
5/9/2011	5/31/2011	6/24/2011	0.101225	9,871
2/8/2011	4/29/2011	5/31/2011	0.101200	9,861
2/8/2011	3/31/2011	4/29/2011	0.101175	8,939
2/8/2011	2/28/2011	3/31/2011	0.101150	8,930
11/8/2010	1/31/2011	2/28/2011	0.101125	8,919
11/8/2010	12/31/2010	1/31/2011	0.101000	8,899
11/8/2010	11/30/2010	12/31/2010	0.100875	8,668
8/26/2010	10/29/2010	11/30/2010	0.100750	8,347
8/26/2010	9/30/2010	10/29/2010	0.100625	7,889
6/18/2010	8/31/2010	9/30/2010	0.100500	7,620
6/18/2010	7/30/2010	8/31/2010	0.100250	7,330
Prior to 6/30/2010				215,157
		Since Inception		$762,211

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*Not yet determinable

SENIOR SECURITIES

Information about our senior securities is shown in the following table as of each fiscal year ended June 30 since the Company commenced operations.

Credit Facility	Total Amount Outstanding(1)	Asset Coverage per Unit(2)	Involuntary Liquidating Preference per Unit(3)	Average Market Value per Unit(4)
Fiscal 2013 (as of June 30, 2013)	$124,000	$34,996	—	—
Fiscal 2012 (as of June 30, 2012)	96,000	22,668	—	—
Fiscal 2011 (as of June 30, 2011)	84,200	18,065	—	—
Fiscal 2010 (as of June 30, 2010)	100,300	8,093	—	—
Fiscal 2009 (as of June 30, 2009)	124,800	5,268	—	—
Fiscal 2008 (as of June 30, 2008)	91,167	5,712	—	—
Fiscal 2007 (as of June 30, 2007)	—	N/A	—	—
Fiscal 2006 (as of June 30, 2006)	28,500	4,799	—	—
Fiscal 2005 (as of June 30, 2005)	—	N/A	—	—
Fiscal 2004 (as of June 30, 2004)	—	N/A	—	—
2015 Notes				
Fiscal 2013 (as of June 30, 2013)	$150,000	$28,930	—	—
Fiscal 2012 (as of June 30, 2012)	150,000	14,507	—	—
Fiscal 2011 (as of June 30, 2011)	150,000	10,140	—	—
2016 Notes				
Fiscal 2013 (as of June 30, 2013)	$167,500	$25,907	—	—
Fiscal 2012 (as of June 30, 2012)	167,500	12,992	—	—
Fiscal 2011 (as of June 30, 2011)	172,500	8,818	—	—
2017 Notes				
Fiscal 2013 (as of June 30, 2013)	$130,000	$33,381	—	—
Fiscal 2012 (as of June 30, 2012)	130,000	16,739	—	—
2018 Notes				
Fiscal 2013 (as of June 30, 2013)	$200,000	$21,697	—	—
2019 Notes				
Fiscal 2013 (as of June 30, 2013)	$200,000	$21,697	—	—
2022 Notes				
Fiscal 2013 (as of June 30, 2013)	$100,000	$43,395	—	—
Fiscal 2012 (as of June 30, 2012)	100,000	21,761	—	—
2023 Notes				
Fiscal 2013 (as of June 30, 2013)	$247,725	$17,517	—	—

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Prospect Capital InterNotes®				
Fiscal 2013 (as of June 30, 2013)	$ 363,777	$ 11,929	—	—
Fiscal 2012 (as of June 30, 2012)	20,638	105,442	—	—
All Senior Securities(5)				
Fiscal 2013 (as of June 30, 2013)	$ 1,683,002	$ 2,578	—	—
Fiscal 2012 (as of June 30, 2012)	664,138	3,277	—	—
Fiscal 2011 (as of June 30, 2011)	406,700	3,740	—	—

(1) Total amount of each class of senior securities outstanding at the end of the period presented (in 000's).

(2) The asset coverage ratio for a class of senior securities representing indebtedness is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness. This asset coverage ratio is multiplied by $1,000 to determine the Asset Coverage Per Unit.

(3) This column is inapplicable.

(4) This column is inapplicable.

(5) On February 16, 2012, we entered into the Selling Agent Agreement and began offering notes (the "Prospect Capital InterNotes® Program"). On March 4, 2013, we entered into a Second Amended and Restated Selling Agent Agreement which continued the Prospect Capital InterNotes® Program on substantially similar terms and provides for our issuance of floating rate notes in addition to fixed rate notes. Through October 10, 2013, we have sold $478.9 million aggregate principal amount of notes. Amounts sold under the Prospect Capital InterNotes® Program after June 30, 2013 are not reflected in the table above. On August 23, 2013, we amended the Selling Agent Agreement for the Prospect Capital InterNotes® to increase the aggregate principal amount of notes that may be issued from time to time under such agreement from $500.0 million to $1.0 billion.

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PRICE RANGE OF COMMON STOCK

Our common stock is quoted on the NASDAQ Global Select Market under the symbol "PSEC." The following table sets forth, for the periods indicated, our NAV per share of common stock and the high and low sales prices per share of our common stock as reported on the NASDAQ Global Select Market. Our common stock historically trades at prices both above and below its NAV per share. There can be no assurance, however, that such premium or discount, as applicable, to NAV per share will be maintained. Common stock of business development companies, like that of closed-end investment companies, frequently trades at a discount to current NAV per share. In the past, our common stock has traded at a discount to our NAV per share. The risk that our common stock may continue to trade at a discount to our NAV per share is separate and distinct from the risk that our NAV per share may decline.

	Stock Price			Premium (Discount) of High to NAV	Premium (Discount) of Low to NAV	Dividend Declared
	NAV(1)	High(2)	Low(2)			
Twelve Months Ending June 30, 2009						
First quarter	$14.63	$14.24	$11.12	(2.7)%	(24.0)%	$0.402500
Second quarter	14.43	13.08	6.29	(9.4)%	(56.4)%	0.403750
Third quarter	14.19	12.89	6.38	(9.2)%	(55.0)%	0.405000
Fourth quarter	12.40	10.48	7.95	(15.5)%	(35.9)%	0.406250
Twelve Months Ending June 30, 2010						
First quarter	$11.11	$10.99	$8.82	(1.1)%	(20.6)%	$0.407500
Second quarter	10.10	12.31	9.93	21.9 %	(1.7)%	0.408750
Third quarter	10.12	13.20	10.45	30.4 %	3.3 %	0.410000
Fourth quarter	10.30	12.20	9.65	18.4 %	(6.3)%	0.100000
Twelve Months Ending June 30, 2011						
First quarter	$10.24	$10.00	$9.18	(2.3)%	(10.4)%	$0.301375
Second quarter	10.25	10.86	9.69	6.0 %	(5.5)%	0.302625
Third quarter	10.33	12.33	10.72	19.4 %	3.8 %	0.303450
Fourth quarter	10.36	12.18	9.95	17.6 %	(4.0)%	0.303675
Twelve Months Ending June 30, 2012						
First quarter	$10.41	$10.18	$7.41	(2.2)%	(28.8)%	$0.303900
Second quarter	10.69	9.88	7.99	(7.6)%	(25.3)%	0.304125
Third quarter	10.82	11.39	9.43	5.3 %	(12.8)%	0.304350
Fourth quarter	10.83	11.39	10.55	5.2 %	(2.5)%	0.304575
Twelve Months Ending June 30, 2013						
First quarter	$10.88	$12.21	$10.83	12.2 %	(0.5)%	$0.304800
Second quarter	10.81	11.98	9.89	10.8 %	(8.5)%	0.313325
Third quarter	10.71	11.49	10.91	7.3 %	1.9 %	0.330150
Fourth quarter	10.72	11.11	10.08	3.6 %	(6.0)%	0.330375
Twelve Months Ending June 30, 2014						
First quarter		$11.61	$10.76			$0.330600
Second quarter (through October 10, 2013)		$11.21	$10.80			$0.330825

(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 NAVs shown are based on outstanding shares of our common stock at the end of each period.

(2) The High/Low Stock Price is calculated as of the closing price on a given day in the applicable quarter.

(3) Our most recently estimated NAV per share is $10.75 on an as adjusted basis solely to give effect to our issuance of common stock since June 30, 2013 in connection with our dividend reinvestment plan, our issuance of 26,733,617 shares of common stock during the period from July 1, 2013 to October 10, 2013 including shares

settling through

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October 16, 2013 under our at-the-market offering program, and our issuance of 1,918,342 shares of common stock on August 2, 2013 in connection with the recapitalization of CP Energy, $0.01 higher than the $10.72 determined by us as of June 30, 2013. NAV per share as of September 30, 2013, may be higher or lower than $10.75 based on potential changes in valuations, issuances of securities, dividends paid and earnings for the quarter then ended.

(4) NAV has not yet been finally determined for any day after June 30, 2013.

(5) On June 17, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110225 per share for September 2013 to holders of record on September 30, 2013 with a payment date of October 24, 2013;
- $0.110250 per share for October 2013 to holders of record on October 31, 2013 with a payment date of November 21, 2013;
- $0.110275 per share for November 2013 to holders of record on November 29, 2013 with a payment date of December 19, 2013; and
- $0.110300 per share for December 2013 to holders of record on December 31, 2013 with a payment date of January 23, 2014.

On August 21, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110325 per share for January 2014 to holders of record on January 31, 2014 with a payment date of February 20, 2014;
- $0.110350 per share for February 2014 to holders of record on February 28, 2014 with a payment date of March 20, 2014; and
- $0.110375 per share for March 2014 to holders of record on March 31, 2014 with a payment date of April 17, 2014.

On October 10, 2013, the last reported sales price of our common stock was $11.07 per share.

As of October 10, 2013, we had approximately 140 stockholders of record.

The below table sets forth each class of our outstanding securities as of October 10, 2013 including sales of shares under our at-the-market offering program which will settle through October 16, 2013.

Title of Class	Amount Authorized	Amount Held by Registrant or for its Account	Amount Outstanding
Common Stock	500,000,000	—	276,844,568

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BUSINESS

General

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 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 currently have seven origination strategies in which we make investments: (1) lending in private equity sponsored transactions, (2) lending directly to companies not owned by private equity firms, (3) control investments in corporate operating companies, (4) control investments in financial companies, (5) investments in structured credit, (6) real estate investments, and (7) investments in syndicated debt. We continue to evaluate other origination strategies in the ordinary course of business with no specific tops-down allocation to any single origination strategy.

Lending in Private Equity Sponsored Transactions—We make loans to companies which are controlled by leading private equity firms. This debt can take the form of first lien, second lien, unitranche or mezzanine loans. In making these investments, we look for a diversified customer base, recurring demand for the product or service, barriers to entry, strong historical cash flow and experienced management teams. These loans typically have significant equity subordinate to our loan position. This strategy has represented approximately 50%-60% of our business.

Lending Directly to Companies—We provide debt financing to companies owned by non-private equity firms, the company founder, a management team or a family. Here, in addition to the strengths we look for in a sponsored transaction, we also look for alignment with the management team with significant invested capital. This strategy often has less competition than the private equity sponsor strategy because such company financing needs are not easily addressed by banks and often require more diligence preparation. Direct lending can result in higher returns and lower leverage than sponsor transactions and may include warrants or equity to us. This strategy generally has comprised approximately 10%-15% of our business.

Control Investments in Corporate Operating Companies—This strategy involves acquiring controlling stakes in non-financial operating companies. Our investments in these companies are generally structured as a combination of yield-producing debt and equity. We provide certainty of closure to our counterparties, give the seller personal liquidity and generally look for management to continue on in their current roles. This strategy has comprised approximately 10%-15% of our business.

Control Investments in Financial Companies—This strategy involves acquiring controlling stakes in financial companies, including consumer direct lending, subprime auto lending and other strategies. Our investments in these companies are generally structured as a combination of yield-producing debt and equity. These investments are often structured in a tax-efficient RIC (as defined below) compliant partnership, enhancing returns. This strategy has comprised approximately 10%-15% of our business.

Investments in Structured Credit—We make investments in Collateralized Loan Obligations ("CLOs"), generally taking a significant position in the subordinated interests (equity) of the CLOs. The CLOs include a diversified portfolio of broadly syndicated loans and do not have direct exposure to real estate, mortgages, sub-prime debt, or consumer based debt. The CLOs in which we invest are managed by top-tier collateral managers that have been thoroughly diligenced prior to investment. This strategy has represented 10%-20% of the portfolio.

Real Estate Investments—We make investments in real estate through our wholly-owned tax-efficient real estate investment trust ("REIT"), American Property Holdings Corp. ("APHC"). Our real estate investments are in various classes of fully developed and occupied real estate properties that generate current yields. We seek to identify properties that have historically high occupancy and steady cash flow generation. We partner with established property managers with experience in managing the property type to manage such properties after acquisition. This is a more recent investment strategy that has represented less than 5% of our business.

Investments in Syndicated Debt—On an opportunistic basis, we make investments in loans and high yield bonds that have been sold to a syndicate of buyers. Here we look for investments with attractive risk-adjusted returns after we have completed a fundamental credit analysis. These investments are purchased with a long term, buy-and-hold outlook and we look to provide significant structuring input by providing anchoring orders. This strategy has represented approximately 5%-10% of the portfolio.

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Typically, we concentrate on making investments in companies with annual revenues of less than $750 million and enterprise values of less than $1 billion. Our typical investment involves a secured loan of less than $250 million. We also 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 total returns to our investors, including both current yield and equity upside, by applying rigorous credit analysis and asset-based and cash-flow based lending techniques to make and monitor our investments.
We are currently pursuing multiple investment opportunities, including purchases of portfolios from private and public companies, as well as originations and secondary purchases of particular securities. We also regularly evaluate control investment opportunities in a range of industries, and some of these investments could be material to us. There can be no assurance that we will successfully consummate any investment opportunity we are currently pursuing. If any of these opportunities are consummated, there can be no assurance that investors will share our view of valuation or that any assets acquired will not be subject to future write downs, each of which could have an adverse effect on our stock price.
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 reduce our exposure to the energy industry, and our holdings in the energy and energy related industries now represent less than 7% of our investment portfolio.
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 Investment Company Act of 1940 (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.
On July 27, 2004, we completed our initial public offering ("IPO") and sold 7 million shares of common stock at a price of $15.00 per share, less underwriting discounts and commissions totaling $1.05 per share. An additional 55,000 shares were issued through the exercise of an over-allotment option with respect to the IPO on August 27, 2004. Since the IPO and the exercise of the related over-allotment option, we have made other common stock share offerings (including options exercised by underwriters) resulting in the issuance of 206,744,448 shares at prices ranging from $7.75 to $17.70. We issued the 2015 Notes on December 21, 2010, the 2016 Notes on February 18, 2011, the 2017 Notes on April 16, 2012, the 2022 Notes on May 1, 2012, the 2018 Notes on August 14, 2012, the 2019 Notes on December 21, 2012, the 2023 Notes on March 15, 2013 and have issued Prospect Capital InterNotes® since February 16, 2012.
Senior Convertible Notes
On December 21, 2010, February 18, 2011, April 16, 2012, August 14, 2012 and December 21, 2012, the Company issued the 2015 Notes, the 2016 Notes, the 2017 Notes, the 2018 Notes and the 2019 Notes, respectively. We refer to the 2015 Notes, the 2016 Notes, the 2017 Notes, the 2018 Notes and the 2019 Notes collectively as the Senior Convertible Notes. The Senior Convertible Notes were issued only to qualified institutional investors under Rule 144A of the 1933 Act. The 2015 Notes mature on December 15, 2015, the 2016 Notes mature on August 15, 2016, the 2017 Notes mature on October 15, 2017, the 2018 Notes mature on March 15, 2018 and the 2019 Notes mature on January 15, 2019, in each case unless previously converted in accordance with their terms. The Senior Convertible Notes are general unsecured obligations of the Company, rank equally in right of payment with the Company's existing and future senior unsecured debt, and rank senior in right of payment to any potential subordinated debt, should any be issued in the future. The Company may not redeem the Senior Convertible Notes prior to maturity. The net proceeds from the offerings of the Senior Convertible Notes were approximately $825.8 million which was used initially to maintain balance sheet liquidity, including repayment of debt under the Company's credit facility, if any, investments in high quality short-term debt instruments or a combination thereof, and to make long-term investments in accordance with the Company's investment objective.

The interest rate on the 2015 Notes is 6.25% per year, payable semiannually in arrears on June 15 and December 15 of each year, commencing June 15, 2011. Holders may convert their 2015 Notes at any time on or prior to the close of business on the business day immediately preceding the maturity date at an initial conversion rate of 88.0902 shares of common stock per $1,000 principal amount of 2015 Notes (equivalent to an initial conversion price of approximately $11.35 per share). The conversion rate is subject to adjustment in certain events and in no event will the total number of shares of common stock issuable upon conversion exceed 96.8992 per $1,000 principal amount of the 2015 Notes, or the "conversion rate cap," except that, to the extent the Company receives written guidance or a no-action letter from the staff of the SEC permitting it to adjust the conversion rate in certain instances without regard to the conversion rate cap, and to make the 2015 Notes convertible into certain reference property in accordance with certain reclassifications, business combinations, asset sales and corporate events of the Company without regard to the conversion rate cap it will make such adjustments without regard to the conversion rate cap and will also, to the extent that it makes any such adjustment without regard to the conversion rate cap pursuant to such written guidance or a no-action, adjust the conversion rate cap accordingly. Prior to obtaining the previously mentioned written guidance or no-action letter from the staff of the SEC, the Company will not engage in certain transactions that would result in an adjustment to the conversion rate of the 2015 Notes increasing the conversion rate beyond what it would have been in the absence of such transaction unless the Company has engaged in a reverse stock split or share combination transaction such that in our reasonable best estimation, the conversion rate following the adjustment for such transaction will not be any closer to the conversion rate cap than it would have been in the absence of such transaction. At June 30, 2013, the 2015 Notes are convertible into 88.1429 shares of common stock per $1,000 principal amount of 2015 Notes (equivalent to a conversion price of approximately $11.35 per share). The conversion rate is subject to adjustment in certain events. The conversion price in effect at June 30, 2013 was last calculated on the anniversary of the issuance (December 21, 2012) and will next be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary.

The interest rate on the 2016 Notes is 5.50% per year, payable semiannually in arrears on February 15 and August 15 of each year, commencing August 15, 2011. Holders may convert their 2016 Notes at any time on or prior to the close of business on the business day immediately preceding the maturity date at an initial conversion rate of 78.3699 shares of common stock per $1,000 principal amount of 2016 Notes (equivalent to an initial conversion price of approximately $12.76 per share). The conversion rate is subject to adjustment in certain events. At June 30, 2013, the 2016 Notes are convertible into 78.5395 shares of common stock per $1,000 principal amount of 2016 Notes (equivalent to a conversion price of approximately $12.73 per share). The conversion rate is subject to adjustment in certain events. The conversion price in effect at June 30, 2013 was last calculated on the anniversary of the issuance (February 14, 2012) and will next be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary.

The interest rate on the 2017 Notes is 5.375% per year, payable semiannually in arrears on April 15 and October 15 of each year, commencing October 15, 2012. Holders may convert their 2017 Notes at any time on or prior to the close of business on the business day immediately preceding the maturity date at an initial conversion rate of 85.8442 shares of common stock per $1,000 principal amount of 2017 Notes (equivalent to an initial conversion price of approximately $11.65 per share). The conversion rate is subject to adjustment in certain events. At June 30, 2013, the 2017 Notes are convertible into 86.1162 shares of common stock per $1,000 principal amount of 2017 Notes (equivalent to a conversion price of approximately $11.61 per share). The conversion rate is subject to adjustment in certain events. The conversion price in effect at June 30, 2013 was last calculated on the anniversary of the issuance (April 16, 2012) and will next be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary.

The interest rate on the 2018 Notes is 5.75% per year, payable semiannually in arrears on March 15 and September 15 of each year, commencing March 15, 2013. Holders may convert their 2018 Notes at any time on or prior to the close of business on the business day immediately preceding the maturity date at an initial conversion rate of 82.3451 shares of common stock per $1,000 principal amount of 2018 Notes (equivalent to an initial conversion price of approximately $12.14 per share). The conversion rate is subject to adjustment in certain events. At June 30, 2013, the 2018 Notes are convertible into 82.3451 shares of common stock, as adjusted for monthly cash dividends paid in excess of $0.1016 per share after closing. The conversion price was adjusted on the anniversary date of August 14, 2013 to 82.8631 shares of common stock per $1,000 principal amount of 2018 Notes (equivalent to an initial conversion price of approximately $12.07 per share) and will be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary.

The interest rate on the 2019 Notes is 5.875% per year, payable semiannually in arrears on January 15 and July 15 of each year, commencing July 15, 2013. Holders may convert their 2019 Notes at any time on or prior to the close of business on the business day immediately preceding the maturity date at an initial conversion rate of 79.7766 shares of common stock per $1,000 principal amount of 2019 Notes (equivalent to an initial conversion price of approximately $12.54 per share). The conversion price has not been adjusted since the issuance (December 21, 2012) and will be adjusted on the first anniversary, unless the exercise price shall have changed by more than 1% before the anniversary.

Senior Unsecured Notes

On May 1, 2012, the Company issued the 2022 Notes pursuant to its effective shelf registration statement. The 2022 Notes are listed on the New York Stock Exchange under the symbol "PRY." The 2022 Notes are general unsecured obligations and rank pari passu with all outstanding and future unsecured unsubordinated indebtedness issued by the Company. The 2022 Notes will mature on November 15, 2022. The Company will pay interest on the 2022 Notes on February 15, May 15, August 15 and November 15 of each year, beginning August 15, 2012. The Company may redeem the 2022 Notes in whole or in part at any time or from time to time on or after May 15, 2015, at a redemption price as specified in the indenture governing the 2022 Notes. The 2022 Notes were issued in minimum denominations of $25 and integral multiples of $25 in excess thereof.

On March 15, 2013, the Company issued the 2023 Notes pursuant to its effective shelf registration statement. The 2023 Notes are general unsecured obligations and rank pari passu with all outstanding and future unsecured unsubordinated indebtedness issued by the Company. The 2023 Notes will mature on March 15, 2023. The Company will pay interest on the 2023 Notes on September 15 and March 15 of each year, commencing on September 15, 2013.

Prospect Capital InterNotes®

On March 4, 2013, the Company entered into a Second Amended and Restated Selling Agent Agreement (the "Selling Agent Agreement") with Incapital LLC and Merrill Lynch, Pierce, Fenner & Smith Incorporated, as purchasing agents for the Company's issuance and sale from time to time of up to $500 million of Prospect Capital InterNotes® (the "InterNotes® Offering"). The initial Selling Agent Agreement was entered into on February 16, 2012. Citigroup Global Markets Inc. joined the Selling Agent Agreement by the Agent Joinder Letter dated April 15, 2013. Additional agents appointed by us from time to time in connection with the InterNotes Offering may become parties to the Selling Agent Agreement. On August 23, 2013, we amended the Selling Agent Agreement to increase the aggregate principal amount of notes that may be issued from time to time under such agreement from $500.0 million to $1.0 billion.

These Prospect Capital InterNotes® are and will be the Company's direct unsecured senior obligations and will and do rank equally with all of the Company's unsecured senior indebtedness from time to time outstanding. Each series of Prospect Capital InterNotes® will be issued by a separate supplemental indenture. The Prospect Capital InterNotes® bear interest at fixed interest rates and offer a variety of maturities no less than twelve months from the original date of issuance. Since the inception of the InterNotes® Offering, the Company has issued $430.1 million in aggregate principal amount of Prospect Capital InterNotes® for net proceeds of approximately $419.3 million. The Prospect Capital InterNotes® were issued with variable and fixed interest rates ranging from 3.28% to 7.00% with an average rate of 5.63%, and maturities ranging from July 15, 2018 to August 15, 2043. The Prospect Capital InterNotes® may be issued with a Survivor's Option, which is a provision in such Note's supplemental indenture pursuant to which the Company will repay that Note, if requested by the authorized representative of the beneficial owner of that Note, following the death of the beneficial owner of the Note, so long as the Note was owned by that beneficial owner or the estate of that beneficial owner at least six months prior to the request. Each of the Prospect Capital InterNotes® issued thus far includes a Survivor's Option.

Under each indenture governing the Notes, there are certain events of default, the occurrence of which may lead to the Notes being due and payable immediately. An event of default under an indenture could have a material adverse effect on our business, financial conditions and results of operations.

If the Company undergoes a "fundamental change" as described in the indenture for each of the Senior Convertible Notes or Unsecured Senior Notes, holders may require the Company to repurchase all or part of their Senior Convertible Notes or Unsecured Senior Notes at a price equal to 100% of the principal amount of the Senior Convertible Notes or Unsecured Senior Notes, plus accrued and unpaid interest (including additional interest, if any).

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. We are a non-diversified company within the meaning of the 1940 Act.

We invest primarily in first and second lien senior loans and mezzanine debt. First and second lien senior loans generally are senior debt instruments that rank ahead of subordinated debt of a given portfolio company. These loans also have the benefit of security interests on the assets of the portfolio company, which may rank ahead of or be junior to other security interests. Mezzanine debt and our investments in CLOs are subordinated to senior loans and are generally unsecured. Our investments have generally ranged between $5 million and $250 million each, although the investment size may be more or less than this range. Our investment sizes are expected to grow as our capital base expands.

We also acquire controlling interests in companies in conjunction with making secured debt investments in such companies. These may be in several industries, including industrial, service, real estate and financial businesses.

We seek to maximize returns and minimize 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. 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. Such investments may also include purchases (either in the primary or secondary markets) of the equity and junior debt tranches of a type of such pools known as CLOs. Structurally, CLOs are entities that are formed to hold a portfolio of senior secured loans ("Senior Secured Loans") made to companies whose debt is rated below investment grade or, in limited circumstances, unrated. The Senior Secured Loans within a CLO are limited to Senior Secured Loans which meet specified credit and diversity criteria and are subject to concentration limitations in order to create an investment portfolio that is diverse by Senior Secured Loan, borrower, and industry, with limitations on non-U.S. borrowers. Within this 30% basket, we have and may make additional investments in debt and equity securities of financial companies and 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 the 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 an investment earlier if a liquidity event takes place, such as the sale or recapitalization of a portfolio company, or if we determine a sale of such investment to be in our best interest.

We have qualified and elected to be treated for U.S. Federal income tax purposes as a regulated 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."

Industry Sectors

While our original investments were concentrated in industrial and energy related companies, we continue to widen our focus in other sectors of the economy to diversify our portfolio holdings. Our portfolio is now well diversified into 36 industry categories with no individual industry comprising more than 14.6% of the portfolio on either a cost or fair value basis.

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

To value our assets, we follow the guidance of Accounting Standards Codification ("ASC") 820 that defines fair value, establishes a framework for measuring fair value in conformity with accounting principles generally accepted in the United States or America, or GAAP, and requires disclosures about fair value measurements.
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.

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.

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 an independent valuation firm engaged by our Board of Directors;
2) the independent valuation firms conduct independent appraisals and make their own independent assessment;
3) the Audit Committee of our Board of Directors reviews and discusses the preliminary valuation of the Investment Adviser and that of the independent valuation firms; 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 the Investment Adviser, the respective independent valuation firm and the Audit Committee.

Investments are valued utilizing a shadow bond approach, a market approach, an income approach, a liquidation approach, or a combination of approaches, as appropriate. The shadow bond and market approaches use 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.

Our investments in CLOs are classified as ASC 820 level 3 securities, and are valued using discounted cash flow model. The valuations have been accomplished through the analysis of the CLO deal structures to identify the risk exposures from the modeling point of view. For each security, the most appropriate valuation approach has been chosen from alternative approaches to ensure the most accurate valuation for each security. To value a CLO, both the assets and liabilities of the CLO capital structure need be modeled. We use a waterfall engine to store the collateral data, generate collateral cash flows from the assets, and distributes the cash flow to the liability structure based on the payment priorities, and discount them back using proper discount rates that incorporate all the risk factors. The main risk factors are: default risk, interest rate risk, downgrade risk, and credit spread risk.

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

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determined in good faith under the direction of 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

ASC Subtopic 820-10-05-1, The Fair Value Option for Financial Assets and Financial Liabilities, ("ASC 820-10-05-1") permits an entity to elect fair value as the initial and subsequent measurement attribute for many assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. We 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. Prospect Administration provides such managerial assistance on our behalf to portfolio companies when we are required to provide this assistance. We are also deemed to be providing managerial assistance to all portfolio companies that we control, either by ourselves or in conjunction with others.

Investment Adviser

Prospect Capital Management manages our investments as the Investment Adviser. Prospect Capital Management is a Delaware limited liability corporation that has been registered as an investment adviser under the Investment Adviser Act of 1940 (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 the Investment Adviser. We also depend, to a significant extent, on the 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 the 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 the Investment Adviser or that we will continue to have access to its investment professionals or its information and deal flow. Under the 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.

Staffing

Mr. John F. Barry III, our chairman and chief executive officer, Mr. Grier Eliasek, our chief operating officer and president, and Mr. Brian H. Oswald, our chief financial officer, chief compliance officer, treasurer and secretary, comprise our senior management. Over time, we expect to add additional officers and employees.

Messrs. Barry and Eliasek each also serves as an officer of Prospect Administration and performs his respective functions under the terms of the Administration Agreement. Our day-to-day investment operations are managed by Prospect Capital Management. In addition, we reimburse Prospect Administration for our allocable portion of expenses incurred by it in performing its obligations under the Administration Agreement, including rent and our allocable portion of the costs of our chief executive officer, president, chief financial officer, chief operating officer, chief compliance officer, treasurer and secretary and their respective staffs. See "Business—Management Services—Administration Agreement."

Properties

We do not own any real estate or other physical properties materially important to our operation. Our corporate headquarters are located at 10 East 40th Street, 44th Floor, New York, NY 10016, where we occupy an office space pursuant to the Administration Agreement.

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 matters that may arise out of these investigations, claims and proceedings will be subject to

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various uncertainties and, even if such matters are without merit, could result in the expenditure of significant financial and managerial resources.

We are not aware of any material pending legal proceeding, and no such material proceedings are contemplated to which we are a party or of which any of our property is subject.

Management

Our business and affairs are managed under the direction of our Board of Directors. Our Board of Directors currently consists of five directors, three of whom are not "interested persons" of the Company as defined in Section 2(a)(19) of the 1940 Act. We refer to these individuals as our independent directors. Our Board of Directors elects our officers to serve for a one-year term and until their successors are duly elected and qualify, or until their earlier removal or resignation.

Board Of Directors And Executive Officers

Under our charter, our directors are divided into three classes. Directors are elected for a staggered term of three years each, with a term of office of one of the three classes of directors expiring each year. At each annual meeting of our stockholders, the successors to the class of directors whose terms expire at such meeting are elected to hold office for a term expiring at the annual meeting of stockholders held in the third year following the year of their election. Each director holds office for the term to which he or she is elected and until his or her successor is duly elected and qualifies.

Directors and Executive Officers

Our directors and executive officers and their positions are set forth below. The address for each director and executive officer is c/o Prospect Capital Corporation, 10 East 40th Street, 44th Floor, New York, NY 10016.

Independent Directors

Name and Age	Position(s) Held with the Company	Term of Office(1) and Length of Time Served	Principal Occupation(s) During Past 5 Years	Number of Portfolios in Fund Complex Overseen by Director	Other Directorships Held by Director
William J. Gremp, 70	Director	Class II Director from 2006 to 2009; Class I Director since April 2010; Term expires 2014	Mr. Gremp is responsible for traditional banking services, credit and lending, private equity and corporate cash management with Merrill Lynch & Co. from 1999 to present.	One	Priority Senior Secured Income Fund, Inc. since October 28, 2012(2), Pathway Energy Infrastructure Fund, Inc. since February 19, 2013(2)
Eugene S. Stark, 55	Director	Class III Director since September 2008; Term expires 2013	Principal Financial Officer, Chief Compliance Officer and Vice President—Administration of General American Investors Company, Inc. from May 2005 to present.	One	Priority Senior Secured Income Fund, Inc. since October 28, 2012(2), Pathway Energy Infrastructure Fund, Inc. since February 19, 2013(2)
	Director			One	

Andrew C. Cooper, 51	Class II Director since February 2009; Term expires 2015	Mr. Cooper is an entrepreneur, who over the last 15 years has founded, built, run and sold three companies. He is Co-Chief Executive Officer of Unison Energy, LLC, a company that develops, owns and operates, distributed combined heat and power co-generation solutions.	Priority Senior Secured Income Fund, Inc. since October 28, 2012(2), Pathway Energy Infrastructure Fund, Inc. since February 19, 2013(2)

(1) Our Board of Directors is divided into three classes of directors serving staggered three-year terms. Mr. Gremp is a Class I director with a term that will expire in 2014, Mr. Eliasek and Mr. Cooper are Class II directors with terms that will expire in 2015 and Mr. Barry and Mr. Stark are Class III directors with terms that will expire in 2013.

(2) An investment company subject to the 1940 Act.

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Interested Directors

Name and Age	Position(s) Held with the Company	Term of Office(1) and Length of Time Served	Principal Occupation(s) During Past 5 Years	Number of Portfolios in Fund Complex Overseen by Director	Other Directorships Held by Director
John F. Barry III, 61(2)	Director, Chairman of the Board of Directors, and Chief Executive Officer	Class III Director since June 2004; Term expires 2013	Chairman and Chief Executive Officer of the Company; Managing Director of Prospect Capital Management and Prospect Administration since June 2004	One	None
M. Grier Eliasek, 40(2)	Director, Chief Operating Officer	Class II Director since June 2004; Term expires 2015	President and Chief Operating Officer of the Company, Managing Director of Prospect Capital Management and Prospect Administration, President and CEO of Priority Senior Secured Income Fund, Inc., President and COO of Priority Senior Secured Income Management, LLC, President and CEO of Pathway Energy Infrastructure Fund, Inc., President and COO of Pathway Energy Infrastructure Management, LLC.	One	Priority Senior Secured Income Fund, Inc. since October 28, 2012(2), Pathway Energy Infrastructure Fund, Inc. since February 19, 2013(2)

(1) Our Board of Directors is divided into three classes of directors serving staggered three-year terms. Mr. Gremp is a Class I director with a term that will expire in 2014, Mr. Eliasek and Mr. Cooper are Class II directors with terms that will expire in 2015 and Mr. Barry and Mr. Stark are Class III directors with terms that will expire in 2013.
(2) Messrs. Barry and Eliasek are each considered an "interested person" under the 1940 Act by virtue of serving as one of our officers and having a relationship with Prospect Capital Management.
(3) An investment company subject to the 1940 Act.

Information about Executive Officers who are not Directors

Name and Age	Position(s) Held with the Company	Term of Office and Length of Time Served	Principal Occupation(s) During Past Five Years
Brian H. Oswald, 52	Chief Financial Officer, Chief Compliance Officer,	November 2008 to present as Chief Financial Officer, Treasurer and Secretary and	Joined Prospect Administration as Managing Director

	Treasurer and Secretary	October 2008 to present as Chief Compliance Officer.	in June 2008.

Board Leadership Structure

The Board of Directors believes that the combined position of Chief Executive Officer of the Company and Chairman of the Board of Directors of the Company is a superior model that results in greater efficiency regarding management of the Company, reduced confusion due to the elimination of the need to transfer substantial information quickly and repeatedly between a chief executive officer and chairman, and business advantages to the Company arising from the specialized knowledge acquired from the duties of the dual roles. The need for efficient decision making is particularly acute in the line of business of the Company, whereby multiple factors including market factors, interest rates and innumerable other financial metrics change on an ongoing and daily basis.

The Company's Board of Directors does not currently have a designated lead independent director. Instead, all of the independent directors play an active role on the Board of Directors. The independent directors compose a majority of the Company's Board of Directors, and are closely involved in all material board level deliberations related to the Company. The Board of Directors believes that, with these practices, each independent director has an equal stake in the Board's actions and oversight role and equal accountability to the Company and its stockholders. The Company believes that Eugene Stark acts as the de facto lead independent director, by virtue of his role as an accounting expert and Chairman of the Audit Committee.

Director Independence

On an annual basis, each member of our Board of Directors is required to complete an independence questionnaire designed to provide information to assist the Board of Directors in determining whether the director is independent. Our Board of Directors has determined that each of our directors, other than Messrs. Barry and Eliasek, is independent under the 1940 Act.

Role of the Chairman and Chief Executive Officer

As Chairman of the Board of Directors and Chief Executive Officer, Mr. Barry assumes a leading role in mid- and long-term strategic planning and supports major transaction initiatives of the Company. Mr. Barry also manages the day-to-day operations of the Company, with the support of the other executive officers. As Chief Executive Officer, Mr. Barry has general responsibility for the implementation of the policies of the Company, as determined by the Board of Directors, and for the management of the business and affairs of the Company. The Board of Directors has determined that its leadership structure, in which the majority of the directors are not affiliated with the Company, Prospect Capital Management or Prospect Administration, is appropriate in light of the services that Prospect Capital Management and Prospect Administration and their affiliates provide to the Company and the potential conflicts of interest that could arise from these relationships.

Experience, Qualifications, Attributes and/or Skills that Led to the Board's Conclusion that such Members Should Serve as Director of the Company

The Board believes that, collectively, the directors have balanced and diverse experience, qualifications, attributes and skills, which allow the Board to operate effectively in governing the Company and protecting the interests of its stockholders. Below is a description of the various experiences, qualifications, attributes and/or skills with respect to each director considered by the Board.

John F. Barry III

The Board benefits from Mr. Barry's years of experience in the investment banking and the financial advisory industries, as well as his service on multiple boards for various companies. In addition to overseeing the Company, Mr. Barry has served on the boards of directors of private and public companies, including financial services, financial technology and energy companies. Mr. Barry also managed an investment bank, focusing on private equity and debt financing for energy and other companies, and was the founding member of the project finance group at Merrill Lynch & Co. The Board also benefits from Mr. Barry's past experience as a corporate securities lawyer at a premiere United States law firm, advising energy companies and their commercial and investment bankers. Mr. Barry is also chairman of the board of directors of the Mathematics Foundation of America, a non-profit foundation which enhances opportunities in mathematics education for students from diverse backgrounds. Mr. Barry's longstanding service as Chairman and Chief Executive Officer of the Company and as a Managing Director of Prospect Capital Management and Prospect Administration provide him with a specific understanding of the Company, its operation, and the business and regulatory issues facing the Company.

M. Grier Eliasek

Mr. Eliasek brings to the Board business leadership and experience and knowledge of senior loan, mezzanine, bridge loan, private equity and venture capital investments, as well as a knowledge of diverse management practices.

Mr. Eliasek is the President and Chief Operating Officer of the Company and a Managing Director of Prospect Capital Management and Prospect Administration. He is also responsible for leading the origination and assessment of investments for the Company. The Board also benefits from Mr. Eliasek's experience as a consultant with Bain & Company, a global strategy consulting firm, where he managed engagements for companies in several different industries, by providing the Company with unique views on investment and management issues. At Bain & Company, Mr. Eliasek analyzed new lines of businesses, developed market strategies, revamped sales organizations, and improved operational performance for Bain & Company clients. Mr. Eliasek's longstanding service as Director, President and Chief Operating Officer of the Company and as a Managing Director of Prospect Capital Management and Prospect Administration provide him with a specific understanding of the Company, its operation, and the business and regulatory issues facing the Company.

Andrew C. Cooper

Mr. Cooper's over 25 years of experience in venture capital management, venture capital investing and investment banking provides the Board with a wealth of leadership, business investing and financial experience. Mr. Cooper's experience as the co-founder, director and former co-CEO of Unison Site Management LLC, a leading cellular site owner with 2,000 plus cell sites which generate more than $40 million in annual cash flow, and as co-founder, CFO and VP of business development for Avesta Technologies, an enterprise, information and technology management software company bought by Visual Networks in 2000, provides the Board with the benefit of leadership and experience in finance and management. Mr. Cooper also serves on the board of Brand Asset Digital, Aquatic Energy and the Madison Square Boys and Girls Club of New York. Further, Mr. Cooper's time as a director of CSG Systems, Protection One Alarm, LionBridge Technologies and Weblink Wireless, provides the Board with a wealth of experience and an in-depth understanding of management practices. Mr. Cooper's knowledge of financial and accounting matters qualifies him to serve on the Company's Audit Committee and his independence from the Company, Prospect Capital Management and Prospect Administration enhances his service as a member of the Nominating and Corporate Governance Committee.

William J. Gremp
Mr. Gremp brings to the Board a broad and diverse knowledge of business and finance as a result of his career as an investment banker, spanning over 40 years working in corporate finance and originating and executing transactions and advisory assignments for energy and utility related clients. Since 1999, Mr. Gremp has been responsible for traditional banking services, credit and lending, private equity and corporate cash management with Merrill Lynch & Co.. From 1996 to 1999, he served at Wachovia as senior vice president, managing director and co-founder of the utilities and energy investment banking group, responsible for origination, structuring, negotiation and successful completion of transactions utilizing investment banking, capital markets and traditional commercial banking products. From 1990 to 1996, Mr. Gremp was the managing director of global power and project finance at JPMorgan Chase & Co., and from 1970 to 1990, Mr. Gremp was with Merrill Lynch & Co., starting out as an associate in the mergers and acquisitions department, then in 1986 becoming the senior vice president, managing director and head of the regulated industries group. Mr. Gremp's knowledge of financial and accounting matters qualifies him to serve on the Company's Audit Committee and his independence from the Company, Prospect Capital Management and Prospect Administration enhances his service as a member of the Nominating and Corporate Governance Committee.
Eugene S. Stark
Mr. Stark brings to the Board over 25 years of experience in directing the financial and administrative functions of investment management organizations. The Board benefits from his broad experience in financial management; SEC reporting and compliance; strategic and financial planning; expense, capital and risk management; fund administration; due diligence; acquisition analysis; and integration activities. Since May 2005, Mr. Stark's position as the Principal Financial Officer, Chief Compliance Officer and Vice President of Administration at General American Investors Company, Inc., where he is responsible for operations, compliance, and financial functions, allows him to provide the Board with added insight into the management practices of other financial companies. From January to April of 2005, Mr. Stark was the Chief Financial Officer of the Company, prior to which he worked at Prudential Financial, Inc. between 1987 and 2004. His many positions within Prudential include 10 years as Vice President and Fund Treasurer of Prudential Mutual Funds, 4 years as Senior Vice President of Finance of Prudential Investments, and 2 years as Senior Vice President of Finance of Prudential Amenities. Mr. Stark is also a Certified Public Accountant. Mr. Stark's knowledge of financial and accounting matters qualifies him to serve on the Company's Audit Committee and his independence from the Company, Prospect Capital Management and Prospect Administration enhances his service as a member of the Nominating and Corporate Governance Committee. Mr. Stark is also a member of Mount Saint Mary Academy's Finance Committee.
Means by Which the Board of Directors Supervises Executive Officers
The Board of Directors is regularly informed on developments and issues related to the Company's business, and monitors the activities and responsibilities of the executive officers in various ways.
At each regular meeting of the Board of Directors, the executive officers report to the Board of Directors on developments and important issues. Each of the executive officers, as applicable, also provide regular updates to the members of the Board of Directors regarding the Company's business between the dates of regular meetings of the Board of Directors.
Executive officers and other members of Prospect Capital Management, at the invitation of the Board of Directors, regularly attend portions of meetings of the Board of Directors and its committees to report on the financial results of the Company, its operations, performance and outlook, and on areas of the business within their responsibility, including risk management and management information systems, as well as other business matters.
The Board's Role in Risk Oversight
The Company's Board of Directors performs its risk oversight function primarily through (a) its two standing committees, which report to the entire Board of Directors and are comprised solely of independent directors and (b) monitoring by the Company's Chief Compliance Officer in accordance with its compliance policies and procedures.
As set forth in the descriptions regarding the Audit Committee and the Nominating and Governance Committee, the Audit Committee and the Nominating and Governance Committee assist the Board of Directors in fulfilling its risk

oversight responsibilities. The Audit Committee's risk oversight responsibilities include reviewing and discussing with management and the independent accountants the annual audited financial statements of the Company, including disclosures made in management's discussion and analysis; reviewing and discussing with management and the independent accountants the Company's quarterly financial statements prior to the filings of its quarterly reports on Form 10-Q; pre-approving the independent accountants' engagement to render audit and/or permissible non-audit services; and evaluating the qualifications, performance and independence of the independent accountants. The Nominating and Governance Committee's risk oversight responsibilities include selecting qualified nominees to be elected to the Board of Directors by stockholders; selecting qualified nominees to fill any vacancies on the Board of Directors or a committee thereof; developing and recommending to the Board of Directors a set of corporate governance principles applicable to the Company; and overseeing the evaluation of the Board of Directors and management. Both the Audit Committee and the Nominating and Governance Committee consist solely of independent directors.

The Company's Board of Directors also performs its risk oversight responsibilities with the assistance of the Chief Compliance Officer. The Company's Chief Compliance Officer prepares a written report annually discussing the adequacy and effectiveness of the compliance policies and procedures of the Company and certain of its service providers. The Chief Compliance Officer's report, which is reviewed by the Board of Directors, addresses at a minimum (a) the operation of the compliance policies and procedures of the Company and certain of its service providers since the last report; (b) any material changes to such policies and procedures since the last report; (c) any recommendations for material changes to such policies and procedures as a result of the Chief Compliance Officer's annual review; and (d) any compliance matter that has occurred since the date of the last report about which the Board of Directors would reasonably need to know to oversee the Company's compliance activities and risks. In addition, the Chief Compliance Officer meets separately in executive session with the independent directors at least once each year.

The Company believes that its Board of Director's role in risk oversight is effective and appropriate given the extensive regulation to which it is already subject as a business development company, or BDC, under the 1940 Act. Specifically, as a BDC the Company must comply with certain regulatory requirements that control certain types of risk in its business and operations. For example, the Company's ability to incur indebtedness is limited such that its asset coverage must equal at least 200% immediately after each time it incurs indebtedness, the Company generally has to invest at least 70% of its total assets in "qualifying assets." In addition, the Company elected to be treated as a regulated investment company, or RIC, under Subchapter M of the Internal Revenue Code, as amended. As a RIC, the Company must, among other things, meet certain income source and asset diversification requirements.

The Company believes that the extent of its Board of Directors' (and its committees') role in risk oversight complements its Board's leadership structure because it allows the Company's independent directors to exercise oversight of risk without any conflict that might discourage critical review through the two fully independent board committees, auditor and independent valuation providers, and otherwise.

The Company believes that a board's roles in risk oversight must be evaluated on a case by case basis and that the Board of Directors' practices concerning risk oversight is appropriate. However, the Company continually re-examines the manners in which the Board administers its oversight function on an ongoing basis to ensure that they continue to meet the Company's needs.

Committees of the Board of Directors

Our Board of Directors has established an Audit Committee and a Nominating and Corporate Governance Committee. For the fiscal year ended June 30, 2013, our Board of Directors held 17 Board of Director meetings, 9 Audit Committee meetings, and 1 Nominating and Corporate Governance Committee meetings. All directors attended at least 75% of the aggregate number of meetings of the Board of Directors and of the respective committees on which they served. We require each director to make a diligent effort to attend all board and committee meetings, as well as each annual meeting of stockholders. Three directors attended last year's annual meeting of stockholders in person.

The Audit Committee. The Audit Committee operates pursuant to a charter approved by the Board of Directors. The charter sets forth the responsibilities of the Audit Committee, which include selecting or retaining each year an independent registered public accounting firm, or independent accountants, to audit the accounts and records of the Company; reviewing and discussing with management and the independent accountants the annual audited financial statements of the Company, including disclosures made in management's discussion and analysis, and recommending to the Board of Directors whether the audited financial statements should be included in the Company's annual report on Form 10-K; reviewing and discussing with management and the independent accountants the Company's quarterly financial statements prior to the filings of its quarterly reports on Form 10-Q; pre-approving the independent accountants' engagement to render audit and/or permissible non-audit services; and evaluating the qualifications, performance and independence of the independent accountants. The Audit Committee is presently composed of three persons: Messrs. Cooper, Gremp and Stark, each of whom is not an "interested person" as defined in the 1940 Act and is considered independent under applicable NASDAQ rules, with Mr. Stark serving as chairman of the committee.

The Board of Directors has determined that Mr. Stark is an "audit committee financial expert" as that term is defined under Item 407 of Regulation S-K. The Audit Committee may delegate its pre-approval responsibilities to one or more of its members. The member(s) to whom such responsibility is delegated must report, for informational purposes only, any pre-approval decisions to the Audit Committee at its next scheduled meeting. Messrs. Cooper, Gremp and Stark were added to the Audit Committee concurrent with their election to the Board of Directors on February 12, 2009, April 1, 2010 and September 4, 2008, respectively.

The function of the Audit Committee is oversight. Our management is primarily responsible for maintaining appropriate systems for accounting and financial reporting principles and policies and internal controls and procedures that provide for compliance with accounting standards and applicable laws and regulations. The independent accountants are primarily responsible for planning and carrying out a proper audit of our annual financial statements in accordance with generally accepted accounting standards. The independent accountants are accountable to the Board of Directors and the Audit Committee, as representatives of our stockholders. The Board of Directors and the Audit Committee have the ultimate authority and responsibility to select, evaluate and, where appropriate, replace our independent accountants (subject, if applicable, to stockholder ratification).

In fulfilling their responsibilities, it is recognized that members of the Audit Committee are not our full-time employees or management and are not, and do not represent themselves to be, accountants or auditors by profession. As such, it is not the duty or the responsibility of the Audit Committee or its members to conduct "field work" or other types of auditing or accounting reviews or procedures, to determine that the financial statements are complete and accurate and are in accordance with generally accepted accounting principles, or to set auditor independence standards. Each member of the Audit Committee shall be entitled to rely on (a) the integrity of those persons within and outside us and management from which it receives information; (b) the accuracy of the financial and other information provided to the Audit Committee absent actual knowledge to the contrary (which shall be promptly reported to the Board of Directors); and (c) statements made by our officers and employees, our investment adviser or other third parties as to any information technology, internal audit and other non-audit services provided by the independent accountants to us.

The Nominating and Corporate Governance Committee. The Nominating and Corporate Governance Committee, or Nominating and Governance Committee, is responsible for selecting qualified nominees to be elected to the Board of Directors by stockholders; selecting qualified nominees to fill any vacancies on the Board of Directors or a committee thereof; developing and recommending to the Board of Directors a set of corporate governance principles applicable to the Company; overseeing the evaluation of the Board of Directors and management; and undertaking such other duties and responsibilities as may from time to time be delegated by the Board of Directors to the Nominating and Governance Committee. The Nominating and Governance Committee takes into consideration the educational, professional and technical backgrounds and diversity of each nominee when evaluating such nominees to be elected to the Board of Directors. The Nominating and Governance Committee does not have a formal policy with respect to diversity. The Nominating and Governance Committee is presently composed of three persons: Messrs. Cooper, Gremp and Stark, each of whom is not an "interested person" as defined in the 1940 Act and is considered independent under applicable NASDAQ rules, with Mr. Gremp serving as chairman of the committee.

Messrs. Cooper, Gremp and Stark were added to the Nominating and Governance Committee concurrent with their election to the Board of Directors on February 12, 2009, April 1, 2010 and September 4, 2008, respectively.

The Nominating and Governance Committee will consider stockholder recommendations for possible nominees for election as directors when such recommendations are submitted in accordance with the Company's Bylaws and any applicable law, rule or regulation regarding director nominations. Nominations should be sent to the Corporate Secretary c/o Prospect Capital Corporation, 10 East 40th Street, 44th Floor, New York, New York 10016. When submitting a nomination to the Company for consideration, a stockholder must provide all information that would be required under applicable Commission rules to be disclosed in connection with election of a director, including the following minimum information for each director nominee: full name, age and address; principal occupation during the past five years; current directorships on publicly held companies and investment companies; number of shares of our common stock owned, if any; and, a written consent of the individual to stand for election if nominated by the Board of Directors and to serve if elected by the stockholders. Criteria considered by the Nominating and Governance Committee in evaluating the qualifications of individuals for election as members of the Board of Directors include compliance with the independence and other applicable requirements of the NASDAQ rules and the 1940 Act and all other applicable laws, rules, regulations and listing standards, the criteria, policies and principles set forth in the Nominating and Corporate Governance Committee Charter, and the ability to contribute to the effective management of the Company, taking into account our needs and such factors as the individual's experience, perspective, skills, expertise and knowledge of the industries in which the Company operates, personal and professional integrity, character, business judgment, time availability in light of other commitments, dedication, and conflicts of interest. The Nominating and Governance Committee also may consider such other factors as it may deem to be in our best interests and those of our stockholders. The Board of Directors also believes it is appropriate for certain key members of our management to participate as members of the Board of Directors.

Corporate Governance

Corporate Governance Guidelines. Upon the recommendation of the Nominating and Governance Committee, the Board of Directors has adopted Corporate Governance Guidelines on behalf of the Company. These Corporate Governance Guidelines address, among other things, the following key corporate governance topics: director responsibilities; the size, composition, and membership criteria of the Board of Directors; composition and responsibilities of directors serving on committees of the Board of Directors; director access to officers, employees, and independent advisors; director orientation and continuing education; director compensation; and an annual performance evaluation of the Board of Directors.

Code of Conduct. We have adopted a code of conduct which applies to, among others, our senior officers, including our Chief Executive Officer and Chief Financial Officer, as well as all of our employees. Our code of conduct is an exhibit to our Annual Report on Form 10-K filed with the SEC, and can be accessed via the Internet site of the SEC at http://www.sec.gov. We intend to disclose amendments to or waivers from a required provision of the code of conduct on Form 8-K.

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.

Internal Reporting and Whistle Blower Protection Policy. The Company's Audit Committee has established guidelines and procedures regarding the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, collectively, Accounting Matters, and the confidential, anonymous submission by our employees of concerns regarding questionable accounting or auditing matters. Persons with complaints or concerns regarding Accounting Matters may submit their complaints to our Chief Compliance Officer, or CCO. Persons who are uncomfortable submitting complaints to the CCO, including complaints involving the CCO, may submit complaints directly to our Audit Committee Chairman. Complaints may be submitted on an anonymous basis.

The CCO may be contacted at: Prospect Capital Corporation, Chief Compliance Officer, 10 East 40th Street, 44th Floor, New York, New York 10016.

The Audit Committee Chairman may be contacted at: Prospect Capital Corporation, Audit Committee Chairman, 10 East 40th Street, 44th Floor, New York, New York 10016.

Independent Directors

The Board of Directors, in connection with the 1940 Act and the applicable Marketplace Rules of NASDAQ, has considered the independence of members of the Board of Directors who are not employed by Prospect Capital Management and has concluded that Messrs. Cooper, Gremp and Stark are not "interested persons" as defined by the 1940 Act and therefore qualify as independent directors under the standards promulgated by the Marketplace Rules of NASDAQ. In reaching this conclusion, the Board of Directors concluded that Messrs. Cooper, Gremp and Stark had no relationships with Prospect Capital Management or any of its affiliates, other than their positions as directors of the Company and, if applicable, investments in us that are on the same terms as those of other stockholders.

Proxy Voting Policies And Procedures

We have delegated our proxy voting responsibility to Prospect Capital Management. The guidelines are reviewed periodically by Prospect Capital Management and our non-interested directors, and, accordingly, are subject to change. See "Regulation—Proxy Voting Policies and Procedures."

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Compensation of Directors and Officers

The following table sets forth information regarding the compensation received by the directors and executive officers from the Company for the fiscal year ended June 30, 2013. No compensation is paid to the interested directors by the Company.

Name and Position	Aggregate Compensation from the Company	Pension or Retirement Benefits Accrued as Part of the Company's Expenses(1)	Total Compensation Paid to Director/ Officer
Interested Directors			
John F. Barry III(2)	None	None	None
M. Grier Eliasek(2)	None	None	None
Independent Directors			
Andrew C. Cooper(3)	$ 100,000	None	$ 100,000
William J. Gremp(4)	$ 100,000	None	$ 100,000
Eugene S. Stark(5)	$ 100,000	None	$ 100,000
Executive Officers			
Brian H. Oswald(2)	None	None	None

(1) We do not have a bonus, profit sharing or retirement plan, and directors do not receive any pension or retirement benefits.

(2) We have not paid, and we do not intend to pay, any annual cash compensation to our executive officers for their services as executive officers. Messrs. Barry and Eliasek are compensated by Prospect Capital Management from the income Prospect Capital Management receives under the management agreement between Prospect Capital Management and us. Mr. Oswald is compensated from the income Prospect Administration receives under the administration agreement.

(3) Mr. Cooper joined our Board of Directors on February 12, 2009.

(4) Mr. Gremp joined our Board of Directors on April 1, 2010.

(5) Mr. Stark joined our Board of Directors on September 4, 2008.

No compensation was paid to directors who are interested persons of the Company as defined in 1940 Act. In addition, the Company purchases directors' and officers' liability insurance on behalf of the directors and officers.

Management Services

Investment Advisory Agreement

We have entered into the Investment Advisory Agreement with Prospect Capital Management 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% on our gross assets (including amounts borrowed). For services 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, which is payable quarterly in arrears, will equal 20% of the excess, if any, of our pre-incentive fee net investment income that exceeds a 1.75% quarterly (7% annualized) hurdle rate, subject to a "catch up" provision measured as of the end of each calendar quarter. In the three months ended June 30, 2013, we paid an incentive fee of $23.0 million (see calculation below). 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

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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% annualized).

We expect the incentive fees we pay to increase to the extent we earn greater interest and dividend income through our investments in portfolio companies and, to a lesser extent, realize capital gains upon the sale of warrants or other equity investments in our portfolio companies and to decrease if our interest and dividend income and capital gains decrease. The "catch-up" provision requires us to pay 100% of our pre-incentive fee net investment income with respect to that portion of such income, if any, that exceeds the hurdle rate but is less than 125% of the quarterly hurdle rate in any calendar quarter (8.75% annualized assuming an annualized hurdle rate of 7%). The catch-up provision is meant to provide Prospect Capital Management with 20% of our pre-incentive fee net investment income as if a hurdle rate did not apply when our pre-incentive fee net investment income exceeds 125% of the quarterly hurdle rate in any calendar quarter (8.75% annualized assuming an annualized hurdle rate of 7%). The income incentive fee will be computed and paid on income that may include interest that is accrued but not yet received in cash. If interest income is accrued but never paid, the Board of Directors would decide to write off the accrual in the quarter when the accrual is determined to be uncollectible. The write off would cause a decrease in interest income for the quarter equal to the amount of the prior accrual. The Investment Adviser is not under any obligation to reimburse us for any part of the incentive fee it received that was based on accrued income that we never receive as a result of a default by an entity on the obligation that resulted in the accrual of such income.

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% 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% 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 out of 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. 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% of such amount, less the aggregate amount of any capital gains incentive fees paid since inception.

The actual transfer or sale of assets by Prospect to a SPE established by Prospect and consolidated with Prospect is disregarded for purposes of calculating the incentive fee.

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The following is a calculation of the most recently paid incentive fee paid in July 2013 (for the quarter ended June 30, 2013) (in thousands):

Prior Quarter Net Asset Value (adjusted for stock offerings during the quarter)	$2,615,648	
Quarterly Hurdle Rate	1.75	%
Current Quarter Hurdle	$45,774	
125% of the Quarterly Hurdle Rate	2.1875	%
125% of the Current Quarter Hurdle	$57,217	
Current Quarter Pre Incentive Fee Net Investment Income	$115,120	
Incentive Fee—"Catch-Up"	$11,443	
Incentive Fee—20% in excess of 125% of the Current Quarter Hurdle	$11,581	
Total Current Quarter Incentive Fee	$23,024	

The total base management fees earned by and paid to Prospect Capital Management during the twelve months ended June 30, 2013, June 30, 2012 and June 30, 2011 were $69.8 million, $35.8 million and $22.5 million, respectively. The income incentive fees were $81.2 million, $46.7 million and $23.6 million for the twelve months ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively. No capital gains incentive fees were earned for the twelve months ended June 30, 2013, June 30, 2012 and June 30, 2011.

The total investment advisory fees were $151.0 million, $82.5 million and $46.1 million for the twelve months ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively.

Because of the structure of the incentive fee, it is possible that we may have to pay an incentive fee in a quarter where we incur a loss. For example, if we receive pre-incentive fee net investment income in excess of the hurdle rate for a quarter, we will pay the applicable income incentive fee even if we have incurred negative total return in that quarter due to realized or unrealized losses on our investments.

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%

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

(1) Represents 7% annualized hurdle rate

(2) Represents 2% annualized base management fee.

(3) Excludes organizational and offering expenses.

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.

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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%

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(1) Represents 7% annualized hurdle rate
(2) Represents 2% annualized base management fee.
(3) Excludes organizational and offering expenses.

Pre-incentive fee net investment income (investment income - (base management fee + other expenses)) = 2%
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% - 1.75%)) + 0% = 100% × 0.25% + 0% = 0.25%)

Alternative 3
Assumptions
Investment income (including interest, dividends, fees, etc.) = 3%
Hurdle rate(1) = 1.75%
Base management fee(2) = 0.50%
Other expenses (legal, accounting, custodian, transfer agent, etc.)(3) = 0.20%

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(1) Represents 7% annualized hurdle rate.
(2) Represents 2% annualized base management fee.
(3) Excludes organizational and offering expenses.

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%

Example 2: Capital Gains Incentive Fee:
Alternative 1
Assumptions

- Year 1: $20 million investment made
- Year 2: Fair market value, or FMV of investment determined to be $22 million

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- Year 3: FMV of investment determined to be $17 million
- Year 4: Investment sold for $21 million

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)

Alternative 3

Assumptions

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

Payment of our expenses

All investment professionals of the Investment Adviser and its 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 firms); 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 his staff, including the internal legal staff.

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 May 3, 2013 for an additional one-year term expiring June 22, 2014. 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."

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.

We reimbursed Prospect Administration $8.7 million, $6.8 million and $5.0 million for the twelve months ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively, for services it provided to the Company at cost.

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.

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 our administrator.

Board of Directors approval of the Investment Advisory Agreement

On May 3, 2013, our Board of Directors voted unanimously to renew the Investment Advisory Agreement for the 12-month period ending June 22, 2014. In its consideration of the Investment Advisory Agreement, the Board of Directors focused on information it had received relating to, among other things: (a) the nature, quality and extent of the advisory and other services to be provided to us by Prospect Capital Management; (b) comparative data with respect to advisory fees or expense ratios paid by other business development companies with similar investment objectives; (c) our projected operating expenses; (d) the projected profitability of Prospect Capital Management and any existing and potential sources of indirect income to Prospect Capital Management or Prospect Administration from their relationships with us and the profitability of those relationships; (e) information about the services to be performed and the personnel performing such services under the Investment Advisory Agreement; (f) the organizational capability and financial condition of Prospect Capital Management and its affiliates and (g) the possibility of obtaining similar services from other third party service providers or through an internally managed structure. In approving the renewal of the Investment

Advisory Agreement, the Board of Directors, including all of the directors who are not "interested persons," considered the following:

- Nature, Quality and Extent of Services. The Board of Directors considered the nature, extent and quality of the investment selection process employed by Prospect Capital Management. The Board of Directors also considered Prospect Capital Management's personnel and their prior experience in connection with the types of investments made by us. The Board of Directors concluded that the services to be provided under the Investment Advisory Agreement are generally the same as those of comparable business development companies described in the available market data.
- Investment Performance. The Board of Directors reviewed our investment performance as well as comparative data with respect to the investment performance of other externally managed business development companies. The Board of Directors concluded that Prospect Capital Management was delivering results consistent with our investment objective and that our investment performance was satisfactory when compared to comparable business development

companies.

- The reasonableness of the fees paid to Prospect Capital Management. The Board of Directors considered comparative data based on publicly available information on other business development companies with respect to services rendered and the advisory fees (including the management fees and incentive fees) of other business development companies as well as our projected operating expenses and expense ratio compared to other business development companies. The Board of Directors, on behalf of the Company, also considered the profitability of Prospect Capital

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Management. Based upon its review, the Board of Directors concluded that the fees to be paid under the Investment Advisory Agreement are reasonable compared to other business development companies.

- Economies of Scale. The Board of Directors considered information about the potential of Prospect Capital Management to realize economies of scale in managing our assets, and determined that at this time there were not economies of scale to be realized by Prospect Capital Management.

Based on the information reviewed and the discussions detailed above, the Board of Directors (including all of the directors who are not "interested persons") concluded that the investment advisory fee rates and terms are fair and reasonable in relation to the services provided and approved the renewal of the Investment Advisory Agreement with Prospect Capital Management as being in the best interests of the Company and its stockholders.

Portfolio Managers

The following individuals function as portfolio managers primarily responsible for the day-to-day management of our portfolio. Our portfolio managers are not responsible for day-to-day management of any other accounts. For a description of their principal occupations for the past five years, see above.

Name	Position	Length of Service with Company (Years)
John F. Barry III	Chairman and Chief Executive Officer	9
M. Grier Eliasek	President and Chief Operating Officer	9

Mr. Eliasek receives no compensation from the Company. Mr. Eliasek receives a salary and bonus from Prospect Capital Management that takes into account his role as a senior officer of the Company and of Prospect Capital Management, his performance and the performance of each of Prospect Capital Management and the Company.

Mr. Barry receives no compensation from the Company. Mr. Barry, as the sole member of Prospect Capital Management, receives a salary and/or bonus from Prospect Capital Management and is entitled to equity distributions after all other obligations of Prospect Capital Management are met.

The following table sets forth the dollar range of our common stock beneficially owned by each of the portfolio managers described above as of June 30, 2013.

Name	Aggregate Dollar Range of Common Stock Beneficially Owned by Prospect Capital Management
John F. Barry III	Over $100,000
M. Grier Eliasek	Over $100,000

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 $5.3 million, $1.6 million and $1.3 million of managerial assistance fees for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively, of which $1.3 million, $165,000 and $128,000 remains on the consolidated statement of assets and liabilities as of June 30, 2013, June 30, 2012 and June 30, 2011, 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.

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.

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CERTAIN RELATIONSHIPS AND TRANSACTIONS

We have entered into the Investment Advisory Agreement with Prospect Capital Management. Our Chairman of the Board of Directors is the sole member of and controls Prospect Capital Management. Our senior management may in the future also serve as principals of other investment managers affiliated with Prospect Capital Management that may in the future manage investment funds with investment objectives similar to ours. In addition, our executive officers and directors and the principals of 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 affiliates. Accordingly, we may not be given the opportunity to participate in certain investments made by investment funds managed by advisers affiliated with Prospect Capital Management. However, our Investment Adviser and other members of the affiliated present and predecessor companies of Prospect Capital Management intend to allocate investment opportunities in a fair and equitable manner consistent with our investment objectives and strategies so that we are not disadvantaged in relation to any other client. See "Risk Factors—Risks Relating To Our Business—Potential conflicts of interest could impact our investment returns" and "Risk Factors—Risks Relating To Our Securities—Our ability to enter into transactions with our affiliates is restricted."

In addition, pursuant to the terms of the Administration Agreement, Prospect Administration provides, or arranges to provide, the Company with the office facilities and administrative services necessary to conduct our day-to-day operations. Prospect Capital Management is the sole member of and controls Prospect Administration.

CONTROL PERSONS AND PRINCIPAL STOCKHOLDERS

As of October 10, 2013, there were no persons that owned 25% or more of our outstanding voting securities, and we believe no person should be deemed to control us, as such term is defined in the 1940 Act.

The following table sets forth, as of October 10, 2013, certain ownership information with respect to our common stock for those persons who directly or indirectly own, control or hold with the power to vote, 5% or more of our outstanding common stock and all officers and directors, as a group. Unless otherwise indicated, we believe that the beneficial owners set forth in the tables below have sole voting and investment power.

Name and Address of Beneficial Owner	Number of Shares Beneficially Owned		Percentage of Class(1)	
5% or more holders				
Zazove Associates, LLC 1001 Tahoe Blvd. Incline Village, NV 89451	15,219,643	(2)	5.2	%
Executive officers and directors as a group	3,769,498		1.4	%

(*) Represents less than one percent.

(1) Based on a total of 276,844,568 shares of our common stock issued and outstanding as of October 10, 2013.

(2) Based upon a Schedule 13G filed with the SEC on February 5, 2013 by Zazove Associates, LLC, or Zazove. According to the Schedule 13G, all of the shares beneficially owned by Zazove represent shares issuable upon the conversion of certain convertible notes, or the Notes, issued by the Company and beneficially owned by Zazove. Notwithstanding the percentage of common stock noted, each of the Notes contain a provision that limits the holders of the Notes from converting the Notes to shares of common stock of the Company to the extent such conversion would cause the holder to become a beneficial owner of more than 5.0% of the Company's outstanding common stock at the time of conversion. Percentage of common stock outstanding included the conversion of these shares in the total outstanding.

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The following table sets forth the dollar range of our equity securities beneficially owned by each of our directors and officers as of June 30, 2013. We are not part of a "family of investment companies" as that term is defined in the 1940 Act.

Name of Director or Officer	Dollar Range of Equity Securities in the Company(1)
Independent Directors	
William J. Gremp	\$10,001 - \$50,000
Andrew C. Cooper	None
Eugene S. Stark	Over \$100,000
Interested Directors	
John F. Barry III(2)	Over \$100,000
M. Grier Eliasek	Over \$100,000
Officer	
Brian H. Oswald	Over \$100,000

(1) Dollar ranges are as follows: none, \$1-\$10,000, \$10,001-\$50,000, \$50,001-\$100,000 or over \$100,000.

(2) Represents an indirect beneficial ownership in shares of our common stock, that are beneficially owned directly by Prospect Capital Management, by reason of Mr. Barry's position as a control person of Prospect Capital Management.

PORTFOLIO COMPANIES

The following is a listing of our portfolio companies at June 30, 2013. Values are as of June 30, 2013.
The portfolio companies are presented in three categories: "companies more than 25% owned" are portfolio companies in which Prospect directly or indirectly owns more than 25% of the outstanding voting securities of such portfolio company and, therefore, such portfolio company is presumed to be controlled by us under the 1940 Act; "companies owned 5% to 25%" are portfolio companies where Prospect directly or indirectly owns 5% to 25% of the outstanding voting securities of such portfolio company and/or holds one or more seats on the portfolio company's Board of Directors and, therefore, such portfolio company is deemed to be an affiliated person with us under the 1940 Act; "companies less than 5% owned" are portfolio companies where Prospect directly or indirectly owns less than 5% of the outstanding voting securities of such portfolio company and where it has no other affiliations with such portfolio company. As of June 30, 2013, Prospect owned 100.0% of the fully diluted common equity of ESHI, 100.0% of the equity of Airmall, 100.0% of the common equity of Borga, 100.0% of the fully diluted common equity of The Healing Staff, Inc., 100.0% of the members unit of AWCNC, LLC, 100.0% of the common equity of Manx Energy, Inc., 100.0% of the common equity of Wolf Energy Holdings, Inc., 100.0% of the common equity of American Property Holdings Corp. through our wholly-owned entity, APH Property Holdings, LLC, 96.3% of the common equity of Valley Electric Co. of Mt. Vernon, Inc., through our wholly-owned entity, Valley Electric Holdings I, Inc., 95.13% of the common equity of CCPI Inc. through our wholly-owned entity, CCPI Holdings, Inc., 93.8% of the common equity of Nationwide Acceptance LLC, through our wholly-owned entity, Nationwide Acceptance Holdings, LLC, 88.3% of the fully diluted equity of R-V, 83.5% of the fully diluted preferred equity of NMMB Holdings, Inc., 80.1% of First Tower Holdings LLC through our wholly-owned entity, First Tower Holdings of Delaware LLC, 77.9% of the fully diluted equity of Ajax and 74.8% of the common equity of Credit Central Holdings LLC., through our wholly-owned entity, Credit Central Holdings of Delaware, LLC. Prospect makes available significant managerial assistance to its portfolio companies. Prospect generally requests and may receive rights to observe the meetings of its portfolio companies' Boards of Directors.

Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value

	(In millions of $)	(In millions of $)
Companies more than 25% owned		

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Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value
Airmail USA, Inc.	Property management Pennsylvania)	Senior secured debt, senior subordinated debt, convertible preferred stock and common equity	First priority lien on substantially all assets	Common shares; convertible preferred shares; senior secured term loan, 12% due 6/30/2015; senior subordinated term loan, 12.00% plus 6.00% PIK, due 12/31/2015	13.4	41.3
Ajax Rolled Ring and Machine, Inc.	Manufacturing (South Carolina)	Senior secured debt, subordinated unsecured debt, convertible preferred stock and common equity	First priority lien on substantially all assets	Common shares; Convertible Preferred shares; Senior secured note Tranche A, 10.50% due 3/30/2018; Subordinated unsecured note 11.50% plus 6.00% PIK, due 3/30/2018	—	39.4
APH Property Holdings, LLC.	Georgia/Real Estate	Senior secured debt, and common equity	First priority lien on substantially all assets	Common shares; Senior secured note 6.00% plus 5.50% PIK, due 10/24/2020	26.6	125.9
AWCNC, LLC	Machinery (North Carolina)	Members Units	N/A	Members units	—	—
Borga, Inc.	Manufacturing (California)	Revolving line of credit, senior secured debt, warrants and common equity	First priority lien on all assets and pledge of all stock	Warrants; common shares; Revolving line of credit, 5.00% plus 3.00% default interest, in non-accrual status effective 03/02/2010, past due; Senior secured Term Loan B, 8.50% plus 3.00% default interest,	—	0.6

				in non-accrual status effective 03/02/2010, past due; 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		
CCPI Holdings, Inc.	Ohio/ Manufacturing	Senior secured debt, net revenue interest and common equity	First priority lien on substantially all assets	Common shares; Net Revenue Interest; Senior secured note, 10.00% due 12/31/2017; Senior secured note, 12.00% plus 7.00% PIK, due 6/30/2018	8.6	25.3
Credit Central Holdings of Delaware, LLC.(1)	Ohio/ Consumer Finance	Senior secured debt, net revenue interest, Senior Secured revolving Credit facility and Common equity.	First priority lien on substantially all assets	Common shares; Net Revenue Interest; Senior secured revolving credit facility $60,000 commitment 20.00% due 12/31/2022	12.4	38.1

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Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value
Energy Solutions Holdings, Inc.	Gas Gathering and Processing (Texas)	Escrow receivable, Senior secured debt, subordinated secured debt, and common equity	First priority lien on substantially all assets	Escrow receivable, Common shares; Senior secured notes, 18.00% due 12/12/2016; Junior secured note, 18.00% due 12/12/2016; Subordinated secured note, 12.00% plus 4.00% PIK, in non-accrual status effective 10/1/2010, past due; Senior Secured Debt, in non-accrual status effective 01/01/2009, past due	6.2	20.4
First Tower Holdings of Delaware, LLC.(1)	Consumer Finance (Mississippi)	Senior Secured Revolving Credit Facility, common equity, net revenue interest	First priority lien on substantially all assets	Common shares; Net revenue interest; Senior Secured Revolving Credit Facility, 20.00% due 6/30/2022	33.3	264.8
Manx Energy, Inc.	Oil and Gas production (Kansas)	Senior secured debt, preferred stock and common	First priority lien on substantially all assets	Common shares; Preferred shares; senior secured note, 13.00%, in non-accrual status effective 1/19/2010, past due	—	0.3
Nationwide Acceptance Holdings, LLC.(1)	Consumer Finance (Chicago)	Senior secured debt, net revenue Interest, Senior Secured revolving credit facility, and	First priority lien on substantially all assets	Net Revenue Interest; Membership Units; Senior secured Revolving credit facility $30,000	3.8	21.3

		Membership units		Commitment 20.00% due 1/31/2023		
NMMB Holdings, Inc.	Media (New York)	Preferred stock, senior term debt and senior subordinated debt	First priority lien on substantially all assets	Preferred shares; senior term loan, 14.00% due 5/6/2016; senior subordinated term loan, 15.00% due 5/6/2016	—	13.1
R-V Industries, Inc.	Manufacturing (Pennsylvania)	Senior Subordinated Note, Warrants and common equity	First priority lien on substantially all assets	Common shares; Warrants, expiring 6/30/2017, Senior Subordinated Note, 10.00% due 6/12/2018	25.3	32.8
The Healing Staff, Inc.	Contracting (North Carolina)	Secured promissory note, Senior and junior secured debt, preferred stock and common equity	First priority lien on substantially all assets	Common shares; Preferred shares; Senior and junior secured notes, 7.00% plus 7.00% PIK plus 6.00% default interest, in non-accrual status effective 10/09/2007 past due; Senior demand note, 15.00%, in non-accrual status effective 11/1/2010 past due; Secured promissory note, 15%, in non-accrual status effective 12/22/2010, due 3/21/2012-12/18/2013	—	—

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Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value
Valley Electric Holdings I, Inc.	Construction & Engineering (Washington)	Senior Secured debt, common equity, and net revenue interest	First priority lien on substantially all assets	Common shares; net revenue interest; senior secured note 9.00% plus 9.00% PIK, due 12/31/2018; senior secured note 8.00% plus 2.5% PIK, due 12/31/2017	9.5	44.1
Wolf Energy Holdings, Inc	Oil & Gas Production (Kansas)	Senior Secured debt, common equity	First priority lien on substantially all assets	Common shares; Senior Secured Note 18.00% in non-accrual status effective 4/15/2013, due 4/15/2018; Senior secured note (AEH), 8% in non-accrual status effective 1/19/2010, past due; senior secured note (Coalbed), 8%, in non- accrual status effective 1/19/2010, past due;	0.5	4.4
Companies 5% to 25% owned						
Biotronic NeuroNetwork	Healthcare (Michigan)	Senior secured debt and preferred stock	First priority lien on substantially all assets	Preferred shares; Senior secured note, 10.00% due 12/17/2017	3.4	29.6
Boxercraft Incorporated	Textiles & Leather (Georgia)	Senior secured debt, subordinated secured debt preferred stock and common equity	First priority lien on substantially all assets	Common shares; Preferred shares; Warrants; Senior secured term loans 10.00% plus 1.00% PIK, due 9/15/2015	—	9.4
Smart, LLC	Diversified Conglomerate Service (New	Membership interests	N/A	Membership interests	0.1	—

	York)					
Companies less than 5% owned						
ADAPCO, Inc.	Ecological (Florida)	Common equity	N/A	Common shares	0.3	—
Aderant North America, Inc. LLC	Software & Computer Services (Georgia)	Second Lien Term Loan	Second priority lien on substantially all assets	Second Lien Term Loan 10.00% due 6/20/2019	—	7.0
Aircraft Fasteners International, LLC	Machinery (California)	Convertible preferred stock	N/A	Convertible preferred shares	0.6	—
ALG USA Holdings, LLC	Hotels, Restaurants & Leisure (Pennsylvania)	Second Lien Term Loan	Second priority lien on substantially all assets	Second Lien Term Loan 10.25%, due 2/28/2020	—	12.0
Allied Defense Group, Inc.	Aerospace & Defense (Virginia)	Common equity	N/A	Common shares	—	—
American Gilsonite Company	Specialty minerals (Utah)	Second lien term loan and membership interests	Second priority lien on substantially all assets	Membership interests; Second lien term loan 11.50% due 9/1/2017	4.1	38.5
Apidos CLO VIII(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Note (Residual Interest)	19.7	—
Apidos CLO IX, Ltd(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	19.3	—
Apidos CLO XI, Ltd(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	38.0	—
Apidos CLO XII, Ltd1(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	40.3	—
Arctic Glacier U.S.A, Inc.	Food Products (Canada)	Second Lien Term Loan	Second lien on all assets	Second Lien Term Loan, 11.25% due 11/10/2019	—	150.0

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Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value
Armor Holding II, LLC.	Diversified Financial Services (New York)	Second Lien Term Loan	Second lien on all assets	Second Lien Term Loan, 9.25% due 12/26/2020	—	7.0
Atlantis Healthcare Group (Puerto Rico), Inc.	Health Care (Puerto Rico)	Senior Term Loan and Revolving Line of Credit	First lien on all assets	Revolving Line of Credit 10.00%, due 2/21/2014; Senior Term Loan, 10.00% due 2/21/2018,	—	41.4
Babson CLO Ltd 2011-I(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	34.5	—
Babson CLO Ltd 2012-IA (1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	27.3	—
Babson CLO Ltd 2012-IIA(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	27.5	—
Blue Coat Systems, Inc.	Software & Computer Services (Massachusetts)	Second Lien Term Loan	Second lien on all other assets and equity pledge	Second Lien Term Loan, 9.50% due 6/28/2020	—	11.0
Broder Bros., Inc.	Textiles, Apparel & Luxury Goods (Pennsylvania)	Senior Secured Notes	First lien on all assets	Senior secured note, 10.75% due 6/27/2018	—	99.3
Brookside Mill CLO Ltd.(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	23.7	—
Byrider Systems Acquisition Corp.(1)	Auto Finance (Indiana)	Senior subordinated debt	Subordinated lien on substantially all assets	Senior subordinated note, 12.00% plus 2.00% PIK due 11/3/2016	—	10.4
Caleel & Hayden	Personal & Nondurable Consumer Products (Colorado)	Escrow receivable and Membership units	N/A	Escrow receivable and Membership units	0.2	—

Capstone Logistics, LLC	Commercial Services (Georgia)	Senior secured debt	First priority lien on substantially all assets	Senior secured Term Loan A, 6.50% due 9/16/2016; Senior secured Term Loan B, 11.50% due 9/16/2016;	—	197.3
Cargo Airport Services USA, LLC	Transportation (New York)	Common equity and senior secured debt	First priority lien on substantially all assets	Common shares; senior secured term loan, 10.50% due 3/31/2016	1.9	44.4
Cent 17 CLO Limited(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	25.5	—
CI Holdings Inc.	Software & Computer Services (Texas)	Senior Secured Notes	First lien on all assets	Senior secured term loan, 10.00% due 6/11/2019	—	114.7
CIFC Funding 2011-I, Ltd.(1)	Diversified Financial Services (Cayman Islands)	Secured Notes, Unsecured Notes	N/A	Secured Class D Notes 5.79% due 1/19/2023; Unsecured Class E Notes 7.79% due 1/19/2023;	—	28.6
Cinedigm DC Holdings, LLC.	Software & Computer Services (New York)	Senior Secured Notes	First lien on all assets	Senior secured term loan, 11.00% due 3/31/2021	—	70.6
The Copernicus Group, Inc.	Healthcare (North Carolina)	Escrow Receivable	N/A	Escrow Receivable	0.1	—
Correctional Healthcare	Healthcare (Colorado)	Second Lien Term Loan	Second lien on all assets	Second Lien Term Loan 11.25% due 1/11/2020	—	27.1
Coverall North America, Inc.	Commercial Services (Florida)	Senior Secured Term Loan	First Priority Lien	Senior Secured Lien Term Loan 11.50% due 12/17/2017	—	39.3
CP Well Testing, LLC	Oil & Gas Products (Oklahoma)	Senior secured debt	First Priority Lien	Senior secured term loan, 13.50% due 10/03/2017	—	19.1

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Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value
CRT MIDCO, LLC	Media (Wisconsin)	Senior secured debt	First priority lien on substantially all assets	Senior secured term loan, 10.5% due 6/30/2017	—	71.1
Deltek, Inc.	Software & Computer Services (Virginia)	Second Lien Term Loan	Second Priority Lien	Second Lien Term Loan, 10.00% due 10/10/2019	—	12.0
Diamondback Operating LP	Oil and gas production (Oklahoma)	Net profit interest	N/A	Net profit interest, 15.00%	—	—
Dover Saddlery, INc.	Retail (Massachusetts)	Common equity	N/A	Common shares	0.1	—
Edmentum, Inc., (f/k/a Archipelago Learning)	Consumer Services (Minnesota)	Second Lien Term Loan	Second priority lien on substantially all assets	Second lien term loan, 11.25% due 5/17/2019	—	50.0
EIG Investors Corp	Software & Computer Services (Illinois)	Second Lien Term Loan	Second priority lien on substantially all assets	Second lien term loan, 10.25% due 5/09/2020	—	22.0
Empire Today, LLC	Durable Consumer Products (Illinois)	Senior secured debt	First priority lien on substantially all assets	Senior secured note, 11.375% due 2/1/2017	—	14.7
Evanta Ventures, Inc.	Commerical Services (Oregon)	Subordinated unsecured debt	Unsecured	Subordinated Unsecured 12.00% plus 1.00% PIK, due 9/28/2018	—	10.5
EXL Acquistion Corp.	Biotechnology (South Carolina)	Escrow Receivable	N/A	Escrow Receivable	—	—
Fairchild Industrial Products, Co.	Electronics (North Carolina)	Escrow Receivable	N/A	Escrow Receivable	0.1	—
Fischbein, LLC	Machinery (North Carolina)	Escrow Receivable	N/A	Escrow Receivable	0.2	—
Focus Brands, Inc.	Consumer Services (Georgia)	Second Lien Term Loan	Second lien on all assets	Common equity; Second Lien Term Loan, 10.25% due 8/21/2018;	—	18.0
FPG, LLC	Durable Consumer Products (Illnois)	Senior secured debt, and common equity	First priority lien on substantially all assets	Senior secured Term Loan, 12.00% due 1/20/2017	—	21.4

Galaxy XII CLO, Ltd(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	21.7	—
Galaxy XV CLO, Ltd1(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	30.2	—
Grocery Outlet, Inc.	Retail (California)	Second Lien Term Loan	Second lien on all assets	Second Lien Term Loan, 10.50%, due 6/17/2019	—	14.5
Gulf Coast Machine & Supply Company	Manufacturing (Texas)	Senior secured debt	First priority lien on substantially all assets	Senior secured Term Loan, 10.50% due 10/12/2017	—	32.0
Halcyon Loan Advisors Funding 2012-I, Ltd.(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	22.7	—
Halcyon Loan Advisors Funding 2013-I, Ltd.(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	38.3	—
Hoffmaster Group, Inc.	Durable Consumer Products (Wisconsin)	Second lien debt	Second priority lien on substantially all assets	Second lien term loan, 11.00% due 1/3/2019; Second lien term loan, 10.25% due 1/03/2019	—	20.6
ICON Health & Fitness, Inc.	Durable Consumer Products (Utah)	Senior secured debt	First priority lien on substantially all assets	Senior secured notes, 11.875%, due 10/15/2016	—	33.9

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Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value
IDQ Holdings, Inc.	Automobile (Texas)	Senior Secured Note	Secured by first liens on substantially all of the Company's assets and a second lien on the Company's working capital assets	Senior Secured Note, 11.50% due 4/01/2017	—	12.5
ING IM CLO 2012-II, Ltd.(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	36.8	—
ING IM CLO 2012-III, Ltd.(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	46.4	—
ING IM CLO 2012-IV, Ltd.(1)	Diversified Financial Services (Cayman Islands)	Income Notes (Residual Interest)	N/A	Income Notes (Residual Interest)	41.2	—
Injured Workers Pharmacy LLC	Healthcare (Massachusetts)	Second lien debt	Second lien on substantially all assets	Second Lien Debt, 11.50% plus 1.00% PIK, due 5/31/2019	—	22.4
Interdent, Inc.	Healthcare (California)	Senior Secured debt	First priority lien on all assets	Senior secured term loan A, 8.00%, due 8/3/2017; senior secured term loan B, 13.00%, due 8/3/2017	—	108.5
JHH Holdings, Inc.	Healthcare (Texas)	Second lien debt	Subordinated lien on substantially all assets	Senior Subordinated debt, 12.00% plus 1.50% PIK, due 6/23/2018	—	16.1
LaserShip Inc.	Transportation (Virginia)	Senior Secured debt and revolving line of credit	First priority lien on all assets	Revolving line of credit 10.25% due 12/21/2014; senior secured term loan, 10.25%, due 12/21/2017	—	37.0

LCM XIV CLO Ltd.(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	25.8	—
LHC Holdings Corp.	Healthcare (Florida)	Revolving line of credit, senior subordinated debt membership interests	First priority lien on all assets and stock	Membership interests; Revolving line of credit 8.50% due 5/31/2015; Senior subordinated debt, 10.50% due 5/31/2015	0.2	2.9
Madison Park Funding IX, Ltd(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	26.6	—
Material Handling Services, LLC	Business Services (Ohio)	Senior Secured Term Loan	First priority lien on all assets	Senior Secured Term Loan, 10.5%, due 7/5/2017; Senior Secured Term Loan, 10.00%, due 12/21/2017	—	64.2
Maverick Healthcare LLC	Healthcare (Arizona)	Preferred units and common units	N/A	Common units; Preferred units	0.8	—
Mountain View CLO 2013-I, Ltd.(1)	Diversified Financial Services (Cayman Islands)	Subordinated Notes (Residual Interest)	N/A	Subordinated Notes (Residual Interest)	43.2	—
Medical Security Card Company, LLC	Healthcare (Arizona)	Revolving line of credit and senior secured debt	First priority lien on substantially all assets	Revolving line of credit, 9.50% due 2/1/2016; First Lien Term Loan, 11.25% due 2/01/2016	—	13.4
National Bankruptcy Services, LLC	Diversified Financial Services (Texas)	Senior Subordinated Term Loan	Second lien on substantially all assets	Senior Subordinated Term Loan, 12.00% plus 1.50% PIK, due 7/17/2017	—	16.9

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Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value
Naylor, LLC	Florida / Media	Revolving line of credit and senior secured debt	First lien on all assets and equity pledge	Revolving line of credit, 11.00% due 6/07/2017; Senior secured term loan, 11.00% due 6/07/2017	—	46.2
New Century Transportation Inc.	Transportation (New Jersey)	Senior Subordinated Term Loan	Second lien on substantially all assets	Senior Subordinated Term Loan, 12.00% plus 3.00% PIK, due 2/3/2018	—	44.2
New Star Metals Inc.	Metal Services & Minerals (Indiana)	Senior Subordinated Term Loan	Second lien on substantially all assets	Senior Subordinated Term Loan, 11.50% plus 1.00% PIK due 2/2/2018	—	50.3
Nixon, Inc	Durable Consumer Products (California)	Senior secured debt	First lien on all assets and equity pledge	Senior secured term loan, 8.75% plus 2.75% PIK, due 4/16/2018	—	15.0
NRG Manufacturing, Inc.	Manufacturing (Texas)	Escrow Receivable	N/A	Escrow Receivable	3.6	—
Octagon Investment Partners, XV, Ltd(1)	Diversified Financial Services (Cayman Islands)	Income Notes (Residual Interest)	N/A	Income Notes (Residual Interest)	25.5	—
Pegasus Business Intelligence, LP	Diversified Financial Services Secured Debt	Revolving Line of of Credit, Senior	First lien on substantially all assets	Revolving Line of Credit, 9.0% due 4/18/2014; Senior secured term loan A, 6.75% due 4/18/2018; Senior secured term loan B, 13.75% due 4/18/2018	—	31.9
Pelican Products, Inc.	Durable Consumer	Subordinated secured debt	Second lien on substantially all	Subordinated Secured, 11.50%	—	15.0

	Products (California)		assets	due 6/14/2019		
Pinnacle (US) Acquisition, Co Limited	Software & Computer Services (Texas)	Senior Subordinated debt	Second lien on all assets	Second Lien Term Loan, 10.50%, due 8/3/2020	—	10.0
Pre-Paid Legal Services, Inc.	Consumer Services (Oklahoma)	Senior subordinated debt	Subordinated lien on substantially all assets	Senior subordinated term loan, 11.50% due 12/31/2016	—	5.0
Prince Mineral Holdings, Corp.	Metal Services & Minerals (New York)	Senior Secured debt	First lien on substantially all assets	Senior subordinated term loan, 11.50% due 12/15/2019	—	10.0
Progexion Holdings, Inc.	Consumer Services (Utah)	Senior secured debt	First priority lien on substantially all assets	Senior Secured Term Loan, 10.50%, due 9/14/2017	—	241.0
Rocket Software, Inc	Software & Computer Services (Massachusetts)	Second Lien Term Loan	Second lien on all assets	Second Lien Term Loan, 10.25% due 2/08/2019	—	20.0
Royal Adhesives & Sealants, LLC	Chemicals (Indiana)	Senior Unsecured debt	Unsecured	Senior Subordinated debt, 12.00% plus 2.00% PIK due 11/29/2016	—	28.6
Ryan LLC,	Business Services (Texas)	Subordinated Secured debt	Second lien on substantially all assets	Subordinated secured 12.00% plus 3.00% PIK, due 6/30/2018	—	70.0
Sandow Media, LLC	Media (Florida)	Senior Secured debt	First lien on substantially all assets	Senior secured term loan, 10.50% plus 1.50% PIK, due 5/8/2018	—	24.9
Seaton Corp.	Business Services (Illinois)	Subordinated secured debt	Second priority lien on substantially all assets	Subordinated secured debt, 12.50% plus 2.00% PIK, due 3/14/2014; Subordinated secured debt, 12.50% plus 2.00 PIK, due 3/14/2015	—	13.3

Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value
SESAC Holdco II LLC	Media (Tennessee)	Second lien Term Loan	Second lien on substantially all assets	Second lien Term Loan, 10.00% due 7/12/2019	—	6.0
Skillsoft Public Limited Company(1)	Software and computer services (Ireland)	Subordinated unsecured debt	Unsecured	Subordinated unsecured debt, 11.125% due 6/1/2018	—	15.0
Snacks Holding Corporation	Food Products (Minnesota)	preferred stock and warrants	N/A	Warrants, expiring 11/12/2020; preferred shares;	0.6	—
Southern Management Corporation(1)	Consumer Finance (South Carolina)	Second Lien Term Loan	Second lien on loan receivables	Second Lien Term Loan, 12.00% plus 5.00% PIK, due 5/31/2017	—	18.3
Spartan Energy Services, Inc.	Energy (Louisiana)	Senior secured term loan	First priority lien on substantially all assets	Senior secured term loan, 10.50% due 12/28/2017	—	29.6
Speedy Group Holdings Corp(1)	Consumer Finance (Canada)	Senior unsecured debt	Unsecured	Senior unsecured, 12.00% due 11/15/2017	—	15.0
Sport Helmets Holdings, LLC	Personal & Non-durable Consumer Products	Escrow Receivable	N/A	Escrow Receivable	0.4	—
Stauber Performance Ingredients, Inc.	Food Products (California)	Senior secured debt	First priority lien on substantially all assets	Senior secured term loan, 10.50% due 1/21/2016, Senior Secured Term Loan, 10.50% due 5/21/2017	—	26.8
Stryker Energy LLC	Oil and gas production (Ohio)	Subordinated secured revolving credit facility and overriding royalty Interest	Second priority lien on substantially all assets	Overriding royalty interest; Subordinated secured revolving credit facility, 8.5% plus 3.75% PIK, in non-accrual	—	—

				status effective 12/01/2011, due 12/1/2015		
Symphony CLO, IX Ltd(1)	Diversified Financial Services (Cayman Islands)	LP Certificates (Residual Interest)	N/A	LP Certificates (Residual Interest)	44.0	—
System One Holdings, LLC	Business Services (Pennsylvania)	Senior Secured Term Loan	First lien on substantially all assets	Senior Secured Term Loan, 11.00%, due 12/31/2018	—	32.0
TB Corp.	Consumer Services (Texas)	Senior Subordinated debt	Second lien on substantially all assets	Senior Subordinated Note, 12.00% plus 1.50% PIK, due 12/18/2018	—	23.4
Targus Group International, Inc.	Durable Consumer Products (California)	First lien debt	First priority lien on substantially all assets	First lien term loan, 11.00% due 5/25/2016	—	23.5
TGG Medical Transitory, Inc.	Healthcare (New Jersey)	Second lien Term Loan	Second lien on substantially all assets	Second lien Term Loan, 11.25% due 6/27/2018	—	8.0
The Petroleum Place, Inc.	Software & Computer Services (Colorado)	Second lien Term Loan	Second lien on substantially all assets	Second lien Term Loan, 10.00% due 5/20/2019	—	22.0
Totes Isotoner Corporation	Nondurable Consumer Products (Ohio)	Second lien Term Loan	Second lien on substantially all assets	Second lien Term Loan, 10.75% due 1/08/2018	—	39.0
Traeger Pellet Grills LLC Products	Durable Consumer Term Loan (Oregon)	Revolving Line of Credit, Senior Secured Term Loan	First lien on substantially all assets	Revolving Line of Credit, 9.00% due 6/18/2014; Senior secured term loan A, 6.50% due 6/18/2018; Senior secured term loan B, 11.50% due 6/18/2018	—	66.1

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Name of Portfolio Company	Nature of its Principal Business (Location)	Title and Class of Securities Held	Collateral Held	Investment Structure	Equity Securities Held, at Fair Value	Loans, at Fair Value
TransFirst Holdings, Inc.	Software & Consumer Services (New York)	Second lien Term Loan	Second lien on substantially all assets	Second lien Term Loan, 11.00% due 6/27/2018	—	5.0
United Sporting Companies Inc.	Durable Consumer Products (South Carolina)	Second lien Term Loan	Second priority lien on Substantially all assets	Second lien term loan, 12.75% due 5/16/2018	—	160.0
Wind River Resources Corp. and Wind River II Corp.	Oil and gas production (Utah)	Senior secured debt and net profit interest	First priority lien on substantially all assets	Net profit interest, 5.00%; Senior secured note, 13.00% plus 3.00% default interest on principal, 16% default interest on past due interest, in non- accrual status effective 12/01/2008, past due	—	—

(1) Certain investments that the Company has determined are not "qualifying" assets" under Section 55(a) of the 1940 Act. Under the 1940 Act, we may not acquire any non-qualifying asset unless, at the time such acquisition is made, qualifying assets represent at least 70% of our total assets. The Company monitors the status of these assets on an ongoing basis

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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."

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 firms 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.

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SALES OF COMMON STOCK BELOW NET ASSET VALUE

At our 2012 annual meeting of stockholders held on December 7, 2012, our stockholders approved our ability to sell, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering, an unlimited number of shares of our common stock at any level of discount from NAV per share during the twelve-month period following such approval. In order to sell shares pursuant to this authorization, a majority of our directors who have no financial interest in the sale and a majority of our independent directors must (a) find that the sale is in our best interests and in the best interests of our stockholders, and (b) in consultation with any underwriter or underwriters or sales manager or sales managers 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 of common stock, 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.

We may make sales of our common stock at prices below our most recently determined NAV per share. Pursuant to the approval of our Board of Directors, we have made such sales in the past and we may continue to do so under this prospectus.

In making a determination that an offering below NAV per share is in our and our stockholders' best interests, our Board of Directors considers a variety of factors including matters such as:

- The effect that an offering below NAV per share would have on our stockholders, including the potential dilution they would experience as a result of the offering;
- The amount per share by which the offering price per share and the net proceeds per share are less than the most recently determined NAV per share;
- The relationship of recent market prices of par common stock to NAV per share and the potential impact of the offering on the market price per share of our common stock;
- Whether the estimated offering price would closely approximate the market value of our shares;
- The potential market impact of being able to raise capital during the current financial market difficulties;
- The nature of any new investors anticipated to acquire shares of common stock in the offering;
- The anticipated rate of return on and quality, type and availability of investments; and
- The leverage available to us.

Our Board of Directors also considers the fact that sales of common stock at a discount will benefit our Advisor as the Advisor will earn additional investment management fees on the proceeds of such offerings, as it would from the offering of any other securities of the Company or from the offering of common stock at premium to NAV per share.

We will not sell shares of common stock under a prospectus supplement to the registration statement (the "current registration statement") if the cumulative dilution to our NAV per share from offerings under the current registration statement exceeds 15%. This limit would be measured separately for each offering pursuant to the current registration statement by calculating the percentage dilution or accretion to aggregate NAV from that offering and then summing the percentage from each offering. For example, if our most recently determined NAV per share at the time of the first offering is $10.75 and we have 275.0 million shares of common stock outstanding, sale of 50.0 million shares of common stock at net proceeds to us of $5.38 per share (an approximately 50% discount) would produce dilution of 7.69%. If we subsequently determined that our NAV per share increased back to $10.50 on the then 325.0 million shares of common stock outstanding and then made an additional offering, we could, for example, sell approximately an additional 55.7 million shares of common stock at net proceeds to us of $5.25 per share, which would produce dilution of 7.31%, before we would reach the aggregate 15% limit. If we file a new post-effective amendment, the threshold would reset.

Sales by us of our common stock at a discount from NAV per share pose potential risks for our existing stockholders whether or not they participate in the offering, as well as for new investors who participate in the offering.

The following three headings and accompanying tables will explain and provide hypothetical examples on the impact of an offering at a price less than NAV per share on three different set of investors:

- existing shareholders who do not purchase any shares of common stock in the offering;

- existing shareholders who purchase a relatively small amount of shares of common stock in the offering or a relatively large amount of shares of common stock in the offering; and
- new investors who become shareholders by purchasing shares of common stock in the offering.

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The tables below provide hypothetical examples of the impact that an offering at a price less than NAV per share may have on the NAV per share of shareholders and investors who do and do not participate in such an offering. However, the tables below do not show and are not intended to show any potential changes in market price that may occur from an offering at a price less than NAV per share and it is not possible to predict any potential market price change that may occur from such an offering.

Impact On Existing Stockholders Who Do Not Participate in the Offering

Our existing stockholders who do not participate in an offering below NAV per share or who do not buy additional shares of common stock in the secondary market at the same or lower price we obtain in the offering (after expenses and commissions) face the greatest potential risks. These stockholders will experience an immediate decrease (often called dilution) in the NAV of the shares of common stock they hold and their NAV per share. 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 will experience in our assets, potential earning power and voting interests due to the offering. These stockholders may also experience a decline in the market price of their shares of common stock, which often reflects to some degree announced or potential increases and decreases in NAV per share. This decrease could be more pronounced as the size of the offering and level of discounts increases.

The following chart illustrates the level of NAV dilution that would be experienced by a nonparticipating stockholder in three different hypothetical offerings of different sizes and levels of discount from NAV per share. It is not possible to predict the level of market price decline that may occur. Actual sales prices and discounts may differ from the presentation below. There is no maximum level of discount from NAV at which we may sell shares pursuant to the stockholder authority.

The examples assume that the issuer has 275.0 million common shares outstanding, $4,756,250,000 in total assets and $1,800,000,000 in total liabilities. The current NAV and NAV per share are thus $2,956,250,000 and $10.75. The chart illustrates the dilutive effect on Stockholder A of (1) an offering of 13,750,000 shares of common stock (5% of the outstanding shares of common stock) at $10.21 per share after offering expenses and commission (a 5% discount from NAV), (2) an offering of 27,500,000 shares of common stock (10% of the outstanding shares of common stock) at $9.68 per share after offering expenses and commissions (a 10% discount from NAV), (3) an offering of 68,750,000 shares of common stock (25% of the outstanding shares of common stock) at $8.06 per share after offering expenses and commissions (a 25% discount from NAV), and (4) an offering of 68,750,000 shares of common stock (25% of the outstanding shares of common stock) at $0.00 per share after offering expenses and commissions (a 100% discount from NAV).

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		Example 1 5% Offering at 5% Discount		Example 2 10% Offering at 10% Discount		Example 3 25% Offering at 25% Discount		Example 4 25% Offering at 100% Discount	
	Prior to Sale Below NAV	Following Sale	% Change	Following Sale	% Change	Following Sale	% Change	Following Sale	% Cha
Offering Price									
Price per Share to Public		$10.77		$10.20		$8.49		$—	
Net Proceeds per Share to Issuer		$10.21		$9.68		$8.06		$—	
Decrease to NAV									
Total Shares Outstanding	275,000,000	288,750,000	5.00 %	302,500,000	10.00 %	343,750,000	25.00 %	343,750,000	25.0
NAV per Share	$10.75	$10.72	(0.24)%	$10.65	(0.91)%	$10.21	(5.00)%	$8.60	(20.
Dilution to Nonparticipating Stockholder									
Shares Held by Stockholder A	275,000	275,000	— %	275,000	— %	275,000	— %	275,000	—
Percentage Held by Stockholder A	0.10 %	0.10 %	(4.76)%	0.09 %	(9.09)%	0.08 %	(20.00)%	0.08 %	(20.
Total NAV Held by Stockholder A	$2,956,250	$2,949,211	(0.24)%	$2,929,375	(0.91)%	$2,808,438	(5.00)%	$2,365,000	(20.
Total Investment by Stockholder A (Assumed to be $10.75 per Share on Shares Held Prior to Sale)		$2,956,250		$2,956,250		$2,956,250		$2,956,250	
Total Dilution to Stockholder A (Total NAV Less Total Investment)		$(7,039)		$(26,875)		$(147,812)		$(591,250)	
NAV per Share Held by Stockholder A		$10.72		$10.65		$10.21		$8.60	
Investment per Share Held by Stockholder A (Assumed to be $10.75 per Share on Shares Held Prior to Sale)	$10.75	$10.75		$10.75		$10.75		$10.75	
Dilution per Share Held by Stockholder A (NAV per Share Less Investment		$(0.03)		$(0.10)		$(0.54)		$(2.15)	

per Share)				
Percentage Dilution to Stockholder A (Dilution per Share Divided by Investment per Share)	(0.24)%	(0.91)%	(5.00)%	(20.(

Impact On Existing Stockholders Who Do Participate in the Offering

Our existing stockholders who participate in an offering below NAV per share or who buy additional shares of common stock in the secondary market at the same or lower price as we obtain in the offering (after expenses and commissions) will experience the same types of NAV dilution as the nonparticipating stockholders, albeit at a lower level, to the extent they purchase less than the same percentage of the discounted offering as their interest in our shares of common stock immediately prior to the offering. The level of NAV dilution will decrease as the number of shares of common stock such stockholders purchase increases. Existing stockholders who buy more than such percentage will experience NAV dilution on their existing shares but will, in contrast to existing stockholders who purchase less than their proportionate share of the offering, experience an increase (often called accretion) in average NAV per share over their investment per share and will also experience a disproportionately greater increase in their participation in our earnings and assets and their voting power than our increase in assets, potential earning power and voting interests due to the offering. The level of accretion will increase as the excess number of shares of common stock such stockholder purchases increases. Even a stockholder who over-participates will, however, be subject to the risk that we may make additional discounted offerings in which such stockholder does not participate, in which case such a stockholder will experience NAV dilution as described above in such subsequent offerings.

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These shareholders may also experience a decline in the market price of their shares of common stock, which often reflects to some degree announced or potential decreases in NAV per share. This decrease could be more pronounced as the size of the offering and level of discounts increases. There is no maximum level of discount from NAV at which we may sell shares pursuant to this authority.
The following chart illustrates the level of dilution and accretion in the hypothetical 25% discount offering from the prior chart (Example 3) for a stockholder that acquires shares of common stock equal to (1) 50% of its proportionate share of the offering (i.e., 34,375 shares of common stock, which is 0.05% of an offering of 68,750,000 shares of common stock) rather than its 0.10% proportionate share and (2) 150% of such percentage (i.e., 103,125 shares of common stock, which is 0.15% of an offering of 68,750,000 shares of common stock rather than its 0.10% proportionate share). It is not possible to predict the level of market price decline that may occur. Actual sales prices and discounts may differ from the presentation below. There is no maximum level of discount from NAV at which we may sell shares pursuant to the stockholder authority.

		50% Participation		150% Participation	
	Prior to Sale Below NAV	Following Sale	% Change	Following Sale	% Change
Offering Price					
Price per Share to Public		$8.49		$8.49	
Net Proceeds per Share to Issuer		$8.06		$8.06	
Decrease to NAV					
Total Shares Outstanding	275,000,000	343,750,000	25.00 %	343,750,000	25.00 %
NAV per Share	$10.75	$10.21	(5.00)%	$10.21	(5.00)%
Dilution to Nonparticipating Stockholder					
Shares Held by Stockholder A	275,000	309,375	12.50 %	378,125	37.50 %
Percentage Held by Stockholder A	0.10 %	0.09 %	(10.00)%	0.11 %	10.00 %
Total NAV Held by Stockholder A	$10.75	$3,159,492	6.88 %	$3,861,602	30.63 %
Total Investment by Stockholder A (Assumed to be $10.75 per Share on Shares Held Prior to Sale)		$3,248,143		$3,831,929	
Total Dilution to Stockholder A (Total NAV Less Total Investment)		$(88,651)		$29,673	
NAV per Share Held by Stockholder A		$10.21		$10.21	
Investment per Share Held by Stockholder A (Assumed to be $10.75 per Share on Shares Held Prior to Sale)		$10.50		$10.13	
Dilution per Share Held by Stockholder A (NAV per Share Less Investment per Share)		$(0.29)		$0.08	
Percentage Dilution to Stockholder A (Dilution per Share Divided by Investment per Share)			(2.73)%		0.77 %

Impact On New Investors
Investors who are not currently stockholders and who participate in an offering below NAV but whose investment per share is greater than the resulting NAV per share due to selling compensation and expenses paid by the issuer will experience an immediate decrease, albeit small, in the NAV of their shares of common stock and their NAV per share compared to the price they pay for their shares of common stock. Investors who are not currently stockholders and who participate in an offering below NAV per share and whose investment per share is also less than the resulting

NAV per share due to selling compensation and expenses paid by the issuer being significantly less than the discount per share will experience an immediate increase in the NAV of their shares of common stock and their NAV per share compared to the price they pay for their shares of common stock. These investors will experience a disproportionately greater participation in our earnings and assets and their voting power than our increase in assets, potential earning power and voting interests. These investors will, however, be subject to the risk that we may make additional discounted offerings in which such new stockholder does not participate, in which case such new stockholder will experience dilution as described above in such subsequent offerings. These investors may also experience a decline in the market price of their shares of common stock, which often reflects to some degree announced or potential increases and decreases in NAV per share. This decrease could be more pronounced as the size of the offering and level of discounts increases. There is no maximum level of discount from NAV at which we may sell shares pursuant to this authority.

The following chart illustrates the level of dilution or accretion for new investors that would be experienced by a new investor in the same hypothetical 5%, 10% and 25% discounted offerings as described in the first chart above. The illustration is for a new investor who purchases the same percentage (0.10%) of the shares of common stock in the offering as Stockholder A in the prior examples held immediately prior to the offering. It is not possible to predict the level of market price decline that may occur. Actual sales prices and discounts may differ from the presentation below. There is no maximum level of discount from NAV at which we may sell shares pursuant to the stockholder authority.

		Example 1 5% Offering at 5% Discount		Example 2 10% Offering at 10% Discount		Example 3 25% Offering at 25% Discount	
	Prior to Sale Below NAV	Following Sale	% Change	Following Sale	% Change	Following Sale	% Change
Offering Price							
Price per Share to Public		$10.77		$10.20		$8.49	
Net Proceeds per Share to Issuer		$10.21		$9.68		$8.06	
Decrease to NAV							
Total Shares Outstanding	275,000,000	288,750,000	5.00 %	302,500,000	10.00 %	343,750,000	25.00 %
NAV per Share	$10.75	$10.72	(0.24)%	$10.65	(0.91)%	$10.21	(5.00)%
Dilution to Nonparticipating Stockholder							
Shares Held by Stockholder A	—	13,750		27,500		68,750	
Percentage Held by Stockholder A	— %	— %		0.01 %		0.02 %	
Total NAV Held by Stockholder A	$—	$147,461		$292,938		$702,109	
Total investment by Stockholder A		$148,128		$280,382		$583,786	
Total Dilution to Stockholder A (Total NAV Less Total investment)		$(667)		$12,556		$118,323	
NAV per Share Held by Stockholder A		$10.72		$10.65		$10.21	
Investment per Share Held by Stockholder A		$10.77		$10.20		$8.49	
Dilution per Share Held by Stockholder A (NAV per Share Less Investment per Share)		$(0.05)		$0.45		$1.72	
Percentage Dilution to Stockholder A (Dilution per Share Divided by Investment per			(0.45)%		4.48 %		20.27 %

Share)

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.

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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.

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 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, 6201 15th Avenue, Brooklyn, NY 11219 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 does not discuss any aspects of U.S. estate or gift tax or foreign, state or local tax. This summary assumes that investors hold our common stock as capital assets (within the meaning of the Code). This discussion is based upon the Code, Treasury regulations, and administrative and judicial interpretations thereof, each as of the date of this prospectus and all of which are subject to differing interpretation or change, possibly retroactively, which could affect the continuing validity of this discussion. We have not sought and will not seek any ruling from the Internal Revenue Service, or the IRS, regarding this offering. No assurance can be given that the IRS would not assert, or that a court would not sustain, a position contrary to the any of the tax aspects set forth below.

This summary does not discuss the consequences of an investment in shares of our preferred stock, debt securities, subscription rights to purchase our securities, warrants representing rights to purchase our securities or separately tradeable units combining two or more of our securities. The tax consequences of such an investment will be discussed in a relevant prospectus supplement.

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 elected and intend to continue to qualify 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 (the Annual Distribution Requirement).

Taxation As A RIC

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) (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."

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 asset diversification tests. If the partnership is a "qualified publicly traded partnership," the net income derived from such partnership will be qualifying income for purposes of the 90% Income Test, and interests in the partnership will be "securities" for purposes of the diversification tests. 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.
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 by such corporation.

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 investment company taxable income and net 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 unless we distribute during each calendar year an amount at least equal to the sum of (1) 98% of our ordinary income for the calendar year and (2) 98.2% of our capital gain net income for the one-year period ending October 31 in that calendar year and (3) any income realized, but not distributed, in preceding years. In addition, the minimum amounts that must be distributed in any year to avoid the excise tax will be increased or decreased to reflect any under-distribution or over-distribution, as the case may be, from the previous year.

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, 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. As a RIC, 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.

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. 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 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 we be required to make distributions. Distributions would generally be taxable to our individual and other non-corporate taxable stockholders as ordinary dividend income eligible for the reduced maximum rate applicable to "qualified dividend income" to the extent of our current and accumulated earnings and profits, provided certain holding period and other requirements are met. Subject to certain limitations under the Code, corporate distributees would be eligible for the dividends-received deduction. To qualify again to be taxed as a RIC in a subsequent year, we would be required to distribute to our stockholders our accumulated earnings and profits attributable to non-RIC years reduced by an interest charge on 50% of such earnings and profits payable by us as an additional tax. In addition, if we failed to qualify as a RIC for a period greater than two taxable years, then, in order to qualify as a RIC in a subsequent year, we would be required to elect to recognize and

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pay tax on any net built-in gain (the excess of aggregate gain, including items of income, over aggregate loss that would have been realized if we had been liquidated) or, alternatively, be subject to taxation on such built-in gain recognized for a period of ten 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.

We may invest in preferred securities or other securities the U.S. federal income tax treatment of which may be unclear 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 and accumulated earnings and profits, whether paid in cash or reinvested in additional common stock. Provided that certain holding period and other requirements are met, such distributions (if designated by us) may qualify (i) for the dividends received deduction available to corporations, but only to the extent that our income consists of dividend income from U.S. corporations and (ii) in the case of individual shareholders, as qualified dividend income eligible to be taxed at long-term capital gain rates to the extent that we receive qualified dividend income (generally, dividend income from taxable domestic corporations and certain qualified foreign corporations). There can be no assurance as to what portion, if any, of our distributions will qualify for favorable treatment as qualified dividend income.

Distributions of our net capital gain (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, regardless of the U.S. Stockholder's holding period for 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. 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, and 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 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 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 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 such U.S. Stockholder's liability for U.S. federal income tax. A U.S. 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

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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 a U.S. Stockholder 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 its investment.

A U.S. Stockholder generally will recognize taxable gain or loss if such U.S. Stockholder sells or otherwise disposes of its shares of our common stock. Any gain or loss arising from such sale or taxable disposition generally will be treated as long-term capital gain or loss if the U.S. Stockholder has held 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 taxable 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 taxable 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. Capital losses are deductible only to the extent of capital gains (subject to an exception for individuals under which a limited amount of capital losses may be offset against ordinary income).

In general, individual U.S. Stockholders currently are subject to a preferential rate 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 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 ordinary income rates.

Certain U.S. Stockholders who are individuals, estates or trusts and whose income exceeds certain thresholds will be required to pay a 3.8% Medicare tax on all or a portion of their "net investment income," which includes dividends received from us and capital gains from the sale or other disposition of our stock.

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 amount and the U.S. federal tax status of each year's distributions generally will be reported to the IRS. Distributions may also be subject to additional state, local and foreign taxes depending on a U.S. Stockholder's particular situation.

Payments of dividends, including deemed payments of constructive dividends, or the proceeds of the sale or other taxable disposition of our common stock generally are subject to information reporting unless the U.S. Stockholder is an exempt recipient. Such payments may also be subject to U.S. federal backup withholding at the applicable rate if the recipient of such payment fails to supply a taxpayer identification number and otherwise comply with the rules for establishing an exemption from backup withholding. Backup withholding is not an additional tax, and any amounts withheld under the backup withholding rules generally will be allowed as a refund or credit against the holder's U.S. federal income tax liability, provided that certain information is provided timely to the IRS.

Taxation Of Non-U.S. Stockholders

Whether an investment in our common stock is appropriate for a Non-U.S. Stockholder will depend upon that person's particular circumstances. An investment in our common stock 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 conducted 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 applicable treaty rate) to the extent of our current and accumulated earnings and profits.

For our taxable years beginning before January 1, 2014 (and, if extended as has happened in the past, for taxable years covered by such extension), properly reported distributions to Non-U.S. Stockholders are generally exempt from U.S. federal withholding tax where they (i) are paid in respect of our "qualified net interest income" (generally, our U.S.-source interest income, other than certain contingent interest and interest from obligations of a corporation or partnership in which we are at least a 10% shareholder, reduced by expenses that are allocable to such income) or

(ii) are paid in respect of our "qualified short-term capital gains" (generally, the excess of our net short-term capital gain over our long-term capital loss for such taxable year). There can be no assurance as to whether this provision will be extended. In addition, depending on our circumstances, we may report all, some or none of our potentially eligible dividends as such qualified net interest income or as qualified short-term capital gains, and/or treat such dividends, in whole or in part, as ineligible for this exemption from withholding. In order to qualify for this exemption from withholding, a Non-U.S. Stockholder needs to comply with applicable certification requirements relating to its non-U.S. status (including, in general, furnishing an IRS Form W-8BEN or substitute Form). In the case of shares held through an intermediary, the intermediary may withhold even if we report the payment as qualified net interest income or qualified short-term capital gain. Non-U.S. Stockholders should contact their intermediaries with respect to the application of these rules to their accounts. There can be no assurance as to what portion of our distributions will qualify for favorable treatment as qualified net interest income or qualified short-term capital gains.

Actual or deemed distributions of our net capital gain to a Non-U.S. Stockholder, and gains recognized 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 conducted 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 U.S. for 183 or more days during the taxable year and meets certain other requirements.

Distributions of our investment company taxable income and net capital gain (including deemed distributions) to Non-U.S. Stockholders, and gains recognized by Non-U.S. Stockholders upon the sale of our common stock, that are effectively connected with a U.S. trade or business conducted by the Non-U.S. Stockholder will be subject to U.S. federal income tax at the graduated rates applicable to U.S. citizens, residents and domestic corporations. In addition, if such Non-U.S. Stockholder is a foreign corporation, it may also be subject to a 30% (or lower applicable treaty rate) branch profits tax on its effectively connected earnings and profits for the taxable year, subject to adjustments, if its investment in our common stock is effectively connected with its conduct of a U.S. trade or business.

If we distribute our net capital gain 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.

In addition, after June 30, 2014, withholding at a rate of 30% will be required on dividends in respect of, and after December 31, 2016, withholding at a rate of 30% will be required on gross proceeds from the sale of, shares of our stock held by or through certain foreign financial institutions (including investment funds), unless such institution enters into an agreement with the Secretary of the Treasury to report, on an annual basis, information with respect to interests in, and accounts maintained by, the institution to the extent such interests or accounts are held by certain U.S. persons or by certain non-U.S. entities that are wholly or partially owned by U.S. persons and to withhold on certain payments. Accordingly, the entity through which our shares are held will affect the determination of whether such withholding is required. An intergovernmental agreement between the United States and an applicable foreign country, or future Treasury regulations or other guidance, may modify these requirements. Similarly, dividends in respect of, and gross proceeds from the sale of, our shares held by an investor that is a non-financial non-U.S. entity that does not qualify under certain exemptions will be subject to withholding at a rate of 30%, unless such entity either (i) certifies to us that such entity does not have any "substantial United States owners" or (ii) provides certain information regarding the entity's "substantial United States owners," which we will in turn provide to the Internal Revenue Service. We will not pay any additional amounts to stockholders in respect of any amounts withheld. Non-U.S. Stockholders are encouraged to consult their tax advisors regarding the possible implications of the legislation on their investment in our shares.

A Non-U.S. Stockholder generally will be required to comply with certain certification procedures to establish that such holder is not a U.S. person in order to avoid backup withholding with respect to payments of dividends, including deemed payments of constructive dividends, or the proceeds of a disposition of our common stock. In addition, we are required to annually report to the IRS and each Non-U.S. Stockholder the amount of any dividends or constructive dividends treated as paid to such Non-U.S. Stockholder, regardless of whether any tax was actually withheld. Copies of the information returns reporting such dividend or constructive dividend payments and the amount withheld may also be made available to the tax authorities in the country in which a Non-U.S. Stockholder resides under the provisions of an applicable income tax treaty. Backup withholding is not an additional tax, and any amounts withheld under the backup withholding rules generally will be allowed as a refund or credit against a

Non-U.S. Stockholder's U.S. federal income tax liability, if any, provided that certain required information is provided timely to the IRS.

Non-U.S. persons should consult their tax advisors with respect to the U.S. federal income tax and withholding tax, and state, local and foreign tax consequences of an investment in our common stock.

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.

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Distributions would generally be taxable to our stockholders as ordinary dividend income eligible for the reduced maximum rate applicable to qualified dividend income 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 advisors concerning the tax considerations relevant to their particular situation.

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DESCRIPTION OF OUR CAPITAL STOCK

The following description is based on relevant portions of the Maryland General Corporation Law and on our charter and bylaws. This summary is not necessarily complete, and we refer you to the Maryland General Corporation Law and our charter and bylaws for a more detailed description of the provisions summarized below.

Capital Stock

Our authorized capital stock consists of 500,000,000 shares of stock, par value $0.001 per share, all of which is initially classified as common stock. Our common stock is traded on The NASDAQ Global Select Market under the symbol "PSEC." There are no outstanding options or warrants to purchase our stock. No stock has been authorized for issuance under any equity compensation plans. Under Maryland law, our stockholders generally are not personally liable for our debts or obligations.

Under our charter, our Board of Directors is authorized to classify and reclassify any unissued shares of stock into other classes or series of stock, and to authorize the issuance of such shares, without obtaining stockholder approval. Our Board of Directors will only take such actions in accordance with Section 18 as modified by Section 61 of the 1940 Act. The 1940 Act limits business development companies to only one class or series of common stock and only one class of preferred stock. As permitted by the Maryland General Corporation Law, our charter provides that the Board of Directors, without any action by our stockholders, may amend the charter from time to time to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class or series that we have authority to issue.

The below table sets forth each class of our outstanding securities as of October 10, 2013 including shares sold with settlement dates through October 16, 2013:

(1) Title of Class	(2) Amount Authorized	(3) Amount Held by the Company or for its Account	(4) Amount Outstanding Exclusive of Amount Shown Under (3)
Common Stock	500,000,000	—	276,844,568

Common Stock

All shares of our common stock have equal rights as to earnings, assets, dividends and voting and, when they are issued, will be duly authorized, validly issued, fully paid and nonassessable. Distributions may be paid to the holders of our common stock if, as and when authorized by our Board of Directors and declared by us out of funds legally available therefor. Shares of our common stock have no preemptive, conversion or redemption rights and are freely transferable, except where their transfer is restricted by U.S. Federal and state securities laws or by contract. In the event of a liquidation, dissolution or winding up of us, each share of our common stock would be entitled to share ratably in all of our assets that are legally available for distribution after we pay all debts and other liabilities and subject to any preferential rights of holders of our preferred stock, if any preferred stock is outstanding at such time. Each share of our common stock is entitled to one vote on all matters submitted to a vote of stockholders, including the election of directors. Except as provided with respect to any other class or series of stock, the holders of our common stock will possess exclusive voting power. There is no cumulative voting in the election of directors, which means that prior to the issuance of preferred stock holders of a majority of the outstanding shares of common stock will elect all of our directors, and holders of less than a majority of such shares will be unable to elect any director.

Preferred Stock

Our charter authorizes our Board of Directors to classify and reclassify any unissued shares of stock into other classes or series of stock, including preferred stock. Prior to issuance of shares of each class or series, the Board of Directors is required by Maryland law and by our charter to set the 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. Thus, the Board of Directors could authorize the issuance of shares of preferred stock with terms and conditions which could have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for holders of our common stock or otherwise be in their best interest. You should note, however, that any issuance of preferred stock must comply with the requirements of the 1940 Act. The 1940 Act requires, among other things, that (1) immediately after issuance and before any dividend or other distribution (other than in shares of stock) is made with respect to our common stock and before any purchase of common stock is made, such preferred stock together with all other senior securities must not exceed an amount equal to 50% of our total assets after deducting the amount of such dividend, distribution or purchase price, as the case may be, and (2) the holders of shares of preferred stock, if any are issued, must be entitled as a class to elect two directors at all times and to elect a majority of the directors if dividends on such preferred stock become in arrears by two years or more until all arrears are cured. Certain matters under the 1940 Act require the separate vote of the holders of any issued and outstanding

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preferred stock. For example, holders of preferred stock would vote separately from the holders of common stock on a proposal to operate other than as an investment company. We believe that the availability for issuance of preferred stock will provide us with increased flexibility in structuring future financings and acquisitions.

Limitation On Liability Of Directors And Officers; Indemnification And Advance Of Expenses

Maryland law permits a Maryland corporation to include in its charter a provision limiting the liability of its directors and officers to the corporation and its stockholders for money damages except for liability resulting from (a) actual receipt of an improper benefit or profit in money, property or services or (b) active and deliberate dishonesty established by a final judgment as being material to the cause of action. Our charter contains such a provision which eliminates directors' and officers' liability to the maximum extent permitted by Maryland law, subject to the requirements of the 1940 Act.

Our charter authorizes us, to the maximum extent permitted by Maryland law and subject to the requirements of the 1940 Act, to obligate ourselves to indemnify any present or former director or officer or any individual who, while serving as a director or officer and at our request, serves or has served another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or other enterprise as a director, officer, partner or trustee, from and against any claim or liability to which that person may become subject or which that person may incur by reason of his or her service in any such capacity and to pay or reimburse their reasonable expenses in advance of final disposition of a proceeding. Our bylaws obligate us, to the maximum extent permitted by Maryland law and subject to the requirements of the 1940 Act, to indemnify any present or former director or officer or any individual who, while serving as a director or officer and at our request, serves or has served another corporation, real estate investment trust, limited liability company, partnership, joint venture, trust, employee benefit plan or other enterprise as a director, officer, partner, manager, member or trustee and who is made, or threatened to be made, a party to the proceeding by reason of his or her service in any such capacity from and against any claim or liability to which that person may become subject or which that person may incur by reason of his or her service in any such capacity and to pay or reimburse their reasonable expenses in advance of final disposition of a proceeding. The charter and bylaws also permit us to indemnify and advance expenses to any person who served a predecessor of us in any of the capacities described above and any of our employees or agents or any employees or agents of our predecessor. In accordance with the 1940 Act, we will not indemnify any person for any liability to which such person would be subject by reason of such person's willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office.

Maryland law requires a corporation (unless its charter provides otherwise, which our charter does not) to indemnify a director or officer who has been successful, on the merits or otherwise, in the defense of any proceeding to which he or she is made, or threatened to be made, a party by reason of his or her service in that capacity. Maryland law permits a corporation to indemnify its present and former directors and officers, among others, against judgments, penalties, fines, settlements and reasonable expenses actually incurred by them in connection with any proceeding to which they may be made, or threatened to be made, a party by reason of their service in those or other capacities unless it is established that (a) the act or omission of the director or officer was material to the matter giving rise to the proceeding and (1) was committed in bad faith or (2) was the result of active and deliberate dishonesty, (b) the director or officer actually received an improper personal benefit in money, property or services or (c) in the case of any criminal proceeding, the director or officer had reasonable cause to believe that the act or omission was unlawful. However, under Maryland law, a Maryland corporation may not indemnify for an adverse judgment in a suit by or in the right of the corporation or for a judgment of liability on the basis that a personal benefit was improperly received, unless in either case a court orders indemnification, and then only for expenses. In addition, Maryland law permits a corporation to advance reasonable expenses to a director or officer upon the corporation's receipt of (a) a written affirmation by the director or officer of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification by the corporation and (b) a written undertaking by him or her or on his or her behalf to repay the amount paid or reimbursed by the corporation if it is ultimately determined that the standard of conduct was not met.

Our insurance policy does not currently provide coverage for claims, liabilities and expenses that may arise out of activities that a present or former director or officer of us has performed for another entity at our request. There is no assurance that such entities will in fact carry such insurance. However, we note that we do not expect to request our present or former directors or officers to serve another entity as a director, officer, partner or trustee unless we can obtain insurance providing coverage for such persons for any claims, liabilities or expenses that may arise out of their activities while serving in such capacities.

Provisions Of The Maryland General Corporation Law And Our Charter And Bylaws

Anti-takeover Effect

The Maryland General Corporation Law and our charter and bylaws contain provisions that could make it more difficult for a potential acquiror to acquire us by means of a tender offer, proxy contest or otherwise. These provisions are expected to discourage certain coercive takeover practices and inadequate takeover bids and to encourage persons seeking to acquire control of us to negotiate first with our Board of Directors. These provisions could have the effect of depriving stockholders of an opportunity to sell their shares at a premium over prevailing market prices by discouraging a third party from seeking to obtain control of us. We believe that the benefits of these provisions outweigh the potential disadvantages of discouraging any such acquisition proposals because, among other things, the negotiation of such proposals may improve their terms.

Control Share Acquisitions

The Maryland General Corporation Law under the Control Share Act provides that control shares of a Maryland corporation acquired in a control share acquisition have no voting rights except to the extent approved by the affirmative vote of holders of two-thirds of the votes entitled to be cast on the matter. Shares owned by the acquiror, by officers or by directors who are employees of the corporation are excluded from shares entitled to vote on the matter. Control shares are voting shares of stock which, if aggregated with all other shares of stock owned by the acquiror or in respect of which the acquiror is able to exercise or direct the exercise of voting power (except solely by virtue of a revocable proxy), would entitle the acquiror to exercise voting power in electing directors within one of the following ranges of voting power:

- one-tenth or more but less than one-third,
- one-third or more but less than a majority, or
- a majority or more of all voting power.

The requisite stockholder approval must be obtained each time an acquiror crosses one of the thresholds of voting power set forth above. Control shares do not include shares the acquiring person is then entitled to vote as a result of having previously obtained stockholder approval. A control share acquisition means the acquisition of control shares, subject to certain exceptions.

A person who has made or proposes to make a control share acquisition may compel the Board of Directors of the corporation to call a special meeting of stockholders to be held within 50 days of demand to consider the voting rights of the shares. The right to compel the calling of a special meeting is subject to the satisfaction of certain conditions, including an undertaking to pay the expenses of the meeting. If no request for a meeting is made, the corporation may itself present the question at any stockholders meeting.

If voting rights are not approved at the meeting or if the acquiring person does not deliver an acquiring person statement as required by the statute, then the corporation may redeem for fair value any or all of the control shares, except those for which voting rights have previously been approved. The right of the corporation to redeem control shares is subject to certain conditions and limitations, including, as provided in our bylaws, compliance with the 1940 Act. Fair value is determined, without regard to the absence of voting rights for the control shares, as of the date of the last control share acquisition by the acquiror or of any meeting of stockholders at which the voting rights of the shares are considered and not approved. If voting rights for control shares are approved at a stockholders meeting and the acquiror becomes entitled to vote a majority of the shares entitled to vote, all other stockholders may exercise appraisal rights. The fair value of the shares as determined for purposes of appraisal rights may not be less than the highest price per share paid by the acquiror in the control share acquisition.

The Control Share Act does not apply (a) to shares acquired in a merger, consolidation or share exchange if the corporation is a party to the transaction or (b) to acquisitions approved or exempted by the charter or bylaws of the corporation.

Our bylaws contain a provision exempting from the Control Share Act any and all acquisitions by any person of our shares of stock. There can be no assurance that such provision will not be amended or eliminated at any time in the future. However, we will notify the Division of Investment Management at the SEC prior to amending our bylaws to be subject to the Control Share Act and will make such amendment only if the Board of Directors determines that it would be in our best interests.

Business Combinations

Under Maryland law, "business combinations" between a Maryland corporation and an interested stockholder or an affiliate of an interested stockholder are prohibited for five years after the most recent date on which the interested stockholder becomes an interested stockholder. These business combinations include a merger, consolidation, share exchange or, in circumstances specified in the statute, an asset transfer or issuance or reclassification of equity securities. An interested stockholder is defined as:

- any person who beneficially owns 10% or more of the voting power of the corporation's shares; or
- an affiliate or associate of the corporation who, at any time within the two-year period prior to the date in question, was the beneficial owner of 10% or more of the voting power of the then outstanding voting stock of the corporation.

A person is not an interested stockholder under this statute if the Board of Directors approved in advance the transaction by which he otherwise would have become an interested stockholder. However, in approving a transaction, the Board of

Directors may provide that its approval is subject to compliance, at or after the time of approval, with any terms and conditions determined by the Board of Directors.

After the five-year prohibition, any such business combination must be recommended by the Board of Directors of the corporation and approved by the affirmative vote of at least:

- 80% of the votes entitled to be cast by holders of outstanding shares of voting stock of the corporation; and
- two-thirds of the votes entitled to be cast by holders of voting stock of the corporation other than shares held by the interested stockholder with whom or with whose affiliate the business combination is to be effected or held by an affiliate or associate of the interested stockholder.

These super-majority vote requirements do not apply if the corporation's common stockholders receive a minimum price, as defined under Maryland law, for their shares in the form of cash or other consideration in the same form as previously paid by the interested stockholder for its shares.

The statute provides various exemptions from its provisions, including for business combinations that are exempted by the Board of Directors before the time that the interested stockholder becomes an interested stockholder. Our Board of Directors has adopted a resolution that any business combination between us and any other person is exempted from the provisions of the Business Combination Act, provided that the business combination is first approved by the Board of Directors, including a majority of the directors who are not interested persons as defined in the 1940 Act. This resolution, however, may be altered or repealed in whole or in part at any time. If this resolution is repealed, or the Board of Directors does not otherwise approve a business combination, the statute may discourage others from trying to acquire control of us and increase the difficulty of consummating any offer.

Conflicts with 1940 Act

Our bylaws provide that, if and to the extent that any provision of the Maryland General Corporation Law, including the Control Share Act (if we amend our bylaws to be subject to such Act) and the Business Combination Act, or any provision of our charter or bylaws conflicts with any provision of the 1940 Act, the applicable provision of the 1940 Act will control.

Classified Board of Directors

Our Board of Directors is divided into three classes of directors serving staggered three-year terms. The current terms of the first, second and third classes will expire at the annual meeting of stockholders held in 2014, 2015 and 2013 respectively, and in each case, until their successors are duly elected and qualify. Each year one class of directors will be elected to the Board of Directors by the stockholders to hold office for a term expiring at the annual meeting of stockholders held in the third year following the year of their election. Each director holds office for the term to which he or she is elected and until his or her successor is duly elected and qualifies. A classified board may render a change in control of us or removal of our incumbent management more difficult. We believe, however, that the longer time required to elect a majority of a classified Board of Directors will help to ensure the continuity and stability of our management and policies.

Election of Directors

Our charter and bylaws provide that the affirmative vote of the holders of a majority of the outstanding shares of stock entitled to vote in the election of directors will be required to elect a director. Under the charter, our Board of Directors may amend the bylaws to alter the vote required to elect directors.

Number of Directors; Vacancies; Removal

Our charter provides that the number of directors will be set only by the Board of Directors in accordance with our bylaws. Our bylaws provide that a majority of our entire Board of Directors may at any time increase or decrease the number of directors. However, unless our bylaws are amended, the number of directors may never be less than three nor more than eight. Our charter provides that, at such time as we are eligible to make the election provided for under Section 3-802(b) of the Maryland General Corporation Law, we elect to be subject to the provision of Subtitle 8 of Title 3 of the Maryland General Corporation Law regarding the filling of vacancies on the Board of Directors. Accordingly, except as may be provided by the Board of Directors in setting the terms of any class or series of preferred stock, any and all vacancies on the Board of Directors may be filled 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 of the directorship in which the vacancy occurred and until a successor is elected and qualifies, subject to any applicable requirements of the 1940 Act.

Our charter provides that a director may be removed only for cause, as defined in our charter, and then only by the affirmative vote of at least two-thirds of the votes entitled to be cast in the election of directors.

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Action by Stockholders

The Maryland General Corporation Law provides that stockholder action can be taken only at an annual or special meeting of stockholders or (unless the charter provides for stockholder action by less than unanimous written consent, which our charter does not) by unanimous written consent in lieu of a meeting. These provisions, combined with the requirements of our bylaws regarding the calling of a stockholder-requested special meeting of stockholders discussed below, may have the effect of delaying consideration of a stockholder proposal until the next annual meeting.

Advance Notice Provisions for Stockholder Nominations and Stockholder Proposals

Our bylaws provide that with respect to an annual meeting of stockholders, nominations of persons for election to the Board of Directors and the proposal of business to be considered by stockholders may be made only (1) pursuant to our notice of the meeting, (2) by or at the direction of the Board of Directors or (3) by a stockholder who was a stockholder of record both at the time of provision of notice and at the annual meeting, who is entitled to vote at the meeting and who has complied with the advance notice procedures of the bylaws. With respect to special meetings of stockholders, only the business specified in our notice of the meeting may be brought before the meeting. Nominations of persons for election to the Board of Directors at a special meeting may be made only (1) by or at the direction of the Board of Directors or (2) provided that the Board of Directors has determined that directors will be elected at the meeting, by a stockholder who was a stockholder of record both at the time of provision of notice and at the special meeting, who is entitled to vote at the meeting and who has complied with the advance notice provisions of the bylaws.

The purpose of requiring stockholders to give us advance notice of nominations and other business is to afford our Board of Directors a meaningful opportunity to consider the qualifications of the proposed nominees and the advisability of any other proposed business and, to the extent deemed necessary or desirable by our Board of Directors, to inform stockholders and make recommendations about such qualifications or business, as well as to provide a more orderly procedure for conducting meetings of stockholders. Although our bylaws do not give our Board of Directors any power to disapprove stockholder nominations for the election of directors or proposals recommending certain action, they may have the effect of precluding a contest for the election of directors or the consideration of stockholder proposals if proper procedures are not followed and of discouraging or deterring a third party from conducting a solicitation of proxies to elect its own slate of directors or to approve its own proposal without regard to whether consideration of such nominees or proposals might be harmful or beneficial to us and our stockholders.

Calling of Special Meetings of Stockholders

Our bylaws provide that special meetings of stockholders may be called by our Board of Directors and certain of our officers. Additionally, our bylaws provide that, subject to the satisfaction of certain procedural and informational requirements by the stockholders requesting the meeting, a special meeting of stockholders will be called by the secretary of the corporation upon the written request of stockholders entitled to cast not less than a majority of all the votes entitled to be cast at such meeting.

Approval of Extraordinary Corporate Action; Amendment of Charter and Bylaws

Under Maryland law, a Maryland corporation generally cannot dissolve, amend its charter, merge, sell all or substantially all of its assets, engage in a share exchange or engage in similar transactions outside the ordinary course of business, unless approved by the affirmative vote of stockholders entitled to cast at least two-thirds of the votes entitled to be cast on the matter. However, a Maryland corporation may provide in its charter for approval of these matters by a lesser percentage, but not less than a majority of all of the votes entitled to be cast on the matter. Our charter generally provides for approval of charter amendments and extraordinary transactions by the stockholders entitled to cast at least a majority of the votes entitled to be cast on the matter.

Our charter also provides that certain charter amendments and any proposal for our conversion, whether by merger or otherwise, from a closed-end company to an open-end company or any proposal for our liquidation or dissolution requires the approval of the stockholders entitled to cast at least 80 percent of the votes entitled to be cast on such matter. However, if such amendment or proposal is approved by at least two-thirds of our continuing directors (in addition to approval by our Board of Directors), such amendment or proposal may be approved by a majority of the votes entitled to be cast on such a matter. The "continuing directors" are defined in our charter as our current directors as well as those directors whose nomination for election by the stockholders or whose election by the directors to fill vacancies is approved by a majority of the continuing directors then on the Board of Directors.

Our charter and bylaws provide that the Board of Directors will have the exclusive power to make, alter, amend or repeal any provision of our bylaws.

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No Appraisal Rights

Except with respect to appraisal rights arising in connection with the Control Share Act discussed above, as permitted by the Maryland General Corporation Law, our charter provides that stockholders will not be entitled to exercise appraisal rights.

DESCRIPTION OF OUR PREFERRED STOCK

In addition to shares of common stock, our charter authorizes the issuance of preferred stock. If we offer preferred stock under this prospectus, we will issue an appropriate prospectus supplement. We may issue preferred stock from time to time in one or more series, without stockholder approval. Our Board of Directors is authorized to fix for any series of preferred stock the number of shares of such series and the designation, relative powers, preferences and rights, and the qualifications, limitations or restrictions of such series; except that, such an issuance must adhere to the requirements of the 1940 Act, Maryland law and any other limitations imposed by law.

The 1940 Act requires, among other things, that (1) immediately after issuance and before any distribution is made with respect to common stock, the liquidation preference of the preferred stock, together with all other senior securities, must not exceed an amount equal to 50% of our total assets (taking into account such distribution) and (2) the holders of shares of preferred stock, if any are issued, must be entitled as a class to elect two directors at all times and to elect a majority of the directors if dividends on the preferred stock are in arrears by two years or more.

For any series of preferred stock that we may issue, our Board of Directors will determine and the prospectus supplement relating to such series will describe:

- the designation and number of shares of such series;
- the rate and time at which, and the preferences and conditions under which, any dividends will be paid on shares of such series, the cumulative nature of such dividends and whether such dividends have any participating feature;
- any provisions relating to convertibility or exchangeability of the shares of such series;
- the rights and preferences, if any, of holders of shares of such series upon our liquidation, dissolution or winding up of our affairs;
- the voting powers of the holders of shares of such series;
- any provisions relating to the redemption of the shares of such series;
- any limitations on our ability to pay dividends or make distributions on, or acquire or redeem, other securities while shares of such series are outstanding;
- any conditions or restrictions on our ability to issue additional shares of such series or other securities;
- if applicable, a discussion of certain U.S. Federal income tax considerations; and
- any other relative power, preferences and participating, optional or special rights of shares of such series, and the qualifications, limitations or restrictions thereof.

All shares of preferred stock that we may issue will be identical and of equal rank except as to the particular terms thereof that may be fixed by our Board of Directors, and all shares of each series of preferred stock will be identical and of equal rank except as to the dates from which cumulative dividends thereon will be cumulative.

DESCRIPTION OF OUR DEBT SECURITIES

We currently have the Notes outstanding. However, we may issue additional debt securities in one or more series in the future which, if publicly offered, will be under an indenture to be entered into between us and a trustee. The specific terms of each series of debt securities we publicly offer will be described in the particular prospectus supplement relating to that series. The prospectus supplement may or may not modify the general terms found in this prospectus and will be filed with the SEC. For a complete description of the terms of a particular series of debt securities, you should read both this prospectus and the prospectus supplement relating to that particular series. The description below is a summary with respect to future debt securities we may issue and not a summary of the Notes. Please see "Business—General—Notes" for a description of the Notes.

As required by federal law for all bonds and notes of companies that are publicly offered, the debt securities are governed by a document called an "indenture." On March 9, 2012, we entered into an Agreement of Resignation, Appointment and Acceptance (the "Agreement") with American Stock Transfer & Trust Company, LLC (the

"Retiring Trustee") and U.S. Bank National Association (the "trustee"). Under the Agreement, we formally accepted the resignation of the Retiring Trustee and appointed the trustee under the Indenture, dated as of February 16, 2012 (the "indenture"), by and between us and the Retiring Trustee, as supplemented by the First Supplemental Indenture, dated as of March 1, 2012, by and between us and the Retiring

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Trustee, as further supplemented by the Second Supplemental Indenture, dated as of March 8, 2012, by and between us and the Retiring Trustee, and as further supplemented by the Joinder Supplemental Indenture, dated as of March 8, 2012, by and among us, the Retiring Trustee and the trustee. We accepted the resignation of the Retiring Trustee and appointed the trustee in order to take advantage of a more efficient money market based system of settling issuances of notes issued pursuant to the indenture not available through the Retiring Trustee. The indenture is subject to and governed by the Trust Indenture Act of 1939, as amended. The trustee has two main roles. First, the trustee can enforce your rights against us if we default. There are some limitations on the extent to which the trustee acts on your behalf, described in the second paragraph under "Events of Default—Remedies if an Event of Default Occurs." Second, the trustee performs certain administrative duties for us.

Because this section is a summary, it does not describe every aspect of the debt securities and the indenture. We urge you to read the indenture because it, and not this description, defines your rights as a holder of debt securities. For example, in this section, we use capitalized words to signify terms that are specifically defined in the indenture. Some of the definitions are repeated in this prospectus, but for the rest you will need to read the indenture. We have filed the form of the indenture with the SEC. See "Available Information" for information on how to obtain a copy of the indenture.

The prospectus supplement, which will accompany this prospectus, will describe the particular series of debt securities being offered by including:

- the designation or title of the series of debt securities;
- the total principal amount of the series of debt securities;
- the percentage of the principal amount at which the series of debt securities will be offered;
- the date or dates on which principal will be payable;
- the rate or rates (which may be either fixed or variable) and/or the method of determining such rate or rates of interest, if any;
- the date or dates from which any interest will accrue, or the method of determining such date or dates, and the date or dates on which any interest will be payable;
- the terms for redemption, extension or early repayment, if any;
- the currencies in which the series of debt securities are issued and payable;
- whether the amount of payments of principal, premium or interest, if any, on a series of debt securities will be determined with reference to an index, formula or other method (which could be based on one or more currencies, commodities, equity indices or other indices) and how these amounts will be determined;
- the place or places, if any, other than or in addition to The City of New York, of payment, transfer, conversion and/or exchange of the debt securities;
- the denominations in which the offered debt securities will be issued;
- the provision for any sinking fund;
- any restrictive covenants;
- any events of default;
- whether the series of debt securities are issuable in certificated form;
- any provisions for defeasance or covenant defeasance;
- any special federal income tax implications, including, if applicable, federal income tax considerations relating to original issue discount;
- whether and under what circumstances we will pay additional amounts in respect of any tax, assessment or governmental charge and, if so, whether we will have the option to redeem the debt securities rather than pay the additional amounts (and the terms of this option);
- any provisions for convertibility or exchangeability of the debt securities into or for any other securities;
- whether the debt securities are subject to subordination and the terms of such subordination;
- the listing, if any, on a securities exchange; and
- any other terms.

The debt securities may be secured or unsecured obligations. Under the provisions of the 1940 Act, we are permitted, as a BDC, to issue debt only in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200%

after each issuance of debt. Unless the prospectus supplement states otherwise, principal (and premium, if any) and interest, if any, will be paid by us in immediately available funds.

General

The indenture provides that any debt securities proposed to be sold under this prospectus and the attached prospectus supplement ("offered debt securities") and any debt securities issuable upon the exercise of warrants or upon conversion or exchange of other offered securities ("underlying debt securities"), may be issued under the indenture in one or more series.

For purposes of this prospectus, any reference to the payment of principal of or premium or interest, if any, on debt securities will include additional amounts if required by the terms of the debt securities.

The indenture limits the amount of debt securities that may be issued thereunder from time to time. Debt securities issued under the indenture, when a single trustee is acting for all debt securities issued under the indenture, are called the "indenture securities." The indenture also provides that there may be more than one trustee thereunder, each with respect to one or more different series of indenture securities. See "Resignation of Trustee" below. At a time when two or more trustees are acting under the indenture, each with respect to only certain series, the term "indenture securities" means the one or more series of debt securities with respect to which each respective trustee is acting. In the event that there is more than one trustee under the indenture, the powers and trust obligations of each trustee described in this prospectus will extend only to the one or more series of indenture securities for which it is trustee. If two or more trustees are acting under the indenture, then the indenture securities for which each trustee is acting would be treated as if issued under separate indentures.

The indenture does not contain any provisions that give you protection in the event we issue a large amount of debt. We refer you to the prospectus supplement for information with respect to any deletions from, modifications of or additions to the Events of Default or our covenants that are described below, including any addition of a covenant or other provision providing event risk or similar protection.

We have the ability to issue indenture securities with terms different from those of indenture securities previously issued and, without the consent of the holders thereof, to reopen a previous issue of a series of indenture securities and issue additional indenture securities of that series unless the reopening was restricted when that series was created.

Conversion and Exchange

If any debt securities are convertible into or exchangeable for other securities, the prospectus supplement will explain the terms and conditions of the conversion or exchange, including the conversion price or exchange ratio (or the calculation method), the conversion or exchange period (or how the period will be determined), if conversion or exchange will be mandatory or at the option of the holder or us, provisions for adjusting the conversion price or the exchange ratio and provisions affecting conversion or exchange in the event of the redemption of the underlying debt securities. These terms may also include provisions under which the number or amount of other securities to be received by the holders of the debt securities upon conversion or exchange would be calculated according to the market price of the other securities as of a time stated in the prospectus supplement.

Issuance of Securities in Registered Form

We may issue the debt securities in registered form, in which case we may issue them either in book-entry form only or in "certificated" form. Debt securities issued in book-entry form will be represented by global securities. We expect that we will usually issue debt securities in book-entry only form represented by global securities.

We also will have the option of issuing debt securities in non-registered form as bearer securities if we issue the securities outside the United States to non-U.S. persons. In that case, the prospectus supplement will set forth the mechanics for holding the bearer securities, including the procedures for receiving payments, for exchanging the bearer securities, including the procedures for receiving payments, for exchanging the bearer securities for registered securities of the same series, and for receiving notices. The prospectus supplement will also describe the requirements with respect to our maintenance of offices or agencies outside the United States and the applicable U.S. federal tax law requirements.

Book-Entry Holders

We will issue registered debt securities in book-entry form only, unless we specify otherwise in the applicable prospectus supplement. This means debt securities will be represented by one or more global securities registered in the name of a depositary that will hold them on behalf of financial institutions that participate in the depositary's book-entry system. These participating institutions, in turn, hold beneficial interests in the debt securities held by the depositary or its nominee. These institutions may hold these interests on behalf of themselves or customers.

Under the indenture, only the person in whose name a debt security is registered is recognized as the holder of that debt security. Consequently, for debt securities issued in book-entry form, we will recognize only the depositary as the holder of the debt securities and we will make all payments on the debt securities to the depositary. The depositary will then pass along the payments it receives to its participants, which in turn will pass the payments along to their customers who are the beneficial owners. The depositary and its participants do so under agreements they have made with one another or with their customers; they are not obligated to do so under the terms of the debt securities.

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As a result, investors will not own debt securities directly. Instead, they will own beneficial interests in a global security, through a bank, broker or other financial institution that participates in the depositary's book-entry system or holds an interest through a participant. As long as the debt securities are represented by one or more global securities, investors will be indirect holders, and not holders, of the debt securities.

Street Name Holders

In the future, we may issue debt securities in certificated form or terminate a global security. In these cases, investors may choose to hold their debt securities in their own names or in "street name." Debt securities held in street name are registered in the name of a bank, broker or other financial institution chosen by the investor, and the investor would hold a beneficial interest in those debt securities through the account he or she maintains at that institution.

For debt securities held in street name, we will recognize only the intermediary banks, brokers and other financial institutions in whose names the debt securities are registered as the holders of those debt securities and we will make all payments on those debt securities to them. These institutions will pass along the payments they receive to their customers who are the beneficial owners, but only because they agree to do so in their customer agreements or because they are legally required to do so. Investors who hold debt securities in street name will be indirect holders, and not holders, of the debt securities.

Legal Holders

Our obligations, as well as the obligations of the applicable trustee and those of any third parties employed by us or the applicable trustee, run only to the legal holders of the debt securities. We do not have obligations to investors who hold beneficial interests in global securities, in street name or by any other indirect means. This will be the case whether an investor chooses to be an indirect holder of a debt security or has no choice because we are issuing the debt securities only in book-entry form.

For example, once we make a payment or give a notice to the holder, we have no further responsibility for the payment or notice even if that holder is required, under agreements with depositary participants or customers or by law, to pass it along to the indirect holders but does not do so. Similarly, if we want to obtain the approval of the holders for any purpose (for example, to amend an indenture or to relieve us of the consequences of a default or of our obligation to comply with a particular provision of an indenture), we would seek the approval only from the holders, and not the indirect holders, of the debt securities. Whether and how the holders contact the indirect holders is up to the holders.

When we refer to you, we mean those who invest in the debt securities being offered by this prospectus, whether they are the holders or only indirect holders of those debt securities. When we refer to your debt securities, we mean the debt securities in which you hold a direct or indirect interest.

Special Considerations for Indirect Holders

If you hold debt securities through a bank, broker or other financial institution, either in book-entry form or in street name, we urge you to check with that institution to find out:

- how it handles securities payments and notices,
- whether it imposes fees or charges,
- how it would handle a request for the holders' consent, if ever required,
- whether and how you can instruct it to send you debt securities registered in your own name so you can be a holder, if that is permitted in the future for a particular series of debt securities,
- how it would exercise rights under the debt securities if there were a default or other event triggering the need for holders to act to protect their interests, and
- if the debt securities are in book-entry form, how the depositary's rules and procedures will affect these matters.

Global Securities

As noted above, we usually will issue debt securities as registered securities in book-entry form only. A global security represents one or any other number of individual debt securities. Generally, all debt securities represented by the same global securities will have the same terms.

Each debt security issued in book-entry form will be represented by a global security that we deposit with and register in the name of a financial institution or its nominee that we select. The financial institution that we select for this purpose is called the depositary. Unless we specify otherwise in the applicable prospectus supplement, The Depository

Trust Company, New York, New York, known as DTC, will be the depositary for all debt securities issued in book-entry form.

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A global security may not be transferred to or registered in the name of anyone other than the depositary or its nominee, unless special termination situations arise. We describe those situations below under "Special Situations when a Global Security Will Be Terminated". As a result of these arrangements, the depositary, or its nominee, will be the sole registered owner and holder of all debt securities represented by a global security, and investors will be permitted to own only beneficial interests in a global security. Beneficial interests must be held by means of an account with a broker, bank or other financial institution that in turn has an account with the depositary or with another institution that has an account with the depositary. Thus, an investor whose security is represented by a global security will not be a holder of the debt security, but only an indirect holder of a beneficial interest in the global security.

Special Considerations for Global Securities

As an indirect holder, an investor's rights relating to a global security will be governed by the account rules of the investor's financial institution and of the depositary, as well as general laws relating to securities transfers. The depositary that holds the global security will be considered the holder of the debt securities represented by the global security.

If debt securities are issued only in the form of a global security, an investor should be aware of the following:

An investor cannot cause the debt securities to be registered in his or her name, and cannot obtain certificates for his or her interest in the debt securities, except in the special situations we describe below.

- An investor will be an indirect holder and must look to his or her own bank or broker for payments on the debt securities and protection of his or her legal rights relating to the debt securities, as we describe under "Issuance of Securities in Registered Form" above.
- An investor may not be able to sell interests in the debt securities to some insurance companies and other institutions that are required by law to own their securities in non-book-entry form.
- An investor may not be able to pledge his or her interest in a global security in circumstances where certificates representing the debt securities must be delivered to the lender or other beneficiary of the pledge in order for the pledge to be effective.
- The depositary's policies, which may change from time to time, will govern payments, transfers, exchanges and other matters relating to an investor's interest in a global security. We and the trustee have no responsibility for any aspect of the depositary's actions or for its records of ownership interests in a global security. We and the trustee also do not supervise the depositary in any way.
- If we redeem less than all the debt securities of a particular series being redeemed, DTC's practice is to determine by lot the amount to be redeemed from each of its participants holding that series.
- An investor is required to give notice of exercise of any option to elect repayment of its debt securities, through its participant, to the applicable trustee and to deliver the related debt securities by causing its participant to transfer its interest in those debt securities, on DTC's records, to the applicable trustee.
- DTC requires that those who purchase and sell interests in a global security deposited in its book-entry system use immediately available funds. Your broker or bank may also require you to use immediately available funds when purchasing or selling interests in a global security.
- Financial institutions that participate in the depositary's book-entry system, and through which an investor holds its interest in a global security, may also have their own policies affecting payments, notices and other matters relating to the debt securities. There may be more than one financial intermediary in the chain of ownership for an investor. We do not monitor and are not responsible for the actions of any of those intermediaries.

Special Situations when a Global Security will be Terminated

In a few special situations described below, a global security will be terminated and interests in it will be exchanged for certificates in non-book-entry form (certificated securities). After that exchange, the choice of whether to hold the certificated debt securities directly or in street name will be up to the investor. Investors must consult their own banks or brokers to find out how to have their interests in a global security transferred on termination to their own names, so that they will be holders. We have described the rights of legal holders and street name investors under "Issuance of Securities in Registered Form" above.

The special situations for termination of a global security are as follows:

- if the depositary notifies us that it is unwilling, unable or no longer qualified to continue as depositary for that global security, and we do not appoint another institution to act as depositary within 60 days,
- if we notify the trustee that we wish to terminate that global security, or
- if an event of default has occurred with regard to the debt securities represented by that global security and has not been cured or waived; we discuss defaults later under "Events of Default."

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The prospectus supplement may list situations for terminating a global security that would apply only to the particular series of debt securities covered by the prospectus supplement. If a global security is terminated, only the depositary, and not we or the applicable trustee, is responsible for deciding the names of the institutions in whose names the debt securities represented by the global security will be registered and, therefore, who will be the holders of those debt securities.

Payment and Paying Agents

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

Payments on Global Securities

We will make payments on a global security in accordance with the applicable policies of the depositary as in effect from time to time. Under those policies, we will make payments directly to the depositary, or its nominee, and not to any indirect holders who own beneficial interests in the global security. An indirect holder's right to those payments will be governed by the rules and practices of the depositary and its participants, as described under "—Special Considerations for Global Securities."

Payments on Certificated Securities

We will make payments on a certificated debt security as follows. We will pay interest that is due on an interest payment date by check mailed on the interest payment date to the holder at his or her address shown on the trustee's records as of the close of business on the regular record date. We will make all payments of principal and premium, if any, by check at the office of the applicable trustee in New York, NY and/or at other offices that may be specified in the prospectus supplement or in a notice to holders against surrender of the debt security.

Alternatively, if the holder asks us to do so, we will pay any amount that becomes due on the debt security by wire transfer of immediately available funds to an account at a bank in New York City, on the due date. To request payment by wire, the holder must give the applicable trustee or other paying agent appropriate transfer instructions at least 15 business days before the requested wire payment is due. In the case of any interest payment due on an interest payment date, the instructions must be given by the person who is the holder on the relevant regular record date. Any wire instructions, once properly given, will remain in effect unless and until new instructions are given in the manner described above.

Payment When Offices Are Closed

If any payment is due on a debt security on a day that is not a business day, we will make the payment on the next day that is a business day. Payments made on the next business day in this situation will be treated under the indenture as if they were made on the original due date, except as otherwise indicated in the attached prospectus supplement. Such payment will not result in a default under any debt security or the indenture, and no interest will accrue on the payment amount from the original due date to the next day that is a business day.

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

Events of Default

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

The term "Event of Default" in respect of the debt securities of your series means any of the following:

- We do not pay the principal of, or any premium on, a debt security of the series on its due date.
- We do not pay interest on a debt security of the series within 30 days of its due date.
- We do not deposit any sinking fund payment in respect of debt securities of the series on its due date.
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We remain in breach of a covenant in respect of debt securities of the series for 90 days after we receive a written notice of default stating we are in breach. The notice must be sent by either the trustee or holders of at least 25% of the principal amount of debt securities of the series.

- We file for bankruptcy or certain other events of bankruptcy, insolvency or reorganization occur.
- Any other Event of Default in respect of debt securities of the series described in the prospectus supplement occurs.

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

Remedies if an Event of Default Occurs

If an Event of Default has occurred and has not been cured, the trustee or the holders of at least 25% in principal amount of the debt securities of the affected series may declare the entire principal amount of all the debt securities of that series to be due and immediately payable. This is called a declaration of acceleration of maturity. A declaration of acceleration of maturity may be canceled by the holders of a majority in principal amount of the debt securities of the affected series under certain circumstances.

Except in cases of default, where the trustee has some special duties, the trustee is not required to take any action under the indenture at the request of any holders unless the holders offer the trustee reasonable protection from expenses and liability (called an "indemnity"). (Section 315 of the Trust Indenture Act of 1939) If reasonable indemnity is provided, the holders of a majority in principal amount of the outstanding debt securities of the relevant series may direct the time, method and place of conducting any lawsuit or other formal legal action seeking any remedy available to the trustee. The trustee may refuse to follow those directions in certain circumstances. No delay or omission in exercising any right or remedy will be treated as a waiver of that right, remedy or Event of Default.

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

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

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

Holders of a majority in principal amount of the debt securities of the affected series may waive any past defaults other than:

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

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

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

Merger or Consolidation

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

- Where we merge out of existence or sell our assets, the resulting entity must agree to be legally responsible for our obligations under the debt securities.
- The merger or sale of assets must not cause a default on the debt securities and we must not already be in default (unless the merger or sale would cure the default). For purposes of this no-default test, a default would include an Event of Default that has occurred and has not been cured, as described under "Events of Default" above. A default for this purpose would also include any event that would be an Event of Default if the requirements for giving us a notice of default or our default having to exist for a specific period of time were disregarded.
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Under the indenture, no merger or sale of assets may be made if as a result any of our property or assets or any property or assets of one of our subsidiaries, if any, would become subject to any mortgage, lien or other encumbrance unless either (i) the mortgage, lien or other encumbrance could be created pursuant to the limitation on liens covenant

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in the indenture (see "Indenture Provisions—Limitation on Liens" below) without equally and ratably securing the indenture securities or (ii) the indenture securities are secured equally and ratably with or prior to the debt secured by the mortgage, lien or other encumbrance.

- We must deliver certain certificates and documents to the trustee.
- We must satisfy any other requirements specified in the prospectus supplement relating to a particular series of debt securities.

Modification or Waiver

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

Changes Requiring Your Approval

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

- change the stated maturity of the principal of, or interest on, a debt security;
- reduce any amounts due on a debt security;
- reduce the amount of principal payable upon acceleration of the maturity of a security following a default;
- adversely affect any right of repayment at the holder's option;
- change the place (except as otherwise described in the prospectus or prospectus supplement) or currency of payment on a debt security;
- impair your right to sue for payment;
- adversely affect any right to convert or exchange a debt security in accordance with its terms;
- modify the subordination provisions in the indenture in a manner that is adverse to holders of the debt securities;
- reduce the percentage of holders of debt securities whose consent is needed to modify or amend the indenture;
- reduce the percentage of holders of debt securities whose consent is needed to waive compliance with certain provisions of the indenture or to waive certain defaults;
- modify any other aspect of the provisions of the indenture dealing with supplemental indentures, modification and waiver of past defaults, changes to the quorum or voting requirements or the waiver of certain covenants; and
- change any obligation we have to pay additional amounts.

Changes Not Requiring Approval

The second type of change does not require any vote by the holders of the debt securities. This type is limited to clarifications and certain other changes that would not adversely affect holders of the outstanding debt securities in any material respect. We also do not need any approval to make any change that affects only debt securities to be issued under the indenture after the change takes effect.

Changes Requiring Majority Approval

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

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

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

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

Further Details Concerning Voting

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

- For original issue discount securities, we will use the principal amount that would be due and payable on the voting date if the maturity of these debt securities were accelerated to that date because of a default.

- For debt securities whose principal amount is not known (for example, because it is based on an index), we will use a special rule for that debt security described in the prospectus supplement.
- For debt securities denominated in one or more foreign currencies, we will use the U.S. dollar equivalent.

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

We will generally be entitled to set any day as a record date for the purpose of determining the holders of outstanding indenture securities that are entitled to vote or take other action under the indenture. If we set a record date for a vote or other action to be taken by holders of one or more series, that vote or action may be taken only by persons who are holders of outstanding indenture securities of those series on the record date and must be taken within eleven months following the record date.

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

Defeasance

The following provisions will be applicable to each series of debt securities unless we state in the applicable prospectus supplement that the provisions of covenant defeasance and full defeasance will not be applicable to that series.

Covenant Defeasance

Under current United States federal tax law, we can make the deposit described below and be released from some of the restrictive covenants in the indenture under which the particular series was issued. This is called "covenant defeasance." In that event, you would lose the protection of those restrictive covenants but would gain the protection of having money and government securities set aside in trust to repay your debt securities. In order to achieve covenant defeasance, we must do the following:

- If the debt securities of the particular series are denominated in U.S. dollars, we must deposit in trust for the benefit of all holders of such debt securities a combination of money and United States government or United States government agency notes or bonds that will generate enough cash to make interest, principal and any other payments on the debt securities on their various due dates.
- We must deliver to the trustee a legal opinion of our counsel confirming that, under current United States federal income tax law, we may make the above deposit without causing you to be taxed on the debt securities any differently than if we did not make the deposit and just repaid the debt securities ourselves at maturity.
- We must deliver to the trustee a legal opinion of our counsel stating that the above deposit does not require registration by us under the 1940 Act, as amended, and a legal opinion and officers' certificate stating that all conditions precedent to covenant defeasance have been complied with.

Full Defeasance

If there is a change in United States federal tax law, as described below, we can legally release ourselves from all payment and other obligations on the debt securities of a particular series (called "full defeasance") if we put in place the following other arrangements for you to be repaid:

- If the debt securities of the particular series are denominated in U.S. dollars, we must deposit in trust for the benefit of all holders of such debt securities a combination of money and United States government or United States government agency notes or bonds that will generate enough cash to make interest, principal and any other payments on the debt securities on their various due dates.
- We must deliver to the trustee a legal opinion confirming that there has been a change in current United States federal tax law or an IRS ruling that allows us to make the above deposit without causing you to be taxed on the debt securities any differently than if we did not make the deposit and just repaid the debt securities ourselves at maturity. Under current United States federal tax law, the deposit and our legal release from the debt securities would be treated as though we paid you your share of the cash and notes or bonds at the time the cash and notes or bonds were deposited in trust in exchange for your debt securities and you would recognize gain or loss on the debt securities at the time of the deposit.
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We must deliver to the trustee a legal opinion of our counsel stating that the above deposit does not require registration by us under the 1940 Act, as amended, and a legal opinion and officers' certificate stating that all conditions precedent to defeasance have been complied with.

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Form, Exchange and Transfer of Certificated Registered Securities

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

- only in fully registered certificated form,
- without interest coupons, and
- unless we indicate otherwise in the prospectus supplement, in denominations of $1,000 and amounts that are multiples of $1,000.

Holders may exchange their certificated securities for debt securities of smaller denominations or combined into fewer debt securities of larger denominations, as long as the total principal amount is not changed.

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

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

If we have designated additional transfer agents for your debt security, they will be named in your prospectus supplement. We may appoint additional transfer agents or cancel the appointment of any particular transfer agent. We may also approve a change in the office through which any transfer agent acts.

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

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

Resignation of Trustee

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

Indenture Provisions—Subordination

Upon any distribution of our assets upon our dissolution, winding up, liquidation or reorganization, the payment of the principal of (and premium, if any) and interest, if any, on any indenture securities denominated as subordinated debt securities is to be subordinated to the extent provided in the indenture in right of payment to the prior payment in full of all Senior Indebtedness (as defined below), but our obligation to you to make payment of the principal of (and premium, if any) and interest, if any, on such subordinated debt securities will not otherwise be affected. In addition, no payment on account of principal (or premium, if any), sinking fund or interest, if any, may be made on such subordinated debt securities at any time unless full payment of all amounts due in respect of the principal (and premium, if any), sinking fund and interest on Senior Indebtedness has been made or duly provided for in money or money's worth.

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

By reason of this subordination, in the event of a distribution of our assets upon our insolvency, certain of our senior creditors may recover more, ratably, than holders of any subordinated debt securities. The indenture provides that these subordination provisions will not apply to money and securities held in trust under the defeasance provisions of the indenture.

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Senior Indebtedness is defined in the indenture as the principal of (and premium, if any) and unpaid interest on:

- our indebtedness (including indebtedness of others guaranteed by us), whenever created, incurred, assumed or guaranteed, for money borrowed (other than indenture securities issued under the indenture and denominated as subordinated debt securities), unless in the instrument creating or evidencing the same or under which the same is outstanding it is provided that this indebtedness is not senior or prior in right of payment to the subordinated debt securities, and
- renewals, extensions, modifications and refinancings of any of this indebtedness.

If this prospectus is being delivered in connection with the offering of a series of indenture securities denominated as subordinated debt securities, the accompanying prospectus supplement will set forth the approximate amount of our Senior Indebtedness outstanding as of a recent date.

The Trustee under the Indenture

U.S. Bank National Association will serve as trustee under the indenture.

Certain Considerations Relating to Foreign Currencies

Debt securities denominated or payable in foreign currencies may entail significant risks. These risks include the possibility of significant fluctuations in the foreign currency markets, the imposition or modification of foreign exchange controls and potential illiquidity in the secondary market. These risks will vary depending upon the currency or currencies involved and will be more fully described in the applicable prospectus supplement.

DESCRIPTION OF OUR SUBSCRIPTION RIGHTS

General

We may issue subscription rights to the holders of the class of securities to whom the subscription rights are being distributed, or the Holders to purchase our Securities. Subscription rights may be issued independently or together with any other offered security and may or may not be transferable by the person purchasing or receiving the subscription rights. In connection with a subscription rights offering to the Holders, we would distribute certificates evidencing the subscription rights and a prospectus supplement to the Holders on the record date that we set for receiving subscription rights in such subscription rights offering.

The applicable prospectus supplement would describe the following terms of subscription rights in respect of which this prospectus is being delivered:

- the period of time the offering would remain open (which shall be open a minimum number of days such that all record holders would be eligible to participate in the offering and shall not be open longer than 120 days);
- the title of such subscription rights;
- the exercise price for such subscription rights (or method of calculation thereof);
- the ratio of the offering;
- the number of such subscription rights issued to each Holder;
- the extent to which such subscription rights are transferable and the market on which they may be traded if they are transferable;
- if applicable, a discussion of certain U.S. federal income tax considerations applicable to the issuance or exercise of such subscription rights;
- the date on which the right to exercise such subscription rights shall commence, and the date on which such right shall expire (subject to any extension);
- the extent to which such subscription rights include an over-subscription privilege with respect to unsubscribed securities and the terms of such over-subscription privilege;
- any termination right we may have in connection with such subscription rights offering; and
- any other terms of such subscription rights, including exercise, settlement and other procedures and limitations relating to the transfer and exercise of such subscription rights.

Exercise of Subscription Rights

Each subscription right would entitle the holder of the subscription right to purchase for cash such amount of our Securities at such exercise price as shall in each case be set forth in, or be determinable as set forth in, the prospectus supplement relating to the subscription rights offered thereby. Subscription rights may be exercised at any time up to the close of business on the expiration date for such subscription rights set forth in the prospectus supplement. After the close of business on the expiration date, all unexercised subscription rights would become void.

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Subscription rights may be exercised as set forth in the prospectus supplement relating to the subscription rights offered thereby. Upon receipt of payment and the subscription rights certificate properly completed and duly executed at the corporate trust office of the subscription rights agent or any other office indicated in the prospectus supplement we will forward, as soon as practicable, the Securities purchasable upon such exercise. To the extent permissible under applicable law, we may determine to offer any unsubscribed offered securities directly to persons other than stockholders, to or through agents, underwriters or dealers or through a combination of such methods, as set forth in the applicable prospectus supplement.

DESCRIPTION OF OUR WARRANTS

The following is a general description of the terms of the warrants we may issue from time to time. Particular terms of any warrants we offer will be described in the prospectus supplement relating to such warrants.

We may issue warrants to purchase shares of our common stock, preferred stock or debt securities from time to time. Such warrants may be issued independently or together with one of our Securities and may be attached or separate from such securities. We will issue each series of warrants under a separate warrant agreement to be entered into between us and a warrant agent. The warrant agent will act solely as our agent and will not assume any obligation or relationship of agency for or with holders or beneficial owners of warrants.

A prospectus supplement will describe the particular terms of any series of warrants we may issue, including the following:

- the title of such warrants;
- the aggregate number of such warrants;
- the price or prices at which such warrants will be issued;
- the currency or currencies, including composite currencies, in which the price of such warrants may be payable;
- the number of shares of common stock, preferred stock or debt securities issuable upon exercise of such warrants;
- the price at which and the currency or currencies, including composite currencies, in which the shares of common stock, preferred stock or debt securities purchasable upon exercise of such warrants may be purchased;
- the date on which the right to exercise such warrants will commence and the date on which such right will expire;
- whether such warrants will be issued in registered form or bearer form;
- if applicable, the minimum or maximum amount of such warrants which may be exercised at any one time;
- if applicable, the number of such warrants issued with each share of common stock, preferred stock or debt securities;
- if applicable, the date on and after which such warrants and the related shares of common stock, preferred stock or debt securities will be separately transferable;
- information with respect to book-entry procedures, if any;
- if applicable, a discussion of certain U.S. federal income tax considerations; and
- any other terms of such warrants, including terms, procedures and limitations relating to the exchange and exercise of such warrants.

We and the warrant agent may amend or supplement the warrant agreement for a series of warrants without the consent of the holders of the warrants issued thereunder to effect changes that are not inconsistent with the provisions of the warrants and that do not materially and adversely affect the interests of the holders of the warrants.

Under the 1940 Act, we may generally only offer warrants provided that (1) the warrants expire by their terms within ten years; (2) the exercise or conversion price is not less than the current market value at the date of issuance; (3) our stockholders authorize the proposal to issue such warrants, and our Board of Directors approves such issuance on the basis that the issuance is in our best interests and the best interest of our stockholders; and (4) if the warrants are accompanied by other securities, the warrants are not separately transferable unless no class of such warrants and the securities accompanying them has been publicly distributed. The 1940 Act also provides that the amount of our voting securities that would result from the exercise of all outstanding warrants at the time of issuance may not exceed 25% of our outstanding voting securities.

DESCRIPTION OF OUR UNITS

A unit is a separate security consisting of two or more other securities that either may or must be traded or transferred together as a single security. The following is a general description of the terms of the units we may issue from time to time. Particular terms of any units we offer will be described in the prospectus supplement relating to such units. For a complete description of the terms of particular units, you should read both this prospectus and the prospectus supplement relating to those particular units.

We may issue units comprised of one or more of the other securities described in this prospectus in any combination. Each unit may also include contracts for purchase of any such security or debt obligations of third parties, such as U.S. Treasury securities, such that the holder holds each component. Thus, the holder of a unit will have the rights and obligations of a holder of each included security.

A prospectus supplement will describe the particular terms of any series of units we may issue, including the following:

- the designation and terms of the units and of the securities comprising the units, including whether and under what circumstances the securities comprising the units may be held or transferred separately;
- a description of the terms of any unit agreement governing the units;
- a description of the provisions for the payment, settlement, transfer or exchange of the units; and
- whether the units will be issued in fully registered or global form.

REGULATION

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.

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 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;

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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;
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.
(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, a 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, exercising control, either on its own or together with others, over a portfolio company or 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.

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Senior Securities
We are permitted, under specified conditions, to issue multiple classes of indebtedness and classes 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. The 1940 Act allows BDCs to issue multiple series of the same class of preferred stock and to issue multiple classes in connection with certain refundings or reorganizations. 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."
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 broadening 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

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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.

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 polices 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.

CUSTODIAN, TRANSFER AND DIVIDEND PAYING AGENT AND REGISTRAR

Our Securities are held under a custody agreement by U.S. Bank National Association. The address of the custodian is: 1555 North Rivercenter Drive, MK-WI-5302, Milwaukee, WI 53212, Attention: Mutual Fund Custody Account Administrator, facsimile: (866) 350-1430. American Stock Transfer & Trust Company acts as our transfer agent, dividend paying agent and registrar. The principal business address of American Stock Transfer & Trust Company is 6201 15th Avenue, Brooklyn, NY 11219, telephone number: (718) 921-8200.

BROKERAGE ALLOCATION AND OTHER PRACTICES

Since we generally acquire and dispose of our investments in privately negotiated transactions, we infrequently use brokers in the normal course of our business. We have not paid any brokerage commissions during the three most recent fiscal years. Subject to policies established by our Board of Directors, Prospect Capital Management is primarily responsible for the execution of the publicly-traded securities portion of our portfolio transactions and the allocation of brokerage commissions.

Prospect Capital Management does not expect to execute transactions through any particular broker or dealer, but seeks to obtain the best net results for the Company, taking into account such factors as price (including the applicable brokerage commission or dealer spread), size of order, difficulty of execution, and operational facilities of the firm and the firm's risk and skill in positioning blocks of securities. While Prospect Capital Management generally seeks reasonably competitive trade execution costs, the Company will not necessarily pay the lowest spread or commission available. Subject to applicable legal requirements, Prospect Capital Management may select a broker based partly upon brokerage or research services provided to it and the Company and any other clients. In return for such services, we may pay a higher commission than other brokers would charge if Prospect Capital Management determines in good faith that such commission is reasonable in relation to the services provided.

PLAN OF DISTRIBUTION

We may sell the Securities pursuant to this prospectus and a prospectus supplement in any of four ways (or in any combination): (a) through underwriters or dealers; (b) directly to a limited number of purchasers or to a single purchaser,

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including existing stockholders in a rights offering; (c) through agents; or (d) directly to our stockholders and others through the issuance of transferable or non-transferable rights to our stockholders. In the case of a rights offering, the applicable prospectus supplement will set forth the number of shares of our common stock or units issuable upon the exercise of each right and the other terms of such rights offering. Any underwriter or agent involved in the offer and sale of the Securities will also be named in the applicable prospectus supplement. The Securities may be sold "at-the-market" to or through a market maker or into an existing trading market for the securities, on an exchange or otherwise. The prospectus supplement will set forth the terms of the offering of such securities, including:

- the name or names of any underwriters or agents and the amounts of Securities underwritten or placed by each of them;
- the offering price of the Securities and the proceeds to us and any discounts, commissions or concessions allowed or reallowed or paid to underwriters or agents; and
- any securities exchanges on which the Securities may be listed.

In addition, we may enter into registration rights agreements or other similar agreements in the future pursuant to which certain of our stockholders may resell our Securities under this prospectus and as described in any related prospectus supplement.

We may use Securities to acquire investments in companies, the terms of which will be further disclosed in a prospectus supplement if such stock is issued in an offering hereunder.

Any offering price and any discounts or concessions allowed or reallowed or paid to underwriters or agents may be changed from time to time.

We may sell our common stock, subscription rights, units, 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 the 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.

If underwriters are used in the sale of any Securities, Securities acquired by the underwriters for their own account may be resold from time to time in one or more transactions, including negotiated transactions, at a fixed public offering price or at varying prices determined at the time of sale. The Securities may be either offered to the public through underwriting syndicates represented by managing underwriters, or directly by underwriters. Generally, any obligations by the underwriters to purchase the Securities will be subject to certain conditions precedent.

In compliance with the guidelines of FINRA, the maximum compensation to the underwriters or dealers in connection with the sale of our Securities pursuant to this prospectus and the accompanying supplement to this prospectus may not exceed 8% of the aggregate offering price of the Securities as set forth on the cover page of the supplement to this prospectus. In connection with any rights offering to our stockholders, we may also enter into a standby underwriting arrangement with one or more underwriters pursuant to which the underwriter(s) will purchase our common stock remaining unsubscribed for after the rights offering.

We may sell the Securities through agents from time to time. The prospectus supplement will name any agent involved in the offer or sale of the Securities and any commissions we pay to them. Generally, any agent will be acting on a best efforts basis for the period of its appointment.

Agents, dealers and underwriters may be entitled to indemnification by us against certain civil liabilities, including liabilities under the Securities Act or to contribution with respect to payments which the agents or underwriters may be required to make in respect thereof. Agents, dealers and underwriters may be customers of, engage in transactions with, or perform services for us in the ordinary course of business.

We may enter into derivative transactions with third parties, or sell Securities outside of this prospectus to third parties in privately negotiated transactions. If the applicable prospectus supplement indicates, in connection with those derivatives, the third parties may sell Securities covered by this prospectus and the applicable prospectus supplement, including in short sale transactions. If so, the third party may use Securities pledged by us or borrowed from us or others to settle those sales or to close out any related open borrowings of stock, and may use securities received from us in settlement of those derivatives to close out any related open borrowings of stock. The third party in such sale transactions will be an underwriter and, if not identified in this prospectus, will be identified in the applicable prospectus supplement (or a post-effective amendment). We or one of our affiliates may loan or pledge Securities to a financial institution or other third party that in turn may sell the securities using this prospectus. Such financial institution or third party may transfer its short position to investors in our Securities or in connection with a simultaneous offering of other Securities offered by this prospectus or otherwise.

Any of our common stock sold pursuant to a prospectus supplement will be listed on The NASDAQ Global Select Market, or another exchange on which our common stock is traded.

In order to comply with the securities laws of certain states, if applicable, the Securities offered hereby will be sold in such jurisdictions only through registered or licensed brokers or dealers. In addition, in certain states, the Securities may not be sold unless they have been registered or qualified for sale in the applicable state or an exemption from the registration or qualification requirements is available and is complied with.

LEGAL MATTERS

Certain legal matters regarding the securities offered by this prospectus will be passed upon for the Company by Skadden, Arps, Slate, Meagher & Flom LLP, New York, NY, and Venable LLP as special Maryland counsel.

INDEPENDENT REGISTERED ACCOUNTING FIRM

BDO USA, LLP is the independent registered public accounting firm of the Company.

AVAILABLE INFORMATION

We have filed with the SEC a registration statement on Form N-2, together with all amendments and related exhibits, under the Securities Act, with respect to our Securities offered by this prospectus. The registration statement contains additional information about us and the Securities being registered by this prospectus. We file with or submit to the SEC annual, quarterly and current periodic reports, proxy statements and other information meeting the informational requirements of the Exchange Act. This information and the information specifically regarding how we voted proxies relating to portfolio securities for the period ended June 30, 2013, are available free of charge by contacting us at 10 East 40th Street, 44th floor, New York, NY 10016 or by telephone at toll-free (888) 748-0702. 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 or by calling 1-800-SEC-0330. 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, or by writing the SEC's Public Reference Section, Washington, D.C. 20549-0102.

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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, the "Company", including the consolidated schedule of investments, as of June 30, 2013 and 2012, 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, 2013, and the financial highlights for each of the five years in the period ended June 30, 2013. These consolidated financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated 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 consolidated financial statements. Our procedures include confirmation of securities owned as of June 30, 2013 and 2012 by correspondence with the custodian, trustees and portfolio companies, and alternative procedures. An audit also includes 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, 2013 and 2012, the results of its operations, the changes in its net assets, and its cash flows for each of the three years in the period ended June 30, 2013, and the financial highlights for each of the five years in the period ended June 30, 2013, 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, 2013, 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 21, 2013 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP
BDO USA, LLP
New York, New York
August 21, 2013, except for Note 16 which is dated October 11, 2013

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

	June 30, 2013	June 30, 2012
Assets (Note 4)		
Investments at fair value:		
Control investments (net cost of $830,151 and $518,015, respectively)	$811,634	$564,489
Affiliate investments (net cost of $49,189 and $44,229, respectively)	42,443	46,116
Non-control/Non-affiliate investments (net cost of $3,376,438 and $1,537,069, respectively)	3,318,775	1,483,616
Total investments at fair value (net cost of $4,255,778 and $2,099,313, respectively, Note 3)	4,172,852	2,094,221
Investments in money market funds	143,262	118,369
Cash	59,974	2,825
Receivables for:		
Interest, net	22,863	14,219
Other	4,397	784
Prepaid expenses	540	421
Deferred financing costs	44,329	24,415
Total Assets	4,448,217	2,255,254
Liabilities		
Credit facility payable (Notes 4 and 8)	124,000	96,000
Senior convertible notes (Notes 5 and 8)	847,500	447,500
Senior unsecured notes (Notes 6 and 8)	347,725	100,000
Prospect Capital InterNotes® (Notes 7 and 8)	363,777	20,638
Due to Broker	43,588	44,533
Dividends payable	27,299	14,180
Due to Prospect Administration (Note 12)	1,366	658
Due to Prospect Capital Management (Note 12)	5,324	7,913
Accrued expenses	2,345	2,925
Interest payable	24,384	6,723
Other liabilities	4,415	2,210
Total Liabilities	1,791,723	743,280
Net Assets	$2,656,494	$1,511,974
Components of Net Assets		
Common stock, par value $0.001 per share (500,000,000 common shares authorized; 247,836,965 and 139,633,870 issued and outstanding, respectively) (Note 9)	$248	$140
Paid-in capital in excess of par (Note 9)	2,739,864	1,544,801
Undistributed net investment income	77,084	23,667
Accumulated realized losses on investments	(77,776)	(51,542)
Unrealized depreciation on investments	(82,926)	(5,092)
Net Assets	$2,656,494	$1,511,974
Net Asset Value Per Share	$10.72	$10.83

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)

	Year Ended June 30, 2013	June 30, 2012	June 30, 2011
Investment Income			
Interest income: (Note 3)			
Control investments	$106,425	$53,408	$21,747
Affiliate investments	6,515	12,155	11,307
Non-control/Non-affiliate investments	234,013	144,592	101,400
CLO Fund securities	88,502	9,381	—
Total interest income	435,455	219,536	134,454
Dividend income:			
Control investments	78,282	63,144	13,569
Affiliate Investments	728	—	—
Non-control/Non-affiliate investments	3,656	1,733	1,507
Money market funds	39	4	16
Total dividend income	82,705	64,881	15,092
Other income: (Note 10)			
Control investments	16,821	25,464	2,829
Affiliate investments	623	108	190
Non-control/Non-affiliate investments	40,732	10,921	16,911
Total other income	58,176	36,493	19,930
Total Investment Income	576,336	320,910	169,476
Operating Expenses			
Investment advisory fees:			
Base management fee (Note 12)	69,800	35,836	22,496
Income incentive fee (Note 12)	81,231	46,671	23,555
Total investment advisory fees	151,031	82,507	46,051
Interest and credit facility expenses	76,341	38,534	17,598
Legal fees	1,918	279	1,062
Valuation services	1,579	1,212	992
Audit, compliance and tax related fees	1,566	1,446	876
Allocation of overhead from Prospect Administration (Note 12)	8,737	6,848	4,979
Insurance expense	356	324	285
Directors' fees	300	273	255
Excise tax	6,500	—	—
Other general and administrative expenses	3,084	2,803	3,157
Total Operating Expenses	251,412	134,226	75,255
Net Investment Income	324,924	186,684	94,221
Net realized (loss) gain on investments (Note 3)	(26,234)	36,588	16,465
Net change in unrealized (depreciation) appreciation on investments (Note 3)	(77,834)	(32,368)	7,552
Net Increase in Net Assets Resulting from Operations	$220,856	$190,904	$118,238
Net increase in net assets resulting from operations per share: (Notes 11 and 15)	$1.07	$1.67	$1.38
Weighted average shares of common stock outstanding:	207,069,971	114,394,554	85,978,757

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)

	Year Ended June 30, 2013	June 30, 2012	June 30, 2011
Increase in Net Assets from Operations:			
Net investment income	$324,924	$186,684	$94,221
Net (loss) gain on investments	(26,234)	36,588	16,465
Net change in unrealized (depreciation) appreciation on investments	(77,834)	(32,368)	7,552
Net Increase in Net Assets Resulting from Operations	220,856	190,904	118,238
Dividends to Shareholders:			
Distribution of net investment income	(271,507)	(136,875)	(94,326)
Distribution of return of capital	—	(4,504)	(11,841)
Total Dividends to Shareholders	(271,507)	(141,379)	(106,167)
Capital Share Transactions:			
Net proceeds from capital shares sold	1,180,899	338,270	381,316
Less: Offering costs of public share offerings	(1,815)	(708)	(1,388)
Reinvestment of dividends	16,087	10,530	10,934
Net Increase in Net Assets Resulting from Capital Share Transactions	1,195,171	348,092	390,862
Total Increase in Net Assets:	1,144,520	397,617	402,933
Net assets at beginning of year	1,511,974	1,114,357	711,424
Net Assets at End of Year	$2,656,494	$1,511,974	$1,114,357
Capital Share Activity:			
Shares sold	101,245,136	30,970,696	37,494,476
Shares issued to acquire controlled investments	5,507,381	—	—
Shares issued through reinvestment of dividends	1,450,578	1,056,484	1,025,352
Net increase in capital share activity	108,203,095	32,027,180	38,519,828
Shares outstanding at beginning of year	139,633,870	107,606,690	69,086,862
Shares Outstanding at End of Year	247,836,965	139,633,870	107,606,690

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)

	Year Ended June 30, 2013	June 30, 2012	June 30, 2011
Cash Flows from Operating Activities:			
Net increase in net assets resulting from operations	$220,856	$190,904	$118,238
Net realized loss (gain) on investments	26,234	(36,588)	(16,465)
Net change in unrealized depreciation (appreciation) on investments	77,834	32,368	(7,552)
Amortization of discounts and premiums	(11,016)	(7,284)	(23,035)
Amortization of deferred financing costs	8,232	8,511	5,365
Payment-in-kind interest	(10,947)	(5,647)	(9,634)
Structuring fees	(52,699)	(8,075)	(13,460)
Change in operating assets and liabilities:			
Payments for purchases of investments	(2,980,320)	(901,833)	(930,243)
Proceeds from sale of investments and collection of investment principal	931,534	500,952	285,862
Net (increase) decrease of investments in money market funds	(24,893)	(58,466)	8,968
Increase in interest receivable, net	(8,644)	(4,950)	(3,913)
(Increase) decrease in other receivables	(3,613)	(517)	153
(Increase) decrease in prepaid expenses	(119)	(320)	270
Decrease in other assets	—	—	534
Decrease in due to Broker	(945)	—	—
Increase (decrease) in due to Prospect Administration	708	446	(82)
Increase (decrease) in due to Prospect Capital Management	(2,589)	207	(1,300)
(Decrease) increase in accrued expenses	(580)	1,052	(1,998)
Increase in interest payable	17,661	2,720	3,817
Increase (decrease) in other liabilities	2,205	(1,361)	2,866
Net Cash Used In Operating Activities:	(1,811,101)	(287,881)	(581,609)
Cash Flows from Financing Activities:			
Borrowings under credit facility (Note 4)	223,000	726,800	465,900
Payments under credit facility (Note 4)	(195,000)	(715,000)	(482,000)
Issuance of Senior Convertible Notes (Note 5)	400,000	130,000	322,500
Repurchases under Senior Convertible Notes (Note 5)	—	(5,000)	—
Issuance of Senior Unsecured Notes	247,725	100,000	—
Issuance of Prospect Capital InterNotes® (Note 7)	343,139	20,638	—
Financing costs paid and deferred	(28,146)	(17,651)	(13,061)
Net proceeds from issuance of common stock	1,121,648	177,699	381,316
Offering costs from issuance of common stock	(1,815)	(708)	(1,388)
Dividends paid	(242,301)	(127,564)	(91,247)
Net Cash Provided By Financing Activities:	1,868,250	289,214	582,020
Total Increase in Cash	57,149	1,333	411
Cash balance at beginning of year	2,825	1,492	1,081
Cash Balance at End of Year	$59,974	$2,825	$1,492
Cash Paid For Interest	$45,363	$24,515	$6,101
Non-Cash Financing Activity:			
Amount of shares issued in connection with dividend reinvestment plan	$16,087	$10,530	$10,934

Amount of shares issued in conjunction with controlled investments	$59,251	$160,571	$—

See notes to consolidated financial statements.

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS
June 30, 2013 and June 30, 2012
(in thousands, except share data)

			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
LEVEL 3 PORTFOLIO INVESTMENTS:							
Control Investments (greater than 25.00% voting control)							
AIRMALL USA, Inc.(27)	Pennsylvania / Property Management	Senior Secured Term Loan (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor), due 6/30/2015)(3)(4)	$28,750	$28,750	$28,750	1.1	%
		Senior Subordinated Term Loan (12.00% plus 6.00% PIK, due 12/31/2015)	12,500	12,500	12,500	0.5	%
		Convertible Preferred Stock (9,919.684 shares)		9,920	9,920	0.4	%
		Common Stock (100 shares)		—	3,478	0.1	%
				51,170	54,648	2.1	%
Ajax Rolled Ring & Machine, Inc.	South Carolina / Manufacturing	Senior Secured Note—Tranche A (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 3/30/2018)(3)(4)	19,737	19,737	19,737	0.7	%
		Subordinated Unsecured Term Loan (11.50% (LIBOR + 8.50% with 3.00% LIBOR floor) plus 6.00% PIK, due 3/30/2018)(4)	19,700	19,700	19,700	0.7	%
		Convertible Preferred Stock—Series A (6,142.6 shares)		6,057	—	—	%
		Unrestricted Common Stock (6 shares)		—	—	—	%
				45,494	39,437	1.4	%
APH Property Holdings, LLC(32)	Georgia / Real Estate	Senior Secured Note (6.00% (LIBOR + 4.00% with 2.00% LIBOR floor) plus 5.50% PIK, due 10/24/2020)(4)	125,892	125,892	125,892	4.8	%
		Common Stock (148,951 shares)		26,648	26,648	1.0.	
				152,540	152,540	5.8	%
AWCNC, LLC(19)	North Carolina / Machinery	Members Units—Class A (1,800,000 units)		—	—	—	%
		Members Units—Class B-1 (1 unit)		—	—	—	%
		Members Units—Class B-2 (7,999,999 units)		—	—	—	%
				—	—	—	%
Borga, Inc.	California / Manufacturing	Revolving Line of Credit—$1,150 Commitment (5.00% (PRIME + 1.75%) plus 3.00% default interest, in non-accrual	1,150	1,095	586	—	%

status effective 03/02/2010, past due)(4)(25)					
Senior Secured Term Loan B (8.50% (PRIME + 5.25%) plus 3.00% default interest, in non-accrual status effective 03/02/2010, past due)(4)	1,611	1,501	—	—	%
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)	9,738	706	—	—	%
Common Stock (100 shares)(21)		—	—	—	%
Warrants (33,750 warrants)(21)		—	—	—	%
		3,302	586	—	%

See notes to consolidated financial statements.
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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
June 30, 2013 and June 30, 2012
(in thousands, except share data)

			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
CCPI Holdings, Inc.(33)	Ohio / Manufacturing	Senior Secured Note (10.00%, due 12/31/2017)(3)	$17,663	$17,663	$17,663	0.7	%
		Senior Secured Note (12.00% plus 7.00% PIK, due 6/30/2018)	7,659	7,659	7,659	0.3	%
		Common Stock (100 shares)		8,581	7,977	0.3	%
		Net Revenue Interest (4% of Net Revenue)		—	604	—	%
				33,903	33,903	1.3	%
Credit Central Holdings of Delaware, LLC(22)(34)	Ohio / Consumer Finance	Senior Secured Revolving Credit Facility—$60,000 Commitment (20.00% (LIBOR + 18.50% with 1.50% LIBOR floor), due 12/31/2022)(4) (25)	38,082	38,082	38,082	1.4	%
		Common Stock (100 shares)		9,581	8,361	0.3	%
		Net Revenue Interest (5% of Net Revenue)		—	4,019	0.2	%
				47,663	50,462	1.9	%
Energy Solutions Holdings, Inc.(8)	Texas / Gas Gathering and Processing	Junior Secured Note (18.00%, due 12/12/2016)	8,500	8,500	8,500	0.3	%
		Senior Secured Note to Vessel Holdings LLC (18.00%, due 12/12/2016)	3,500	3,500	3,500	0.1	%
		Subordinated Secured Note to Freedom Marine Holdings, LLC (12.00% (LIBOR + 6.11% with 5.89% LIBOR floor) plus 4.00% PIK, in non-accrual status effective 10/1/2010, past due)(4)	13,906	12,503	8,449	0.3	%
		Senior Secured Debt to Yatesville Coal Holdings, Inc. (Non-accrual status effective 1/1/2009, past due)	1,449	1,449	—	—	%
		Escrow Receivable		—	—	—	%
		Common Stock (100 shares)		8,318	6,247	0.2	%
				34,270	26,696	0.9	%
First Tower Holdings of Delaware, LLC(22)(29)	Mississippi / Consumer Finance	Senior Secured Revolving Credit Facility—$400,000 Commitment (20.00% (LIBOR + 18.50% with 1.50% LIBOR floor), due 6/30/2022)(4) (25)	264,760	264,760	264,760	10.0	%
				43,193	20,447	0.8	%

		Common Stock (83,729,323 shares)					
		Net Revenue Interest (5% of Net Revenue & Distributions)		—	12,877	0.5	%
				307,953	298,084	11.3	%
Manx Energy, Inc. ("Manx")(12)	Kansas / Oil & Gas Production	Senior Secured Note (13.00%, in non-accrual status effective 1/19/2010, past due)	500	500	346	—	%
		Preferred Stock (6,635 shares)		—	—	—	%
		Common Stock (17,082 shares)		—	—	—	%
				500	346	—	%

See notes to consolidated financial statements.

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
June 30, 2013 and June 30, 2012
(in thousands, except share data)

			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Nationwide Acceptance Holdings, LLC(22)(36)	Chicago / Consumer Finance	Senior Secured Revolving Credit Facility—$30,000 Commitment (20.00% (LIBOR + 18.50% with 1.50% LIBOR floor), due 1/31/2023)(4)(25)	$21,308	$21,308	$21,308	0.8	%
		Membership Units (100 shares)		3,843	2,142	0.1	%
		Net Revenue Interest (5% of Net Revenue)		—	1,701	0.1	%
				25,151	25,151	1.0	%
NMMB Holdings, Inc.(24)	New York / Media	Senior Term Loan (14.00%, due 5/6/2016)	16,000	16,000	13,149	0.5	%
		Senior Subordinated Term Loan (15.00%, due 5/6/2016)	2,800	2,800	—	—	%
		Series A Preferred Stock (4,400 shares)		4,400	—	—	%
				23,200	13,149	0.5	%
R-V Industries, Inc.	Pennsylvania / Manufacturing	Senior Subordinated Note (10.00% (LIBOR + 9.00% with 1.00% LIBOR floor), due 6/12/2018)(4)	32,750	32,750	32,750	1.2	%
		Warrants (200,000 warrants, expiring 6/30/2017)		1,682	6,796	0.3	%
		Common Stock (545,107 shares)		5,087	18,522	0.7	%
				39,519	58,068	2.2	%
The Healing Staff, Inc.(9)	North Carolina / Contracting	Secured Promissory Notes (15.00%, in non-accrual status effective 12/22/2010, past due)	1,688	1,686	—	—	%
		Senior Demand Note (15.00%, in non-accrual status effective 11/1/2010, past due)	1,170	1,170	—	—	%
		Common Stock (1,000 shares)		975	—	—	%
				3,831	—	—	%
Valley Electric Holdings I, Inc.	Washington / Construction & Engineering	Senior Secured Note (9.00% (LIBOR + 6.00%, with 3.00% LIBOR floor) plus 9.00% PIK, due 12/31/2018)(4)	34,063	34,063	34,063	1.3	%
		Senior Secured Note (8.00% (LIBOR + 5.00% with 3.00% LIBOR floor) plus 2.50% PIK, due 12/31/2017)(3)(4)	10,026	10,026	10,026	0.4	%
		Common Stock (50,000 shares)		9,526	8,288	0.3	%
				—	1,238	0.1	%

Net Revenue Interest (5% of Net Revenue)	53,615	53,615	2.1	%

See notes to consolidated financial statements.

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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Wolf Energy Holdings, Inc.(12)(37)	Kansas / Oil & Gas Production	Senior Secured Promissory Note secured by assets formerly owned by H&M (18.00%, in non-accrual status effective 4/15/2013, due 4/15/2018)	$22,000	$—	$3,832	0.1	%
		Appalachian Energy Holdings, LLC ("AEH")—Senior Secured First Lien Note (8.00%, in non-accrual status effective 1/19/2010, past due)	2,642	2,000	546	—	%
		Appalachian Energy Holdings, LLC ("AEH")—Senior Secured First Lien Note (8.00%, in non-accrual status, past due)	51	50	51	—	%
		Coalbed, LLC—Senior Secured Note (8.00%, in non-accrual status effective 1/19/2010, past due)(6)	7,930	5,990	—	—	%
		Common Stock (100 shares)		—	—	—	%
		Net Profits Interest (8.00% payable on Equity distributions)(7)		—	520	—	%
				8,040	4,949	0.1	%
		Total Control Investments		830,151	811,634	30.6	%
Affiliate Investments (5.00% to 24.99% voting control)							
BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork)	Michigan / Healthcare	Senior Secured Note (10.00% (LIBOR + 8.00% with 2.00% LIBOR floor), due 12/17/2017)(3)(4)	29,550	29,550	29,550	1.1	%
		Preferred Stock Series A (9,925.455 shares)(13)		2,300	2,832	0.1	%
		Preferred Stock Series B (1,753.64 shares)(13)		579	533	—	%
				32,429	32,915	1.2	%
Boxercraft Incorporated(20)	Georgia / Textiles & Leather	Senior Secured Term Loan A (10.00% plus 1.00% PIK, due 9/15/2015)	1,712	1,702	1,712	0.1	%
		Senior Secured Term Loan B (10.00% plus 1.00% PIK, due 9/15/2015)	4,892	4,809	4,892	0.2	%
		Senior Secured Term Loan C (10.00% plus 1.00% PIK, due	2,371	2,371	2,371	0.1	%

		9/15/2015)					
		Senior Secured Term Loan (10.00% plus 1.00% PIK, due 9/15/2015)	8,325	7,878	410	—	%
		Preferred Stock (1,000,000 shares)		—	—	—	%
		Common Stock (10,000 shares)		—	—	—	%
		Warrants (1 warrant, expiring 8/31/2022)		—	—	—	%
				16,760	9,385	0.4	%
Smart, LLC(14)	New York / Diversified / Conglomerate Service	Membership Interest		—	143	—	%
				—	143	—	%
		Total Affiliate Investments		49,189	42,443	1.6	%

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CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Non-control/Non-affiliate Investments (less than 5.00% of voting control)							
ADAPCO, Inc.	Florida / Ecological	Common Stock (5,000 shares)		$ 141	$ 335	—	%
				141	335	—	%
Aderant North America, Inc.	Georgia / Software & Computer Services	Second Lien Term Loan (10.00% (LIBOR + 8.75% with 1.25% LIBOR floor), due 6/20/2019)(4)	$ 7,000	6,900	7,000	0.3	%
				6,900	7,000	0.3	%
Aircraft Fasteners International, LLC	California / Machinery	Convertible Preferred Stock (32,500 units)		396	565	—	%
				396	565	—	%
ALG USA Holdings, LLC	Pennsylvania / Hotels, Restaurants & Leisure	Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 2/28/2020)(4)	12,000	11,764	12,000	0.4	%
				11,764	12,000	0.4	%
American Gilsonite Company	Utah / Specialty Minerals	Second Lien Term Loan (11.50%, due 9/1/2017)	38,500	38,500	38,500	1.4	%
		Membership Interest in AGC/PEP, LLC (99.9999%)(15)		—	4,058	0.2	%
				38,500	42,558	1.6	%
Apidos CLO VIII, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	19,730	19,931	19,718	0.7	%
				19,931	19,718	0.7	%
Apidos CLO IX, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	20,525	19,609	19,294	0.7	%
				19,609	19,294	0.7	%
Apidos CLO XI, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	38,340	39,239	37,972	1.4	%
				39,239	37,972	1.4	%
Apidos CLO XII, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	44,063	43,480	40,294	1.5	%
				43,480	40,294	1.5	%

Arctic Glacier U.S.A, Inc.(4)	Canada / Food Products	Second Lien Term Loan (11.25% (LIBOR + 10.00% with 1.25% LIBOR floor), due 11/10/2019)	150,000	150,000	150,000	5.6	%
				150,000	150,000	5.6	%
Armor Holding II LLC(4)	New York / Diversified Financial Services	Second Lien Term Loan (9.25% (LIBOR + 8.00% with 1.25% LIBOR floor), due 12/26/2020)	7,000	6,860	7,000	0.3	%
				6,860	7,000	0.3	%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Atlantis Healthcare Group (Puerto Rico), Inc.(4)	Puerto Rico / Healthcare	Revolving Line of Credit—$7,000 Commitment (10.00% (LIBOR + 8.00% with 2.00% LIBOR floor), due 2/21/2014)(25)(26)	$2,000	$2,000	$2,000	0.1	%
		Senior Term Loan (10.00% (LIBOR + 8.00% with 2.00% LIBOR floor), due 2/21/2018)(3)	39,352	39,352	39,352	1.5	%
				41,352	41,352	1.6	%
Babson CLO Ltd 2011-I(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	35,000	34,499	34,450	1.3	%
				34,499	34,450	1.3	%
Babson CLO Ltd 2012-IA(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	29,075	25,917	27,269	1.0	%
				25,917	27,269	1.0	%
Babson CLO Ltd 2012-IIA(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	27,850	28,863	27,510	1.0	%
				28,863	27,510	1.0	%
Blue Coat Systems, Inc.	Massachusetts / Software & Computer Services	Second Lien Term Loan (9.50% (LIBOR + 8.50% with 1.00% LIBOR floor), due 6/28/2020)(4)	11,000	10,890	11,000	0.4	%
				10,890	11,000	0.4	%
Broder Bros., Co	Pennsylvania / Textiles, Apparel & Luxury Goods	Senior Secured Notes (10.75% (LIBOR + 9.00% with 1.75% LIBOR floor), due 6/27/2018(3)(4)	99,500	99,500	99,323	3.7	%
				99,500	99,323	3.7	%
Brookside Mill CLO Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	26,000	23,896	23,743	0.9	%
				23,896	23,743	0.9	%
Byrider Systems Acquisition Corp(22)	Indiana / Auto Finance	Senior Subordinated Notes (12.00% plus 2.00% PIK, due 11/3/2016)(3)	10,914	10,914	10,417	0.4	%

			10,914	10,417	0.4	%
Caleel + Hayden, LLC(14)(31)	Colorado / Personal & Nondurable Consumer Products	Membership Units (13,220 shares)	—	104	—	%
		Escrow Receivable	—	137	—	%
			—	241	—	%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Capstone Logistics, LLC(4)	Georgia / Commercial Services	Senior Secured Term Loan A (6.50% (LIBOR + 5.00% with 1.50% LIBOR floor), due 9/16/2016)(3)	$97,291	$97,291	$97,291	3.7	%
		Senior Secured Term Loan B (11.50% (LIBOR + 10.00% with 1.50% LIBOR floor), due 9/16/2016)	100,000	100,000	100,000	3.8	%
				197,291	197,291	7.5	%
Cargo Airport Services USA, LLC	New York / Transportation	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 3/31/2016)(3)(4)	43,977	43,977	44,417	1.7	%
		Common Equity (1.6 units)		1,639	1,860	0.1	%
				45,616	46,277	1.8	%
Cent 17 CLO Limited(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	24,870	24,615	25,454	1.0	%
				24,615	25,454	1.0	%
CI Holdings(4)	Texas / Software & Computer Services	Senior Secured Term Loan (10.00% (LIBOR + 5.00% with 5.00% LIBOR floor), due 6/11/2019)	114,713	114,713	114,713	4.3	%
				114,713	114,713	4.3	%
CIFC Funding 2011-I, Ltd.(4)(22)	Cayman Islands / Diversified Financial Services	Secured Class D Notes (5.32% (LIBOR + 5.00%), due 1/19/2023)	19,000	15,029	15,844	0.6	%
		Unsecured Class E Notes (7.32% (LIBOR + 7.00%), due 1/19/2023)	15,400	12,638	12,745	0.5	%
				27,667	28,589	1.1	%
Cinedigm DC Holdings, LLC(4)	New York / Software & Computer Services	Senior Secured Term Loan (11.00% (LIBOR + 9.00% with 2.00% LIBOR floor) plus 2.50% PIK, due 3/31/2021)	70,595	70,595	70,595	2.7	%
				70,595	70,595	2.7	%
The Copernicus Group, Inc.	North Carolina / Healthcare	Escrow Receivable		—	130	—	%
				—	130	—	%
			27,100	27,100	27,100	1.0	%

Correctional Healthcare Holding Company, Inc.	Colorado / Healthcare	Second Lien Term Loan (11.25%, due 1/11/2020)(3)					
				27,100	27,100	1.0	%
Coverall North America, Inc.	Florida / Commercial Services	Senior Secured Term Loan (11.50% (LIBOR + 8.50% with 3.00% LIBOR floor), due 12/17/2017)(3)(4)	39,303	39,303	39,303	1.5	%
				39,303	39,303	1.5	%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
CP Well Testing, LLC	Oklahoma / Oil & Gas Products	Senior Secured Term Loan (13.50% (LIBOR + 11.00% with 2.50% LIBOR floor), due 10/03/2017)(4)	$19,125	$19,125	$19,125	0.7	%
				19,125	19,125	0.7	%
CRT MIDCO, LLC	Wisconsin / Media	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 6/30/2017)(3)(4)	71,106	71,106	71,106	2.7	%
				71,106	71,106	2.7	%
Deltek, Inc.	Virginia / Software & Computer Services	Second Lien Term Loan (10.00% (LIBOR + 8.75% with 1.25% LIBOR floor), due 10/10/2019)(4)	12,000	11,833	12,000	0.5	%
				11,833	12,000	0.5	%
Diamondback Operating, LP	Oklahoma / Oil & Gas Production	Net Profits Interest (15.00% payable on Equity distributions)(7)		—	—	—	%
				—	—	—	%
Edmentum, Inc (f/k/a Archipelago Learning, Inc)(4)	Minnesota / Consumer Services	Second Lien Term Loan (11.25% (LIBOR + 9.75% with 1.50% LIBOR floor), due 5/17/2019)	50,000	48,218	50,000	1.9	%
				48,218	50,000	1.9	%
EIG Investors Corp	Massachusetts / Software & Computer Services	Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 5/09/2020)(4)(16)	22,000	21,792	22,000	0.8	%
				21,792	22,000	0.8	%
Empire Today, LLC	Illinois / Durable Consumer Products	Senior Secured Note (11.375%, due 2/1/2017)	15,700	15,332	14,650	0.6	%
				15,332	14,650	0.6	%
EXL Acquisition Corp	South Carolina / Biotechnology	Escrow Receivable	—	—	14	—	%
				—	14	—	%
Evanta Ventures, Inc.(11)	Oregon / Commercial Services	Subordinated Unsecured (12.00% plus 1.00% PIK, due 9/28/2018)	10,479	10,479	10,479	0.4	%
				10,479	10,479	0.4	%
Fairchild Industrial Products, Co.	North Carolina / Electronics	Escrow Receivable		—	149	—	%

				—	149	—	%
Fischbein, LLC	North Carolina / Machinery	Escrow Receivable		—	225	—	%
				—	225	—	%
Focus Brands, Inc.(4)	Georgia / Consumer Services	Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 8/21/2018)	18,000	17,731	18,000	0.7	%
				17,731	18,000	0.7	%

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CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
FPG, LLC	Illinois / Durable Consumer Products	Senior Secured Term Loan (12.00% (LIBOR + 11.00% with 1.00% LIBOR floor), due 1/20/2017)(4)	$21,401	$21,401	$21,401	0.8	%
		Common Stock (5,638 shares)		27	19	—	%
				21,428	21,420	0.8	%
Galaxy XII CLO, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	22,000	20,792	21,657	0.8	%
				20,792	21,657	0.8	%
Galaxy XV CLO, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	35,025	32,119	30,227	1.1	%
				32,119	30,227	1.1	%
Grocery Outlet, Inc.	California / Retail	Second Lien Term Loan (10.50% (LIBOR + 9.25% with 1.25% LIBOR floor), due 6/17/2019)(4)	14,457	14,127	14,457	0.5	%
				14,127	14,457	0.5	%
Gulf Coast Machine & Supply Company	Texas / Manufacturing	Senior Secured Term Loan (10.50% (LIBOR + 8.50% with 2.00% LIBOR floor), due 10/12/2017)(3)(4)	41,213	41,213	31,972	1.2	%
				41,213	31,972	1.2	%
Halcyon Loan Advisors Funding 2012-I, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	23,188	22,279	22,724	0.9	%
				22,279	22,724	0.9	%
Halcyon Loan Advisors Funding 2013-I, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	40,400	41,085	38,291	1.4	%
				41,085	38,291	1.4	%
Hoffmaster Group, Inc.(4)	Wisconsin / Durable Consumer Products	Second Lien Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 1/3/2019)	20,000	19,831	19,598	0.7	%
		Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 1/3/2019)	1,000	991	955	—	%

				20,822	20,553	0.7	%
ICON Health & Fitness, Inc.	Utah / Durable Consumer Products	Senior Secured Note (11.875%, due 10/15/2016)(3)	43,100	43,310	33,929	1.3	%
				43,310	33,929	1.3	%
IDQ Holdings, Inc.	Texas / Automobile	Senior Secured Note (11.50%, due 4/1/2017)	12,500	12,300	12,500	0.5	%
				12,300	12,500	0.5	%

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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
ING IM CLO 2012-II, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	$38,070	$34,904	$36,848	1.4	%
				34,904	36,848	1.4	%
ING IM CLO 2012-III, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	46,632	44,454	46,361	1.7	%
				44,454	46,361	1.7	%
ING IM CLO 2012-IV, Ltd.(22)	Cayman Islands / Diversified Financial Services	Income Notes (Residual Interest)	40,613	39,255	41,153	1.5	%
				39,255	41,153	1.5	%
Injured Workers Pharmacy LLC	Massachusetts / Healthcare	Second Lien Debt (11.50% (LIBOR + 7.00% with 4.50% LIBOR floor) plus 1.00% PIK, due 5/31/2019)(3)(4)	22,430	22,430	22,430	0.8	%
				22,430	22,430	0.8	%
Interdent, Inc.(4)	California / Healthcare	Senior Secured Term Loan A (8.00% (LIBOR + 6.50% with 1.50% LIBOR floor), due 8/3/2017)	53,475	53,475	53,475	2.0	%
		Senior Secured Term Loan B (13.00% (LIBOR + 10.00% with 3.00% LIBOR floor), due 8/3/2017)(3)	55,000	55,000	55,000	2.1	%
				108,475	108,475	4.1	%
JHH Holdings, Inc.	Texas / Healthcare	Second Lien Debt (12.00% (LIBOR + 10.00% with 2.00% LIBOR floor) plus 1.50% PIK, due 6/23/2018)(3)(4)	16,119	16,119	16,119	0.6	%
				16,119	16,119	0.6	%
LaserShip, Inc.(4)	Virginia / Transportation	Revolving Line of Credit—$5,000 Commitment (10.25% (LIBOR + 8.25% with 2.00% LIBOR floor), due 12/21/2014)(25)	—	—	—	—	%
		Senior Secured Term Loan (10.25% (LIBOR + 8.25% with 2.00% LIBOR floor), due	37,031	37,031	37,031	1.4	%

		12/21/2017)(3)					
				37,031	37,031	1.4	%
LCM XIV CLO Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	26,500	25,838	25,838	1.0	%
				25,838	25,838	1.0	%

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CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
LHC Holdings Corp.	Florida / Healthcare	Revolving Line of Credit—$750 Commitment (8.50% (LIBOR + 6.00% with 2.50% LIBOR floor), due 5/31/2015)(4)(25)(26)	$—	$—	$—	—	%
		Senior Subordinated Debt (10.50%, due 5/31/2015)(3)	2,865	2,865	2,865	0.1	%
		Membership Interest (125 units)		216	245	—	%
				3,081	3,110	0.1	%
Madison Park Funding IX, Ltd.(22)	Cayman Islands / Diversified Financial Services	Income Notes (Residual Interest)	31,110	26,401	26,596	1.0	%
				26,401	26,596	1.0	%
Material Handling Services, LLC(4)	Ohio / Business Services	Senior Secured Term Loan (10.50% (LIBOR + 8.50% with 2.00% LIBOR floor), due 7/5/2017)(3)	27,580	27,580	27,199	1.0	%
		Senior Secured Term Loan (10.00% (LIBOR + 8.00% with 2.00% LIBOR floor), due 12/21/2017)	37,959	37,959	37,035	1.4	%
				65,539	64,234	2.4	%
Maverick Healthcare, LLC	Arizona / Healthcare	Preferred Units (1,250,000 units)		1,252	780	—	%
		Common Units (1,250,000 units)		—	—	—	%
				1,252	780	—	%
Mountain View CLO 2013-I Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	43,650	44,235	43,192	1.6	%
				44,235	43,192	1.6	%
Medical Security Card Company, LLC(4)	Arizona / Healthcare	Revolving Line of Credit—$1,500 Commitment (9.50% (LIBOR + 7.00% with 2.50% LIBOR floor), due 2/1/2016)(25)	—	—	—	—	%
		First Lien Term Loan (11.25% (LIBOR + 8.75% with 2.50% LIBOR floor), due 2/1/2016)(3)	13,427	13,427	13,427	0.5	%
				13,427	13,427	0.5	%
National Bankruptcy Services, LLC(3)(4)	Texas / Diversified Financial Services	Senior Subordinated Term Loan (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor) plus 1.50% PIK, due 7/17/2017)	18,683	18,683	16,883	0.6	%

18,683	16,883	0.6	%

See notes to consolidated financial statements.

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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Naylor, LLC(4)	Florida / Media	Revolving Line of Credit—$2,500 Commitment (11.00% (LIBOR + 8.00% with 3.00% LIBOR floor), due 6/7/2017)(25)	$—	$—	$—	—	%
		Senior Secured Term Loan (11.00% (LIBOR + 8.00% with 3.00% LIBOR floor), due 6/7/2017)(3)	46,170	46,170	46,170	1.7	%
				46,170	46,170	1.7	%
New Century Transportation, Inc.	New Jersey / Transportation	Senior Subordinated Term Loan (12.00% (LIBOR + 10.00% with 2.00% LIBOR floor) plus 3.00% PIK, due 2/3/2018)(3)(4)	45,120	45,120	44,166	1.7	%
				45,120	44,166	1.7	%
New Star Metals, Inc.	Indiana / Metal Services & Minerals	Senior Subordinated Term Loan (11.50% (LIBOR + 8.50% with 3.00% LIBOR floor) plus 1.00% PIK, due 2/2/2018)(4)	50,274	50,274	50,274	1.9	%
				50,274	50,274	1.9	%
Nixon, Inc.	California / Durable Consumer Products	Senior Secured Term Loan (8.75% plus 2.75% PIK, due 4/16/2018)(16)	15,509	15,252	14,992	0.6	%
				15,252	14,992	0.6	%
NRG Manufacturing, Inc.	Texas / Manufacturing	Escrow Receivable		—	3,618	0.1	%
				—	3,618	0.1	%
Pegasus Business Intelligence, LP(4)	Texas / Diversified Financial Services	Revolving Line of Credit—$2,500 Commitment (9.00% (LIBOR + 7.75% with 1.25% LIBOR floor), due 4/18/2014)(25)	—	—	—	—	%
		Senior Secured Term Loan A (6.75% (LIBOR + 5.50% with 1.25% LIBOR floor), due 4/18/2018)	15,938	15,938	15,938	0.6	%
		Senior Secured Term Loan B (13.75% (LIBOR + 12.50% with 1.25% LIBOR floor), due 4/18/2018)	15,938	15,938	15,938	0.6	%
				31,876	31,876	1.2	%
Octagon Investment Partners XV, Ltd.(22)	Cayman Islands / Diversified	Income Notes (Residual Interest)	26,901	26,919	25,515	1.0	%

	Financial Services						
				26,919	25,515	1.0	%
Pelican Products, Inc.(16)	California / Durable Consumer Products	Subordinated Secured (11.50% (LIBOR + 10.00% with 1.50% LIBOR floor), due 6/14/2019)(3)(4)	15,000	14,729	15,000	0.6	%
				14,729	15,000	0.6	%

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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Pinnacle (US) Acquisition Co Limited(16)	Texas / Software & Computer Services	Second Lien Term Loan (10.50% (LIBOR + 9.25% with 1.25% LIBOR floor), due 8/3/2020)(4)	$10,000	$9,815	$10,000	0.4	%
				9,815	10,000	0.4	%
Pre-Paid Legal Services, Inc.(16)	Oklahoma / Consumer Services	Senior Subordinated Term Loan (11.50% (PRIME + 8.25%), due 12/31/2016)(3)(4)	5,000	5,000	5,000	0.2	%
				5,000	5,000	0.2	%
Prince Mineral Holding Corp.	New York / Metal Services & Minerals	Senior Secured Term Loan (11.50%, due 12/15/2019)	10,000	9,888	10,000	0.4	%
				9,888	10,000	0.4	%
Progrexion Holdings, Inc.(4)(28)	Utah / Consumer Services	Senior Secured Term Loan (10.50% (LIBOR + 8.50% with 2.00% LIBOR floor), due 9/14/2017)(3)	241,033	241,033	241,033	9.1	%
				241,033	241,033	9.1	%
Rocket Software, Inc.(3)(4)	Massachusetts / Software & Computer Services	Second Lien Term Loan (10.25% (LIBOR + 8.75% with 1.50% LIBOR floor), due 2/8/2019)	20,000	19,719	20,000	0.8	%
				19,719	20,000	0.8	%
Royal Adhesives & Sealants, LLC	Indiana / Chemicals	Senior Subordinated Unsecured Term Loan (12.00% plus 2.00% PIK, due 11/29/2016)	28,364	28,364	28,648	1.1	%
				28,364	28,648	1.1	%
Ryan, LLC(4)	Texas / Business Services	Subordinated Secured (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor) plus 3.00% PIK, due 6/30/2018)	70,000	70,000	70,000	2.6	%
				70,000	70,000	2.6	%
Sandow Media, LLC	Florida / Media	Senior Secured Term Loan (10.50% (LIBOR + 8.50% with 2.00% LIBOR floor) plus 1.50% PIK, due 5/8/2018)(4)	24,900	24,900	24,900	0.9	%
				24,900	24,900	0.9	%
Seaton Corp.(3)(4)	Illinois / Business Services	Subordinated Secured (12.50% (LIBOR + 9.00% with 3.50% LIBOR floor) plus 2.00% PIK, due 3/14/2014)	3,305	3,249	3,305	0.1	%

		Subordinated Secured (12.50% (LIBOR + 9.00% with 3.50% LIBOR floor) plus 2.00% PIK, due 3/14/2015)	10,005	10,005	10,005	0.4	%
				13,254	13,310	0.5	%
SESAC Holdco II LLC	Tennessee / Media	Second Lien Term Loan (10.00% (LIBOR + 8.75% with 1.25% LIBOR floor), due 7/12/2019)(4)	6,000	5,914	6,000	0.2	%
				5,914	6,000	0.2	%

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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Skillsoft Public Limited Company(22)	Ireland / Software & Computer Services	Senior Unsecured (11.125%, due 6/1/2018)	$15,000	$14,927	$15,000	0.6	%
				14,927	15,000	0.6	%
Snacks Holding Corporation	Minnesota / Food	Series A Preferred Stock (4,021.45 shares)		56	56	—	%
	Products	Series B Preferred Stock (1,866.10 shares)		56	56	—	%
		Warrant (to purchase 31,196.52 voting common shares, expires 11/12/2020)		479	484	—	%
				591	596	—	%
Southern Management Corporation (22)(30)	South Carolina / Consumer Finance	Second Lien Term Loan (12.00% plus 5.00% PIK, due 5/31/2017)	17,565	17,565	18,267	0.7	%
				17,565	18,267	0.7	%
Spartan Energy Services, Inc.(3)(4)	Louisiana / Energy	Senior Secured Term Loan (10.50% (LIBOR + 9.00% with 1.50% LIBOR floor), due 12/28/2017)	29,625	29,625	29,625	1.1	%
				29,625	29,625	1.1	%
Speedy Group Holdings Corp.	Canada / Consumer Finance	Senior Unsecured (12.00%, due 11/15/2017)(22)	15,000	15,000	15,000	0.6	%
				15,000	15,000	0.6	%
Sport Helmets Holdings, LLC(14)	New York / Personal & Nondurable Consumer Products	Escrow Receivable		—	389	—	%
				—	389	—	%
Stauber Performance Ingredients, Inc.(3)(4)	California / Food Products	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 1/21/2016)	16,594	16,594	16,594	0.6	%
		Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 5/21/2017)	10,238	10,238	10,238	0.4	%
				26,832	26,832	1.0	%
Stryker Energy, LLC			34,738	32,711	—	—	%

Ohio / Oil & Gas Production	Subordinated Secured Revolving Credit Facility—$50,300 Commitment (8.50% (LIBOR + 7.00% with 1.50% LIBOR floor) plus 3.75% PIK, in non-accrual status effective 12/1/2011, due 12/1/2015)(4)(25)				
	Overriding Royalty Interests(18)	—	—	—	%
		32,711	—	—	%

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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Symphony CLO, IX Ltd.(22)	Cayman Islands / Diversified Financial Services	LP Certificates (Residual Interest)	$45,500	$42,289	$43,980	1.7	%
				42,289	43,980	1.7	%
System One Holdings, LLC(3)(4)	Pennsylvania / Business Services	Senior Secured Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 12/31/2018)	32,000	32,000	32,000	1.2	%
				32,000	32,000	1.2	%
TB Corp.(3)	Texas / Consumer Service	Senior Subordinated Note (12.00% plus 1.50% PIK, due 12/18/2018)	23,361	23,361	23,361	0.9	%
				23,361	23,361	0.9	%
Targus Group International, Inc. (16)	California / Durable Consumer Products	First Lien Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 5/25/2016)(3)(4)	23,520	23,209	23,520	0.9	%
				23,209	23,520	0.9	%
TGG Medical Transitory, Inc.	New Jersey / Healthcare	Second Lien Term Loan (11.25% (LIBOR + 10.00% with 1.25% LIBOR floor), due 6/27/2018)(4)	8,000	7,773	8,000	0.3	%
				7,773	8,000	0.3	%
The Petroleum Place, Inc.	Colorado / Software & Computer Services	Second Lien Term Loan (10.00% (LIBOR + 8.75% with 1.25% LIBOR floor), due 5/20/2019)(4)	22,000	21,690	22,000	0.8	%
				21,690	22,000	0.8	%
Totes Isotoner Corporation	Ohio / Nondurable Consumer Products	Second Lien Term Loan (10.75%, (LIBOR + 9.25% with 1.50% LIBOR floor), due 1/8/2018)(3)(4)	39,000	39,000	39,000	1.5	%
				39,000	39,000	1.5	%
Traeger Pellet Grills LLC(4)	Oregon / Durable Consumer Products	Revolving Line of Credit—$10,000 Commitment (9.00% (LIBOR + 7.00% with 2.00% LIBOR floor), due 6/18/2014)(25)	6,143	6,143	6,143	0.3	%
		Senior Secured Term Loan A (6.50% (LIBOR + 4.50% with 2.00% LIBOR floor), due 6/18/2018)	30,000	30,000	30,000	1.1	%

		Senior Secured Term Loan B (11.50% (LIBOR + 9.50% with 2.00% LIBOR floor), due 6/18/2018)	30,000	30,000	30,000	1.1	%
				66,143	66,143	2.5	%
TransFirst Holdings, Inc.(4)	New York / Software & Computer Services	Second Lien Term Loan (11.00%, (LIBOR + 9.75% with 1.25% LIBOR floor), due 6/27/2018)	5,000	4,860	5,000	0.2	%
				4,860	5,000	0.2	%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
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			June 30, 2013				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
United Sporting Companies, Inc.(5)	South Carolina / Durable Consumer Products	Second Lien Term Loan (12.75% (LIBOR + 11.00% with 1.75% LIBOR floor), due 5/16/2018)(4)	$160,000	$160,000	$160,000	6.0	%
				160,000	160,000	6.0	%
Wind River Resources Corp. and Wind River II Corp.	Utah / Oil & Gas Production	Senior Secured Note (13.00% (LIBOR + 7.50% with 5.50% LIBOR floor) plus 3.00% default interest on principal, 16.00% default interest on past due interest, in non-accrual status effective 12/1/2008, past due)(4)	15,000	14,750	—	—	%
		Net Profits Interest (5.00% payable on Equity distributions)(7)		—	—	—	%
				14,750	—	—	%
		Total Non-control/Non-affiliate Investments (Level 3 Investments)		3,376,319	3,318,663	124.9	%
		Total Level 3 Portfolio Investments		4,255,659	4,172,740	157.1	%
LEVEL 1 PORTFOLIO INVESTMENTS:							
Non-control/Non-affiliate Investments (less than 5.00% of voting control)							
Allied Defense Group, Inc.	Virginia / Aerospace & Defense	Common Stock (10,000 shares)		56	—	—	%
				56	—	—	%
Dover Saddlery, Inc.	Massachusetts / Retail	Common Stock (30,974 shares)		63	112	—	%
				63	112	—	%
		Total Non-control/Non-affiliate Investments (Level 1 Investments)		119	112	—	%
		Total Portfolio Investments		4,255,778	4,172,852	157.1	%
SHORT TERM INVESTMENTS: Money Market Funds (Level 2 Investments)							
Fidelity Institutional Money Market Funds—Government Portfolio (Class I)				83,456	83,456	3.1	%

Fidelity Institutional Money Market Funds—Government Portfolio (Class I)(3)	49,804	49,804	1.9	%
Victory Government Money Market Funds	10,002	10,002	0.4	%
Total Money Market Funds	143,262	143,262	5.4	%
Total Investments	$4,399,040	$4,316,114	162.5	%

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			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
LEVEL 3 PORTFOLIO INVESTMENTS:							
Control Investments (greater than 25.00% voting control)							
AIRMALL USA, Inc.(27)	Pennsylvania / Property Management	Senior Secured Term Loan (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor), due 6/30/2015)(3)(4)	$29,350	$29,350	$29,350	2.0	%
		Senior Subordinated Term Loan (12.00% plus 6.00% PIK, due 12/31/2015)	12,500	12,500	12,500	0.8	%
		Convertible Preferred Stock (9,919.684 shares)		9,920	6,132	0.4	%
		Common Stock (100 shares)		—	—	—	%
				51,770	47,982	3.2	%
Ajax Rolled Ring & Machine, Inc.	South Carolina / Manufacturing	Senior Secured Note—Tranche A (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 4/01/2013)(3)(4)	20,167	20,167	20,167	1.3	%
		Subordinated Secured Note—Tranche B (11.50% (LIBOR + 8.50% with 3.00% LIBOR floor) plus 6.00% PIK, due 4/01/2013)(3)(4)	15,035	15,035	15,035	1.0	%
		Convertible Preferred Stock—Series A (6,142.6 shares)		6,057	17,191	1.1	%
		Unrestricted Common Stock (6 shares)		—	17	—	%
				41,259	52,410	3.4	%
AWCNC, LLC(19)	North Carolina / Machinery	Members Units—Class A (1,800,000 units)		—	—	—	%
		Members Units—Class B-1 (1 unit)		—	—	—	%
		Members Units—Class B-2 (7,999,999 units)		—	—	—	%
				—	—	—	%
Borga, Inc.	California / Manufacturing	Revolving Line of Credit—$1,000 Commitment (5.00% (PRIME + 1.75%) plus 3.00% default interest, in non-accrual status effective 03/02/2010, past due)(4)(25)	1,000	945	668	—	%
		Senior Secured Term Loan B (8.50% (PRIME + 5.25%) plus 3.00% default interest, in	1,612	1,500	—	—	%

non-accrual status effective 03/02/2010, past due)(4)					
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)	9,352	707	—	—	%
Common Stock (100 shares)(21)		—	—	—	%
Warrants (33,750 warrants)(21)		—	—	—	%
		3,152	668	—	%

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			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Energy Solutions Holdings, Inc.(8)	Texas / Gas Gathering and Processing	Senior Secured Note (18.00%, due 12/11/2016)(3)	$25,000	$25,000	$25,000	1.7	%
		Junior Secured Note (18.00%, due 12/12/2016)(3)	12,000	12,000	12,000	0.8	%
		Senior Secured Note to Vessel Holdings LLC (18.00%, due 12/12/2016)	3,500	3,500	3,500	0.2	%
		Subordinated Secured Note to Freedom Marine Holdings, LLC (12.00% (LIBOR + 6.11% with 5.89% LIBOR floor) plus 4.00% PIK, in non-accrual status effective 10/1/2010, due 12/31/2011)(4)	13,352	12,504	5,603	0.4	%
		Senior Secured Debt to Yatesville Coal Holdings, Inc. (Non-accrual status effective 1/1/2009, past due)	1,449	1,449	—	—	%
		Escrow Receivable		—	9,825	0.6	%
		Common Stock (100 shares)		8,792	70,940	4.7	%
				63,245	126,868	8.4	%
First Tower Holdings of Delaware, LLC(22)(29)	Mississippi / Consumer Finance	Senior Secured Revolving Credit Facility—$400,000 Commitment (20.00% (LIBOR + 18.50% with 1.50% LIBOR floor), due 6/30/2022)(25)	244,760	244,760	244,760	16.2	%
		Common Stock (83,729,323 shares)		43,193	43,193	2.9	%
		Net Revenue Interest (5% of Net Revenue & Distributions)		—	—	—	%
				287,953	287,953	19.1	%
Integrated Contract Services, Inc.(9)	North Carolina / Contracting	Secured Promissory Notes (15.00%, in non-accrual status effective 12/22/2010, due 3/21/2012—12/18/2013)(10)	2,581	2,580	—	—	%
		Senior Demand Note (15.00%, in non-accrual status effective 11/1/2010, past due)(10)	1,170	1,170	—	—	%
		Senior Secured Note (7.00% plus 7.00% PIK plus 6.00% default interest, in non-accrual status	300	—	—	—	%

		effective 10/9/2007, past due)					
		Junior Secured Note (7.00% plus 7.00% PIK plus 6.00% default interest, in non-accrual status effective 10/9/2007, past due)	11,520	11,520	—	—	%
		Preferred Stock—Series A (10 shares)		—	—	—	%
		Common Stock (49 shares)		679	—	—	%
				15,949	—	—	%
Manx Energy, Inc. ("Manx")(12)	Kansas / Oil & Gas Production	Senior Secured Note (13.00%, in non-accrual status effective 1/19/2010, due 6/21/2013)	3,550	3,550	—	—	%
		Preferred Stock (6,635 shares)		6,307	—	—	%
		Common Stock (17,082 shares)		1,170	—	—	%
				11,027	—	—	%

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			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
NMMB Holdings, Inc.(24)	New York / Media	Senior Term Loan (14.00%, due 5/6/2016)	$21,700	$21,700	$21,700	1.4	%
		Senior Subordinated Term Loan (15.00%, due 5/6/2016)	2,800	2,800	2,800	0.2	%
		Series A Preferred Stock (4,400 shares)		4,400	252	—	%
				28,900	24,752	1.6	%
R-V Industries, Inc.	Pennsylvania / Manufacturing	Warrants (200,000 warrants, expiring 6/30/2017)		1,682	6,403	0.4	%
		Common Stock (545,107 shares)		5,087	17,453	1.2	%
				6,769	23,856	1.6	%
Wolf Energy Holdings, Inc.(12)	Kansas / Oil & Gas Production	Appalachian Energy Holdings, LLC ("AEH")—Senior Secured First Lien Note (8.00%, in non-accrual status effective 1/19/2010, due 6/21/2013)	2,437	2,000	—	—	%
		Coalbed, LLC—Senior Secured Note (8.00%, in non-accrual status effective 1/19/2010, due 6/21/2013)(6)	7,311	5,991	—	—	%
		Common Stock (100 Shares)		—	—	—	%
				7,991	—	—	%
		Total Control Investments		518,015	564,489	37.3	%
Affiliate Investments (5.00% to 24.99% voting control)							
BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork)	Michigan / Healthcare	Senior Secured Note (11.50% (LIBOR + 7.00% with 4.50% LIBOR floor) plus 1.00% PIK, due 2/21/2013)(3)(4)	26,227	26,227	26,227	1.8	%
		Preferred Stock Series A (9,925.455 shares)(13)		2,300	2,151	0.2	%
		Preferred Stock Series B (1,753.64 shares)(13)		579	542	—	%
				29,106	28,920	2.0	%
Boxercraft Incorporated	Georgia / Textiles & Leather	Senior Secured Term Loan A (9.50% (LIBOR + 6.50% with 3.00% LIBOR floor), due 9/16/2013)(3)(4)	1,644	1,532	1,644	0.1	%
		Senior Secured Term Loan B (10.00% (LIBOR + 7.00% with 3.00% LIBOR floor), due 9/16/2013)(3)(4)	4,698	4,265	4,698	0.3	%
			2,277	2,277	2,277	0.2	%

		Senior Secured Term Loan C (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 9/16/2013)(3)(4)					
		Senior Secured Term Loan (12.00% plus 3.00% PIK, due 3/16/2014)(3)	7,966	7,049	7,966	0.5	%
		Preferred Stock (1,000,000 shares)		—	576	—	%
		Common Stock (10,000 shares)		—	—	—	%
				15,123	17,161	1.1	%
Smart, LLC(14)	New York / Diversified / Conglomerate Service	Membership Interest		—	35	—	%
				—	35	—	%
		Total Affiliate Investments		44,229	46,116	3.1	%

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			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Non-control/Non-affiliate Investments (less than 5.00% of voting control)							
ADAPCO, Inc.	Florida / Ecological	Common Stock (5,000 shares)		$141	$240	—	%
				141	240	—	%
Aircraft Fasteners International, LLC	California / Machinery	Convertible Preferred Stock (32,500 units)		396	471	—	%
				396	471	—	%
American Gilsonite Company	Utah / Specialty Minerals	Senior Subordinated Note (12.00% (LIBOR + 10.00% with 2.00% LIBOR floor) plus 2.50% PIK, due 3/10/2016)(3)(4)	$30,232	30,232	30,232	2.0	%
		Senior Subordinated Note (12.00% (LIBOR + 10.00% with 2.00% LIBOR floor) plus 2.50% PIK, due 3/10/2016)(4)	7,500	7,500	7,500	0.5	%
		Membership Interest in AGC/PEP, LLC (99.9999%)(15)		—	6,830	0.5	%
				37,732	44,562	3.0	%
Apidos CLO VIII, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	19,730	18,056	19,509	1.3	%
				18,056	19,509	1.3	%
Apidos CLO IX, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	20,525	18,723	18,723	1.2	%
				18,723	18,723	1.2	%
Archipelago Learning, Inc	Minnesota / Consumer Services	Second Lien Debt (11.25% (LIBOR + 9.75% with 1.50% LIBOR floor), due 5/17/2019)(4)(16)	50,000	48,022	49,271	3.3	%
				48,022	49,271	3.3	%
Babson CLO Ltd 2011-I(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	35,000	33,080	34,244	2.3	%
				33,080	34,244	2.3	%
Babson CLO Ltd 2012-IA(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	29,075	27,014	27,197	1.8	%

				27,014	27,197	1.8	%
Babson CLO Ltd 2012-IIA(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	27,850	27,486	27,017	1.8	%
				27,486	27,017	1.8	%
Blue Coat Systems, Inc.(3)(4)	Massachusetts / Software & Computer Services	Second Lien Term Loan (11.50% (LIBOR + 10.00% with 1.50% LIBOR floor), due 8/15/2018)	25,000	24,279	25,000	1.7	%
				24,279	25,000	1.7	%

See notes to consolidated financial statements.
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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
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			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Byrider Systems Acquisition Corp(22)	Indiana / Auto Finance	Senior Subordinated Notes (12.00% plus 2.00% PIK, due 11/3/2016)(3)	$20,546	$20,546	$19,990	1.3	%
				20,546	19,990	1.3	%
Caleel + Hayden, LLC(14)(31)	Colorado / Personal & Nondurable Consumer Products	Membership Units (7,500 shares)		351	1,031	0.1	%
				351	1,031	0.1	%
Capstone Logistics, LLC(4)	Georgia / Commercial Services	Senior Secured Term Loan A (7.50% (LIBOR + 5.50% with 2.00% LIBOR floor), due 9/16/2016)	33,793	33,793	33,793	2.2	%
		Senior Secured Term Loan B (13.50% (LIBOR + 11.50% with 2.00% LIBOR floor), due 9/16/2016)(3)	41,625	41,625	41,625	2.8	%
				75,418	75,418	5.0	%
Cargo Airport Services USA, LLC	New York / Transportation	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 3/31/2016)(3)(4)	48,891	48,891	48,891	3.2	%
		Common Equity (1.6 units)		1,639	1,886	0.1	%
				50,530	50,777	3.3	%
CIFC Funding 2011-I, Ltd.(4)	Cayman Islands / Diversified Financial Services	Secured Class D Notes (5.79% (LIBOR + 5.00%), due 1/19/2023)	19,000	14,778	15,229	1.0	%
		Unsecured Class E Notes (7.79% (LIBOR + 7.00%), due 1/19/2023)	15,400	12,480	12,488	0.8	%
				27,258	27,717	1.8	%
The Copernicus Group, Inc.	North Carolina / Healthcare	Escrow Receivable		—	315	—	%
				—	315	—	%
CRT MIDCO, LLC	Wisconsin / Media	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 6/30/2017)(3)(4)	73,500	73,500	73,491	4.9	%
				73,500	73,491	4.9	%
				—	—	—	%

Diamondback Operating, LP	Oklahoma / Oil & Gas Production	Net Profits Interest (15.00% payable on Equity distributions)(7)					
				—	—	—	%
Empire Today, LLC	Illinois / Durable Consumer Products	Senior Secured Note (11.375%, due 2/1/2017)	15,700	15,255	15,700	1.0	%
				15,255	15,700	1.0	%
Fairchild Industrial Products, Co.	North Carolina / Electronics	Escrow Receivable		—	144	—	%
				—	144	—	%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
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June 30, 2013 and June 30, 2012
(in thousands, except share data)

			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Fischbein, LLC	North Carolina / Machinery	Senior Subordinated Debt (12.00% plus 2.00% PIK, due 10/31/2016)	$3,413	$3,413	$3,413	0.3	%
		Escrow Receivable Escrow Escrow		—	565	—	%
		Membership Class A (875,000 units)		875	2,036	0.1	%
				4,288	6,014	0.4	%
Focus Brands, Inc.(4)	Georgia / Consumer Services	Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 8/21/2018)	15,000	14,711	14,711	1.0	%
				14,711	14,711	1.0	%
Galaxy XII CLO, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	22,000	21,526	21,897	1.4	%
				21,526	21,897	1.4	%
H&M Oil & Gas, LLC	Texas / Oil & Gas Production	Senior Secured Note (13.00% (LIBOR + 7.50% with 5.50% LIBOR floor) plus 3.00% PIK, plus 2.00% default interest, in non-accrual status effective 1/1/2011, past due)(4)	62,814	60,019	30,524	2.0	%
		Senior Secured Note (18.00% PIK, in non-accrual status effective 4/27/2012, past due)	4,507	4,430	4,507	0.3	%
		Net Profits Interest (8.00% payable on Equity distributions)(7)		—	—	—	%
				64,449	35,031	2.3	%
Hi-Tech Testing Service, Inc. and Wilson Inspection X-Ray Services, Inc.	Texas / Oil & Gas Equipment & Services	Senior Secured Term Loan (11.00%, due 9/26/2016)	7,400	7,188	7,391	0.5	%
				7,188	7,391	0.5	%
Hoffmaster Group, Inc.(4)	Wisconsin / Durable Consumer Products	Second Lien Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 1/3/2019)	10,000	9,810	9,811	0.6	%
		Second Lien Term Loan (10.25% (LIBOR + 9.00% with 1.25% LIBOR floor), due 1/3/2019)	1,000	990	951	0.1	%

				10,800	10,762	0.7	%
Hudson Products Holdings, Inc.(16)	Texas / Manufacturing	Senior Secured Term Loan (9.00% (PRIME + 5.00% with 4.00% PRIME floor), due 8/24/2015)(3)(4)	6,299	5,880	5,826	0.4	%
				5,880	5,826	0.4	%
ICON Health & Fitness, Inc.	Utah / Durable Consumer Products	Senior Secured Note (11.875% , due 10/15/2016)(3)	43,100	43,361	43,100	2.9	%
				43,361	43,100	2.9	%
IDQ Holdings, Inc.	Texas / Automobile	Senior Secured Note (11.50%, due 4/1/2017)	12,500	12,260	12,488	0.8	%
				12,260	12,488	0.8	%

See notes to consolidated financial statements.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
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June 30, 2013 and June 30, 2012
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			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Injured Workers Pharmacy LLC	Massachusetts / Healthcare	Second Lien Debt (12.00% (LIBOR + 7.50% with 4.50% LIBOR floor) plus 1.00% PIK, due 11/4/2017)(3)(4)	$15,100	$15,100	$15,100	1.0	%
				15,100	15,100	1.0	%
Iron Horse Coiled Tubing, Inc.(23)	Alberta, Canada / Production Services	Common Stock (3,821 shares)		268	2,040	0.1	%
				268	2,040	0.1	%
JHH Holdings, Inc.	Texas / Healthcare	Second Lien Debt (12.00% (LIBOR + 10.00% with 2.00% LIBOR floor) plus 2.50% PIK, due 6/23/2016)(3)(4)	15,736	15,736	15,736	1.0	%
				15,736	15,736	1.0	%
LHC Holdings Corp.	Florida / Healthcare	Revolving Line of Credit—$750 Commitment (8.50% (LIBOR + 6.00% with 2.50% LIBOR floor), due 5/31/2015)(4)(25)(26)	—	—	—	—	%
		Senior Subordinated Debt (10.50%, due 5/31/2015)(3)	4,265	4,125	4,125	0.3	%
		Membership Interest (125 units)		216	225	—	%
				4,341	4,350	0.3	%
Madison Park Funding IX, Ltd.(22)	Cayman Islands / Diversified Financial Services	Subordinated Notes (Residual Interest)	31,110	25,810	25,810	1.7	%
				25,810	25,810	1.7	%
Maverick Healthcare, LLC	Arizona / Healthcare	Preferred Units (1,250,000 units)		1,252	1,756	0.1	%
		Common Units (1,250,000 units)		—	95	—	%
				1,252	1,851	0.1	%
Medical Security Card Company, LLC(4)	Arizona / Healthcare	Revolving Line of Credit—$1,500 Commitment (9.50% (LIBOR + 7.00% with 2.50% LIBOR floor), due 2/1/2016)(25)	—	—	—	—	%
		First Lien Term Loan (11.25% (LIBOR + 8.75% with 2.50% LIBOR floor), due 2/1/2016)(3)	17,317	17,317	17,317	1.1	%
				17,317	17,317	1.1	%
	Canada / Media		15,000	14,866	15,000	1.0	%

Mood Media Corporation(3)(16)(22)	Senior Subordinated Term Loan (10.25% (LIBOR + 8.75% with 1.50% LIBOR floor), due 11/6/2018)(4)	14,866	15,000	1.0	%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
June 30, 2013 and June 30, 2012
(in thousands, except share data)

			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
National Bankruptcy Services, LLC(3)(4)	Texas / Diversified Financial Services	Senior Subordinated Term Loan (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor) plus 1.50% PIK, due 7/16/2017)	$18,402	$18,402	$18,402	1.2	%
				18,402	18,402	1.2	%
Naylor, LLC(4)	Florida / Media	Revolving Line of Credit—$2,500 Commitment (11.00% (LIBOR + 8.00% with 3.00% LIBOR floor), due 6/7/2017)(25)	—	—	—	—	%
		Senior Secured Term Loan (11.00% (LIBOR + 8.00% with 3.00% LIBOR floor), due 6/7/2017)	48,600	48,600	48,600	3.2	%
				48,600	48,600	3.2	%
New Meatco Provisions, LLC	California / Food Products	Senior Subordinated Term Loan (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor) plus 4.00%, PIK due 4/18/2016)(4)	12,438	12,438	6,571	0.4	%
				12,438	6,571	0.4	%
Nixon, Inc.	California / Durable Consumer Products	Senior Secured Term Loan (8.75% plus 2.75% PIK, due 4/16/2018)(16)	15,085	14,792	14,792	1.0	%
				14,792	14,792	1.0	%
Nobel Learning Communities, Inc.	Pennsylvania / Consumer Services	Subordinated Unsecured (11.50% plus 1.50% PIK, due 8/9/2017)	15,147	15,147	15,147	1.0	%
				15,147	15,147	1.0	%
Northwestern Management Services, LLC	Florida / Healthcare	Revolving Line of Credit—$1,500 Commitment (10.50% (PRIME + 6.75% with 3.75% PRIME floor), due 7/30/2015)(4)(25)	200	200	200	—	%
		Senior Secured Term Loan A (10.00% (LIBOR + 7.00% with 3.00% LIBOR floor), due 7/30/2015)(3)(4)	16,092	16,092	16,092	1.1	%
		Common Stock (50 shares)		371	1,205	0.1	%
				16,663	17,497	1.2	%
NRG Manufacturing, Inc.	Texas / Manufacturing	Escrow Receivable		—	6,431	0.4	%
				—	6,431	0.4	%

Out Rage, LLC(4)	Wisconsin / Durable Consumer Products	Revolving Line of Credit—$1,500 Commitment (11.0% (LIBOR + 8.00% with 3.00% LIBOR floor), due 3/02/2013)(25)	—	—	—	—	%
		Senior Secured Term Loan (11.00% (LIBOR + 8.00% with 3.00% LIBOR floor), due 3/2/2015)	10,756	10,756	10,686	0.7	%
				10,756	10,686	0.7	%

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
June 30, 2013 and June 30, 2012
(in thousands, except share data)

			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Pinnacle Treatment Centers, Inc.(4)	Pennsylvania / Healthcare	Revolving Line of Credit—$1,000 Commitment (8.0% (LIBOR + 5.00% with 3.00% LIBOR floor), due 1/10/2016)(25)	$—	$—	$—	—	%
		Senior Secured Term Loan (11.00% (LIBOR + 8.00% with 3.00% LIBOR floor), due 1/10/2016)(3)	17,475	17,475	17,475	1.2	%
				17,475	17,475	1.2	%
Potters Holdings II, L.P.(16)	Pennsylvania / Manufacturing	Senior Subordinated Term Loan (10.25% (LIBOR + 8.50% with 1.75% LIBOR floor), due 11/6/2017)(3)(4)	15,000	14,803	14,608	1.0	%
				14,803	14,608	1.0	%
Pre-Paid Legal Services, Inc.(16)	Oklahoma / Consumer Services	Senior Subordinated Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 12/31/2016)(3)(4)	5,000	5,000	4,989	0.3	%
				5,000	4,989	0.3	%
Progrexion Holdings, Inc.(4)(28)	Utah / Consumer Services	Senior Secured Term Loan A (11.25% (LIBOR + 9.25% with 2.00% LIBOR floor), due 12/31/2014)(3)	34,502	34,502	34,502	2.3	%
		Senior Secured Term Loan B (11.25% (LIBOR + 9.25% with 2.00% LIBOR floor), due 12/31/2014)	28,178	28,178	28,178	1.9	%
				62,680	62,680	4.2	%
Renaissance Learning, Inc.(16)	Wisconsin / Consumer Services	Second Lien Term Loan (12.00% (LIBOR + 10.50% with 1.50% LIBOR floor), due 10/19/2018)(4)	6,000	5,775	6,000	0.4	%
				5,775	6,000	0.4	%
Rocket Software, Inc.(3)(4)	Massachusetts / Software & Computer Services	Second Lien Term Loan (10.25% (LIBOR + 8.75% with 1.50% LIBOR floor), due 2/8/2019)	15,000	14,711	14,711	1.0	%
				14,711	14,711	1.0	%
Royal Adhesives & Sealants, LLC	Indiana / Chemicals	Senior Subordinated Unsecured Term Loan (12.00% plus 2.00% PIK due 11/29/2016)	27,798	27,798	27,798	1.8	%
				27,798	27,798	1.8	%
Seaton Corp.			3,288	3,164	3,288	0.2	%

Illinois / Business Services	Subordinated Secured (12.50% (LIBOR + 9.00% with 3.50% LIBOR floor) plus 2.00% PIK, due 3/14/2014)(3)(4)	3,164	3,288	0.2	%

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			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
SG Acquisition, Inc.(4)	Georgia / Insurance	Senior Secured Term Loan A (8.50% (LIBOR + 6.50% with 2.00% LIBOR floor), due 3/18/2016)	$27,469	$27,469	$27,469	1.8	%
		Senior Secured Term Loan B (14.50% (LIBOR + 12.50% with 2.00% LIBOR floor), due 3/18/2016)(3)	29,625	29,625	29,625	2.0	%
		Senior Secured Term Loan C (8.50% (LIBOR + 6.50% with 2.00% LIBOR floor), due 3/18/2016)	12,686	12,686	12,686	0.8	%
		Senior Secured Term Loan D (14.50% (LIBOR + 12.50% with 2.00% LIBOR floor), due 3/18/2016)	13,681	13,681	13,681	0.9	%
				83,461	83,461	5.5	%
Shearer's Foods, Inc.	Ohio / Food Products	Junior Secured Debt (12.00% plus 3.75% PIK (3.75% LIBOR floor), due 3/31/2016)(3)(4)	37,639	37,639	37,639	2.5	%
		Membership Interest in Mistral Chip Holdings, LLC—Common (2,000 units)(17)		2,000	2,161	0.1	%
		Membership Interest in Mistral Chip Holdings, LLC 2—Common (595 units)(17)		1,322	643	—	%
		Membership Interest in Mistral Chip Holdings, LLC 3—Preferred (67 units)(17)		673	883	0.1	%
				41,634	41,326	2.7	%
Skillsoft Public Limited Company(22)	Ireland / Software & Computer Services	Senior Unsecured (11.125%, due 6/1/2018)	15,000	14,918	15,000	1.0	%
				14,918	15,000	1.0	%
Snacks Holding Corporation	Minnesota / Food Products	Senior Subordinated Unsecured Term Loan (12.00% plus 1.00% PIK, due 11/12/2017)	15,250	14,754	5,250	1.0	%
		Series A Preferred Stock (4,021.45 shares)		56	42	—	%
		Series B Preferred Stock (1,866.10 shares)		56	42	—	%

		Warrant (to purchase 31,196.52 voting common shares, expires 11/12/2020)		479	357	—	%
				15,345	15,691	1.0	%
Southern Management Corporation(22)(30)	South Carolina / Consumer Finance	Second Lien Term Loan (12.00% plus 5.00% PIK due 5/31/2017)	17,568	17,568	17,568	1.2	%
				17,568	17,568	1.2	%
Sport Helmets Holdings, LLC(14)	New York / Personal & Nondurable Consumer Products	Escrow Receivable		—	406	—	%
				—	406	—	%

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			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Springs Window Fashions, LLC	Wisconsin / Durable Consumer Products	Second Lien Term Loan (11.25% (LIBOR + 9.25% with 2.00% LIBOR floor), due 11/30/2017)(3)(4)	$35,000	$35,000	$34,062	2.3	%
				35,000	34,062	2.3	%
ST Products, LLC	Pennsylvania/ Manufacturing	Senior Secured Term Loan (12.00% (LIBOR + 9.00% with 3.00% LIBOR floor), due 6/16/2016)(3)(4)	23,328	23,328	23,328	1.5	%
				23,328	23,328	1.5	%
Stauber Performance Ingredients, Inc.(4)	California / Food Products	Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 1/21/2016)(3)	22,058	22,058	22,058	1.5	%
		Senior Secured Term Loan (10.50% (LIBOR + 7.50% with 3.00% LIBOR floor), due 5/21/2017)	10,500	10,500	10,500	0.7	%
				32,558	32,558	2.2	%
Stryker Energy, LLC	Ohio / Oil & Gas Production	Subordinated Secured Revolving Credit Facility—$50,300 Commitment (8.50% (LIBOR + 7.00% with 1.50% LIBOR floor) plus 3.75% PIK, in non-accrual status effective 12/1/2011, due 12/1/2015)(4)(25)	33,444	32,711	—	—	%
		Overriding Royalty Interests(18)		—	1,623	0.1	%
				32,711	1,623	0.1	%
Symphony CLO, IX Ltd.(22)	Cayman Islands / Diversified Financial Services	LP Certificates (Residual Interest)	45,500	42,864	43,612	2.9	%
				42,864	43,612	2.9	%
Targus Group International, Inc.(16)	California / Durable Consumer Products	First Lien Term Loan (11.00% (LIBOR + 9.50% with 1.50% LIBOR floor), due 5/25/2016)(3)(4)	23,760	23,363	23,760	1.6	%
				23,363	23,760	1.6	%
Totes Isotoner Corporation	Ohio / Nondurable Consumer	Second Lien Term Loan (10.75%, (LIBOR + 9.25% with 1.50% LIBOR floor) due	39,000	39,000	38,531	2.5	%

	Products	1/8/2018)(3)(4)					
				39,000	38,531	2.5	%
U.S. HealthWorks Holding Company, Inc.(16)	California / Healthcare	Second Lien Term Loan (10.50% (LIBOR + 9.00% with 1.50% LIBOR floor), due 6/15/2017)(3)(4)	25,000	25,000	25,000	1.7	%
				25,000	25,000	1.7	%
VanDeMark Chemicals, Inc.(3)	New York / Chemicals	Senior Secured Term Loan (12.20% (LIBOR + 10.20% with 2.0% LIBOR floor), due 12/31/2014)(4)	30,306	30,306	30,306	2.0	%
				30,306	30,306	2.0	%

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			June 30, 2012				
Portfolio Company	Locale / Industry	Investments(1)	Principal Value	Cost	Fair Value(2)	% of Net Assets	
Wind River Resources Corp. and Wind River II Corp.	Utah / Oil & Gas Production	Senior Secured Note (13.00% (LIBOR + 7.50% with 5.50% LIBOR floor) plus 3.00% default interest on principal, 16.00% default interest on past due interest, in non-accrual status effective 12/1/2008, past due)(4)	$14,750	$14,750	$2,339	0.2	%
		Net Profits Interest (5.00% payable on Equity distributions)(7)		—	—	—	%
				14,750	2,339	0.2	%
		Total Non-control/Non-affiliate Investments (Level 3 Investments)		1,536,950	1,483,487	98.1	%
		Total Level 3 Portfolio Investments		2,099,194	2,094,092	138.5	%
LEVEL 1 PORTFOLIO INVESTMENTS:							
Non-control/Non-affiliate Investments (less than 5.00% of voting control)							
Allied Defense Group, Inc.	Virginia / Aerospace & Defense	Common Stock (10,000 shares)		56	—	—	%
				56	—	—	%
Dover Saddlery, Inc.	Massachusetts / Retail	Common Stock (30,974 shares)		63	129	—	%
				63	129	—	%
		Total Non-control/Non-affiliate Investments (Level 1 Investments)		119	129	—	%
		Total Portfolio Investments		2,099,313	2,094,221	138.5	%
SHORT TERM INVESTMENTS: Money Market Funds (Level 2 Investments)							
Fidelity Institutional Money Market Funds—Government Portfolio (Class I)				86,596	86,596	5.7	%
Fidelity Institutional Money Market Funds—Government Portfolio (Class I)(3)				31,772	31,772	2.1	%
Victory Government Money Market Funds				1	1	—	%
		Total Money Market Funds		118,369	118,369	7.8	%
		Total Investments		$2,217,682	$2,212,590	146.3	%

See notes to consolidated financial statements.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
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Endnote Explanations for the Consolidated Schedule of Investments as of June 30, 2013 and June 30, 2012

(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, 2013 and June 30, 2012, two of our portfolio investments, Allied Defense Group, Inc. ("Allied") and Dover Saddlery, Inc. ("Dover") were publicly traded and classified as Level 1 within the valuation hierarchy established by Accounting Standards Codification ("ASC") 820, Fair Value Measurements and Disclosures ("ASC 820"). As of June 30, 2013 and June 30, 2012, 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 2 and Note 3 within the accompanying consolidated financial statements for further discussion.

(3) Security, or a portion thereof, is held by Prospect Capital Funding LLC, a bankruptcy remote special purpose entity, and is pledged as collateral for the revolving credit facility and such security is not available as collateral to our general creditors (See Note 4). The market values of these investments at June 30, 2013 and June 30, 2012 were $883,114 and $783,384, respectively; they represent 20.5% and 35.4% of total investments at fair value, respectively. Prospect Capital Funding LLC (See Note 1), our wholly-owned subsidiary, holds an aggregate market value of $883,114 and $783,384 of these investments as of June 30, 2013 and June 30, 2012, respectively.

(4) Security, or portion thereof, has a floating interest rate which may be subject to a LIBOR or PRIME floor. Stated interest rate was in effect at June 30, 2013 and June 30, 2012.

(5) Ellett Brothers, LLC., Evans Sports, Inc., Jerry's Sports, Inc., Simmons Gun Specialties, Inc., Bonitz Brothers, Inc. and Outdoor Sports Headquarters, Inc., are joint borrowers on our second lien loan. United Sporting Companies, Inc., is a parent guarantor of this debt investment.

(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 were assigned to Manx, the holding company. On June 30, 2012, Manx reassigned our investment in Coalbed to Wolf Energy Holdings, Inc. ("Wolf"), a newly-formed, separately owned holding company. Our Board of Directors set value at zero for the loan position in Coalbed LLC investment as of June 30, 2013 and June 30, 2012.

(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) During the quarter ended December 31, 2011, our ownership of Change Clean Energy Holdings, Inc. ("CCEHI") and Change Clean Energy, Inc. ("CCEI"), Freedom Marine Holding, Inc. ("Freedom Marine") and Yatesville Coal Holdings, Inc. ("Yatesville") was transferred to Energy Solutions Holdings, Inc. (f/k/a Gas Solutions Holdings, Inc.) ("Energy Solutions") to consolidate all of our energy holdings under one management team. We own 100% of Energy Solutions.

(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.

During the three months ended December 31, 2012, we determined that the impairment of Integrated Contract Services, Inc. ("ICS") was other-than-temporary and recorded a realized loss of $12,198 for the amount that the amortized cost exceeded the fair market value. Our remaining investment in The Healing Staff ("THS"), an affiliate of ICS, was valued at zero as of June 30, 2013 and continues to provide staffing solutions for health care facilities and security staffing.

(10) Loan is with THS, an affiliate of ICS.

(11) Evanta Ventures, Inc. and Sports Leadership Institute, Inc. are joint borrowers on our investment.

(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 of the assets of AEH, Coalbed and Kinley Exploration. The assets

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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. On June 30, 2012, Manx reassigned our investments in Coalbed and AEH to Wolf, a newly-formed, separately owned holding company. We continue to fully reserve any income accrued for Manx. During the quarter ended June 30, 2013, we determined that the impairment of Manx was other-than-temporary and recorded a realized loss of $9,397 for the amount that the amortized cost exceeded the fair market value. The Board of Directors set the fair value of our investment in Manx at $346 as of June 30, 2013.

(13) On a fully diluted basis, represents 10.00% of voting common shares.

(14) A portion of the positions listed was issued by an affiliate of the portfolio company.

(15) 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 5,111 vested and unvested management options) of American Gilsonite Holding Company which owns 100% of American Gilsonite Company.

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

(17) At June 30, 2012, 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. On November 7, 2012, we redeemed our membership interests in Mistral Chip Holdings, LLC, Mistral Chip Holdings 2, LLC and Mistral Chip Holdings 3, LLC in connection with the sale of Shearer's, receiving $6,022 of net proceeds and realizing a gain of approximately $2,027 on the redemption.

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

(19) On December 31, 2009, we sold our investment in Aylward Enterprises, LLC. AWCNC, LLC is the remaining holding company with zero assets. Our remaining outstanding debt after the sale was written off on December 31, 2009 and no value has been assigned to the equity position as of June 30, 2013 and June 30, 2012.

(20) We own a warrant to purchase 3,755,000 shares of Series A Preferred Stock, 625,000 shares of Series B Preferred Stock, and 43,800 shares of Voting Common Stock in Boxercraft Incorporated.

(21) 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.

(22) Certain investments that we have determined are not "qualifying" assets under Section 55(a) of the 1940 Act. Under the 1940 Act, we may not acquire any non-qualifying asset unless, at the time such acquisition is made, qualifying assets represent at least 70% of our total assets. We monitor the status of these assets on an ongoing basis.

(23) 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. During the period from June 30, 2011 to June 30, 2012, our fully diluted ownership of Iron Horse decreased from 57.8% to 5.0%, respectively, as we continued to transfer ownership interests to Iron Horse's management as they repaid our outstanding debt. Iron Horse management had an option to repurchase our remaining interest for $2,040.

On July 24, 2012, we sold our 3,821 shares of Iron Horse Coiled Tubing, Inc. common stock in connection with the exercise of the equity buyout option, receiving $2,040 of net proceeds and realizing a gain of approximately $1,772 on the sale.

(24) On May 6, 2011, we made a secured first lien $24,250 debt investment to NMMB Acquisition, Inc., a $2,800 secured debt and $4,400 equity investment to NMMB Holdings, Inc. We own 100% of the Series A Preferred

Stock in NMMB Holdings, Inc. NMMB Holdings, Inc. owns 100% of the Convertible Preferred in NMMB Acquisition, Inc. NMMB Acquisition, Inc. has a 5.8% dividend rate which is paid to NMMB Holdings, Inc. Our fully diluted ownership in NMMB Holdings, Inc. is 100% as of June 30, 2013 and June 30, 2012. Our fully diluted ownership in NMMB Acquisition, Inc. is 83.5% as of June 30, 2013 and June 30, 2012.

(25) Undrawn committed revolvers incur commitment and unused fees ranging from 0.50% to 2.00%. As of June 30, 2013 and June 30, 2012, we had $202,518 and $180,646 of undrawn revolver commitments to our portfolio companies, respectively.

(26) Stated interest rates are based on June 30, 2013 and June 30, 2012 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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(27) On July 30, 2010, we made a secured first lien $30,000 debt investment to AIRMALL USA, Inc., a $12,500 secured second lien to AMU Holdings, Inc., and acquired 100% of the Convertible Preferred Stock and Common stock of AMU Holdings, Inc. Our Convertible Preferred Stock in AMU Holdings, Inc. has a 12.0% dividend rate which is paid from the dividends received from the underlying operating company, AIRMALL USA Inc. AMU Holdings, Inc. owns 100% of the common stock in AIRMALL USA, Inc.

(28) Progrexion Marketing, Inc., Progrexion Teleservices, Inc., Progrexion ASG, Inc. Progrexion IP, Inc. and Efolks, LLC, are joint borrowers on our senior secured investment. Progrexion Holdings, Inc. and eFolks Holdings, Inc. are the guarantors of this debt investment.

(29) Our wholly-owned entity, First Tower Holdings of Delaware, LLC, owns 80.1% of First Tower Holdings LLC, the operating company of First Tower, LLC.

(30) Southern Management Corporation, Thaxton Investment Corporation, Southern Finance of Tennessee, Inc., Covington Credit of Texas, Inc., Covington Credit, Inc., Covington Credit of Alabama, Inc., Covington Credit of Georgia, Inc., Southern Finance of South Carolina, Inc. and Quick Credit Corporation, are joint borrowers on our senior secured investment. SouthernCo, Inc. is the guarantor of this debt investment.

(31) We own 2.8% (13,220 shares) of the Mineral Fusion Natural, LLC, a subsidiary of Caleel + Hayden, common and preferred interest.

(32) Our wholly-owned entity, APH Property Holdings, LLC, owns 100% of the common equity of American Property Holdings Corp., a REIT which holds investments in several real estate properties.

(33) Our wholly-owned entity, CCPI Holdings, Inc. owns 95.13% of CCPI Inc., the operating company.

(34) Our wholly-owned entity, Credit Central Holdings of Delaware, LLC owns 74.8% of Credit Central Holdings, LLC, which owns 100% of each of Credit Central, LLC, Credit Central South, LLC and Credit Central of Tennessee, LLC, the operating companies.

(35) Our wholly-owned entity, Valley Electric Holdings I, Inc. ("HoldCo"), owns 100% of Valley Electric Holdings, II, Inc. ("Valley II"). Valley II owns 96.3% of Valley Electric Co. of Mt. Vernon, Inc. ("OpCo"), the operating company. Our debt investments are with both HoldCo and OpCo.

(36) Our wholly-owned entity, Nationwide Acceptance Holdings, LLC owns 93.8% of Nationwide Acceptance LLC, the operating company.

(37) On April 15, 2013, assets previously held by H&M were assigned to Wolf in exchange for a $66,000 term loan secured by the assets. The cost basis in this loan of $44,632 was determined in accordance with ASC 310-40, Troubled Debt Restructurings by Creditors, and was equal to the fair value of assets at the time of transfer resulting in a capital loss of $19,647 in connection with the foreclosure on the assets. On May 17, 2013, Wolf sold the assets located in Martin County for $66,000. Proceeds from the sale were primarily used to repay the loan and net profits interest receivable due to us resulting in a realized capital gain of $11,826. We received $3,960 of structuring and advisory fees from Wolf during the year ended June 30, 2013 related to the sale and $991 under the net profits interest agreement which was recognized as other income during the fiscal year ended June 30, 2013.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
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(38) As defined in the Investment Company Act, the Company is deemed to be both an "Affiliated Person" and "Control" this portfolio company because it owns more than 25% of the portfolio company's outstanding voting securities or it has the power to exercise control over the management or policies of such portfolio company (including through a management agreement). Transactions during the period for the year ended June 30, 2013 in which the issuer was both an Affiliated company and a portfolio company that the Company is deemed to Control are as follows:

Company	Purchases	Redemptions	Sales	Interest income	Dividend income	Structuring fee	Other income	Net realized gains (losses)	Net unrealized gains (losses)
AIRMALL USA, Inc.	$—	$ 600	$—	$ 5,822	$—	$—	$—	$—	$ 7,266
Ajax Rolled Ring & Machine, Inc.	23,300	19,065	—	5,176	—	155	—	—	(17,208)
APH Property Holdings, LLC	151,648	—	—	2,898	—	4,511	140	—	—
AWCNC, LLC	—	—	—	—	—	—	—	—	—
Borga, Inc.	150	—	—	—	—	—	—	—	(232)
CCPI Holdings, Inc.	34,081	338	—	1,792	—	575	32	—	—
Credit Central Holdings of Delaware, LLC	47,663	—	—	3,893	—	1,440	240	—	2,799
Energy Solutions Holdings, Inc.	—	28,500	475	24,809	53,820	—	—	—	(71,198)
First Tower Holdings of Delaware, LLC	20,000	—	—	52,476	—	—	2,426	—	(9,869)
Manx Energy, Inc.	—	—	—	—	—	—	—	(9,397)	18,865
Nationwide Acceptance Holdings, LLC	25,151	—	—	1,787	—	753	131	—	—
NMMB Holdings, Inc.	—	—	5,700	3,026	—	—	—	—	(5,903)
R-V Industries, Inc.	32,750	—	—	781	24,462	143	—	—	1,463
The Healing Staff, Inc.	975	—	894	2	—	—	—	(12,117)	12,117
Valley Electric Holdings I, Inc.	52,098	—	100	3,511	—	1,227	98	—	—
Wolf Energy Holdings, Inc.	50	—	—	452	—	3,960	991	11,826	(3,092)

(39)

As defined in the Investment Company Act, the Company is deemed to be an "Affiliated Person" of a portfolio company because it owns 5% or more of the portfolio company's outstanding voting securities or it has the power to exercise control over the management or policies of such portfolio company (including through a management agreement). Transactions during the year ended June 30, 2013 in which the issuer was an Affiliated company (but not a portfolio company that the Company ("Controls") are as follows:

Company	Purchases	Redemptions	Sales	Interest income	Dividend income	Structuring fee	Other income	Net realized gains (losses)	Net unrealized gains (losses)
BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork)	$30,000	$26,677	$—	$3,159	$—	$600	$22	$—	$672
Boxercraft Incorporated	—	—	—	3,356	—	—	—	—	(9,413)
Smart, LLC	—	—	—	—	728	—	—	—	108

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
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(in thousands, except share data)

(40) As defined in the Investment Company Act, the Company is deemed to be both an "Affiliated Person" and "Control" this portfolio company because it owns more than 25% of the portfolio company's outstanding voting securities or it has the power to exercise control over the management or policies of such portfolio company (including through a management agreement). Transactions during the period for the year ended June 30, 2012 in which the issuer was both an Affiliated company and a portfolio company that the Company is deemed to Control are as follows:

Company	Purchases	Redemptions	Sales	Interest income	Dividend income	Structuring fee	Other income	Net realized gains (losses)	Net unrealized gains (losses)
AIRMALL USA, Inc.	$—	$ 650	$—	$ 5,900	$—	$—	$—	$—	$ (3,094)
Ajax Rolled Ring & Machine, Inc.	—	440	—	4,849	—	—	—	—	18,973
AWCNC, LLC	—	—	—	—	—	—	—	—	—
Borga, Inc.	—	—	—	—	—	—	—	—	(1,023)
C&J Cladding LLC	—	—	580	—	—	1,500	—	2,420	(4,119)
Change Clean Energy Holdings, Inc.	—	—	—	—	—	—	—	—	2,540
Energy Solutions Holdings, Inc.	5,951	—	—	7,174	47,850	5,220	4,983	—	(63,403)
First Tower Holdings of Delaware, LLC	287,953	—	—	2,312	—	8,075	—	—	—
Integrated Contract Services, Inc.	1,033	1,054	—	—	—	—	—	—	503
Iron Horse Coiled Tubing, Inc.	—	14,338	—	324	—	—	—	—	802
Manx Energy, Inc.	—	—	—	—	—	—	—	—	(1,312)
NMMB Holdings, Inc.	—	2,550	—	3,683	—	—	—	—	(4,148)
NRG Manufacturing, Inc.	37,218	50,299	2,317	28,579	15,011	372	3,800	36,940	(23,655)
Nupla Corporation	—	1,995	—	587	—	1,500	14	2,907	(4,194)
R-V Industries, Inc.	—	—	—	—	283	—	—	—	15,740
	—	—	—	—	—	—	—	—	1,035

Yatesville Coal Holdings, Inc.

(41) As defined in the Investment Company Act, the Company is deemed to be an "Affiliated Person" of a portfolio company because it owns 5% or more of the portfolio company's outstanding voting securities or it has the power to exercise control over the management or policies of such portfolio company (including through a management agreement). Transactions during the year ended June 30, 2012 in which the issuer was an Affiliated company (but not a portfolio company that the Company ("Controls") are as follows:

Company	Purchases	Redemptions	Sales	Interest income	Dividend income	Structuring fee	Other income	Net realized gains (losses)	Net unrealized gains (losses)
BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork)	$—	$—	$—	$3,333	$—	$—	$—	$—	$(5,099)
Boxercraft Incorporated	2,300	1,144	—	2,947	—	—	70	—	(662)
Smart, LLC	—	—	—	—	—	—	—	—	35
Sport Helmets Holdings, LLC	—	19,102	—	5,875	—	—	38	4,445	(7,483)

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 1. Organization

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

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 of 1986 (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, recapitalizations and other purposes.

On May 15, 2007, we formed a wholly-owned subsidiary, Prospect Capital Funding LLC ("PCF"), a Delaware limited liability company and a bankruptcy remote special purpose entity, which holds certain of our portfolio loan investments that are used as collateral for the credit facility at PCF.

Note 2. Significant Accounting Policies

The following are significant accounting policies consistently applied by us:

Basis of Presentation

The accompanying consolidated 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.

Reclassifications

Certain reclassifications have been made in the presentation of prior consolidated financial statements and accompanying notes to conform to the presentation as of and for the twelve months ended June 30, 2013.

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 consolidated financial statements include our accounts and the accounts of PCF, 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.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 2. Significant Accounting Policies (Continued)

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

Many 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

To value our assets, we follow the guidance of ASC 820 that defines fair value, establishes a framework for measuring fair value in conformity with accounting principles generally accepted in the United States or America, or GAAP, and requires disclosures about fair value measurements.

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 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.

ASC 820 applies to fair value measurements already required or permitted by other standards.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 2. Significant Accounting Policies (Continued)

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.
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 an independent valuation firm engaged by our Board of Directors;
2) the independent valuation firms conduct independent appraisals and make their own independent assessment;
3) the Audit Committee of our Board of Directors reviews and discusses the preliminary valuation of Prospect Capital Management LLC (the "Investment Adviser") and that of the independent valuation firms; 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 the Investment Adviser, the respective independent valuation firm and the Audit Committee.

Investments are valued utilizing a shadow bond approach, a market approach, an income approach, a liquidation approach, or a combination of approaches, as appropriate. The shadow bond and market approaches use 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.
Our investments in CLOs are classified as ASC 820 level 3 securities, and are valued using a discounted cash flow model. The valuations have been accomplished through the analysis of the CLO deal structures to identify the risk exposures from the modeling point of view. For each security, the most appropriate valuation approach has been chosen from alternative approaches to ensure the most accurate valuation for each security. To value a CLO, both the assets and liabilities of the CLO capital structure need be modeled. We use a waterfall engine to store the collateral data, generate collateral cash flows from the assets, and distributes the cash flow to the liability structure based on the payment priorities, and discount them back using proper discount rates that incorporate all the risk factors. The main risk factors are: default risk, interest rate risk, downgrade risk, and credit spread risk.
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 under the direction of 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
ASC Subtopic 820-10-05-1, The Fair Value Option for Financial Assets and Financial Liabilities ("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 elected not to value some assets and liabilities at fair value as would be permitted by ASC 820-10-05-1.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 2. Significant Accounting Policies (Continued)

Senior Convertible Notes

We have recorded the Senior Convertible Notes (See Note 5) at their contractual amounts. The Senior Convertible Notes were analyzed for any features that would require their accounting to be bifurcated and such features were determined to be immaterial.

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 Capital Funding, Inc. ("Patriot") was determined based on the difference between par value and fair market value as of December 2, 2009, and continues to accrete until maturity or repayment of the respective loans.

Interest income from investments in the "equity" class of security of CLO Funds (typically income notes or subordinated notes) is recorded based upon an estimation of an effective yield to expected maturity utilizing assumed cash flows in accordance with ASC 325-40-35, Beneficial Interests in Securitized Financial Assets. We monitor the expected cash inflows from our CLO equity investments, including the expected residual payments, and the effective yield is determined and updated periodically.

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 there is reasonable doubt that principal or interest will be collected in accordance with the terms of the investment. 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 of collectability. 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 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 ordinary income and 98.2% of our capital gains 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 ordinary income and 98.2% of our capital gains exceed 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.

If we fail to satisfy the annual distribution requirement or otherwise fail to qualify as a RIC in any taxable year, 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 we be required to make distributions. Distributions would generally be taxable to our individual and other non-corporate taxable stockholders as ordinary dividend income eligible for the reduced maximum rate applicable to

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 2. Significant Accounting Policies (Continued)

qualified dividend income to the extent of our current and accumulated earnings and profits, provided certain holding period and other requirements are met. Subject to certain limitations under the Internal Revenue Code, corporate distributions would be eligible for the dividends-received deduction. To qualify again to be taxed as a RIC in a subsequent year, we would be required to distribute to our shareholders our accumulated earnings and profits attributable to non-RIC years reduced by an interest charge of 50% of such earnings and profits payable by us as an additional tax. In addition, if we failed to qualify as a RIC for a period greater than two taxable years, then, in order to qualify as a RIC in a subsequent year, we would be required to elect to recognize and pay tax on any net built-in gain (the excess of aggregate gain, including items of income, over aggregate loss that would have been realized if we had been liquidated) or, alternatively, be subject to taxation on such built-in gain recognized for a period of ten years.

We follow 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. As of June 30, 2013 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 monthly dividend or distribution is approved by our Board of Directors quarterly 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 and Senior Convertible Notes, Senior Unsecured Notes and Prospect Capital InterNotes® (collectively, our "Senior Notes"), as deferred financing costs. These expenses are deferred and amortized as part of interest expense using the straight-line method for our revolving credit facility and the effective interest method for our Senior Notes, over the respective expected life.

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 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.

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. In accordance with ASC 946, Financial Services—Investment Companies, convertible securities are not considered in the calculation of net assets per share.

Recent Accounting Pronouncements

In May 2011, the FASB issued Accounting Standards Update 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs ("ASU 2011-04"). ASU 2011-04 amends Accounting Standards Codification 820, Fair Value Measurements ("ASC 820") by: (1) clarifying that the highest-and-best-use and valuation-premise concepts only apply to measuring the fair value of non-financial assets; (2) allowing a reporting entity to measure the fair value of the net asset or net liability position in a manner consistent with how market participants would price the net risk position, if certain criteria are met; (3) providing a framework for considering whether a premium or discount can be applied in a fair value measurement; (4) providing that the fair value of an instrument classified in a reporting entity's

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 2. Significant Accounting Policies (Continued)

shareholders' equity is estimated from the perspective of a market participant that holds the identical item as an asset; and (5) expanding the qualitative and quantitative fair value disclosure requirements. The expanded disclosures include, for Level 3 items, a description of the valuation process and a narrative description of the sensitivity of the fair value to changes in unobservable inputs and interrelationships between those inputs if a change in those inputs would result in a significantly different fair value measurement. ASU 2011-4 also requires disclosures about the highest-and-best-use of a non-financial asset when this use differs from the asset's current use and the reasons for such a difference. In addition, this ASU amends ASC 820, Fair Value Measurements, to require disclosures to include any transfers between Level 1 and Level 2 of the fair value hierarchy. These amendments were effective for fiscal years beginning after December 15, 2011 and for interim periods within those fiscal years. The adoption of the amended guidance in ASU 2011-04 did not have a significant effect on our financial statements. See Note 3 for the disclosure required by ASU 2011-04.

In August 2012, the FASB issued Accounting Standards Update 2012-03, Technical Amendments and Corrections to SEC Sections: Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 114 ("SAB No. 114"), Technical Amendments Pursuant to SEC Release No. 33-9250, and Corrections Related to FASB Accounting Standards Update 2010-22 ("ASU 2012-03"). The update amends various SEC paragraphs pursuant to the issuance of SAB No. 114 and is effective upon issuance. The adoption of the amended guidance in ASU 2012-03 did not have a significant effect on our financial statements.

In October 2012, the FASB issued Accounting Standards Update 2012-04, Technical Corrections and Improvements ("ASU 2012-04"). The amendments in this update cover a wide range of Topics in the ASC. These amendments include technical corrections and improvements to the ASC and conforming amendments related to fair value measurements. The adoption of the amended guidance in ASU 2012-04 did not have a significant effect on our financial statements.

In June 2013, the FASB issued Accounting Standards Update 2013-08, Financial Services—Investment Companies (Topic 946)—Amendments to the Scope, Measurement, and Disclosure Requirements ("ASU 2013-08"). ASU 2013-08 clarifies the approach to be used for determining whether an entity is an investment company and provides new measurement and disclosure requirements. ASU 2013-08 is effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013. Earlier application is prohibited. The adoption of ASU 2013-08 is not expected to materially effect on our financial statements.

Note 3. Portfolio Investments

At June 30, 2013, we had investments in 124 long-term portfolio investments, which had an amortized cost of $4,255,778 and a fair value of $4,172,852 and at June 30, 2012, we had investments in 85 long-term portfolio investments, which had an amortized cost of $2,099,313 and a fair value of $2,094,221.

As of June 30, 2013, we own controlling interests in AIRMALL USA, Inc. ("Airmall"), Ajax Rolled Ring & Machine, Inc., APH Property Holdings, LLC ("APH"), AWCNC, LLC, Borga, Inc. ("Borga"), CCPI Holdings, Inc., Credit Central Holdings of Delaware, LLC, Energy Solutions Holdings, Inc. (f/k/a Gas Solutions Holdings, Inc.) ("Energy Solutions"), First Tower Holdings of Delaware, LLC ("First Tower Delaware"), Manx Energy, Inc. ("Manx"), Nationwide Acceptance Holdings, LLC, NMMB Holdings, Inc., R-V Industries, Inc., The Healing Staff, Inc. ("THS"), Valley Electric Holdings I, Inc. and Wolf Energy Holdings, Inc. ("Wolf"). We also own an affiliated interest in BNN Holdings Corp. (f/k/a Biotronic NeuroNetwork), Boxercraft Incorporated and Smart, LLC.

The composition of our investments and money market funds as of June 30, 2013 and June 30, 2012 at cost and fair value was as follows:

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 3. Portfolio Investments (Continued)

	June 30, 2013		June 30, 2012	
	Cost	Fair Value	Cost	Fair Value
Revolving Line of Credit	$9,238	$8,729	$1,145	$868
Senior Secured Debt	2,262,327	2,207,091	1,138,991	1,080,053
Subordinated Secured Debt	1,062,386	1,024,901	544,363	488,113
Subordinated Unsecured Debt	88,470	88,827	72,617	73,195
CLO Debt	27,667	28,589	27,258	27,717
CLO Residual Interest	660,619	658,086	214,559	218,009
Equity	145,071	156,629	100,380	206,266
Total Investments	4,255,778	4,172,852	2,099,313	2,094,221
Money Market Funds	143,262	143,262	118,369	118,369
Total Investments and Money Market Funds	$4,399,040	$4,316,114	$2,217,682	$2,212,590

The fair values of our investments and money market funds as of June 30, 2013 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Investments at fair value				
Revolving Line of Credit	$—	$—	$8,729	$8,729
Senior Secured Debt	—	—	2,207,091	2,207,091
Subordinated Secured Debt	—	—	1,024,901	1,024,901
Subordinated Unsecured Debt	—	—	88,827	88,827
CLO Debt	—	—	28,589	28,589
CLO Residual Interest	—	—	658,086	658,086
Equity	112	—	156,517	156,629
Total Investments	112	—	4,172,740	4,172,852
Money Market Funds	—	143,262	—	143,262
Total Investments and Money Market Funds	$112	$143,262	$4,172,740	$4,316,114

	Fair Value Hierarchy			
	Level 1	Level 2	Level 3	Total
Investments at fair value				
Control investments	$—	$—	$811,634	$811,634
Affiliate investments	—	—	42,443	42,443
Non-control/non-affiliate investments	112	—	3,318,663	3,318,775
	112	—	4,172,740	4,172,852
Investments in money market funds	—	143,262	—	143,262
Total assets reported at fair value	$112	$143,262	$4,172,740	$4,316,114

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 3. Portfolio Investments (Continued)

The fair values of our investments and money market funds as of June 30, 2012 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Investments at fair value				
Revolving Line of Credit	$—	$—	$868	$868
Senior Secured Debt	—	—	1,080,053	1,080,053
Subordinated Secured Debt	—	—	488,113	488,113
Subordinated Unsecured Debt	—	—	73,195	73,195
CLO Debt	—	—	27,717	27,717
CLO Residual Interest	—	—	218,009	218,009
Equity	129	—	206,137	206,266
Total Investments	129	—	2,094,092	2,094,221
Money Market Funds	—	118,369	—	118,369
Total Investments and Money Market Funds	$129	$118,369	$2,094,092	$2,212,590

	Fair Value Hierarchy			
	Level 1	Level 2	Level 3	Total
Investments at fair value				
Control investments	$—	$—	$564,489	$564,489
Affiliate investments	—	—	46,116	46,116
Non-control/non-affiliate investments	129	—	1,483,487	1,483,616
	129	—	2,094,092	2,094,221
Investments in money market funds	—	118,369	—	118,369
Total assets reported at fair value	$129	$118,369	$2,094,092	$2,212,590

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 3. Portfolio Investments (Continued)

The aggregate values of Level 3 portfolio investments changed during the year ended June 30, 2013 as follows:

	Fair Value Measurements Using Unobservable Inputs (Level 3)			
	Control Investments	Affiliate Investments	Non-Control/Non-Affiliate Investments	Total
Fair value as of June 30, 2012	$564,489	$46,116	$ 1,483,487	$2,094,092
Total realized loss, net	(9,688)	—	(16,672)	(26,360)
Change in unrealized depreciation	(64,991)	(8,634)	(4,192)	(77,817)
Net realized and unrealized loss	(74,679)	(8,634)	(20,864)	(104,177)
Purchases of portfolio investments	387,866	30,000	2,674,404	3,092,270
Payment-in-kind interest	2,668	715	7,564	10,947
Accretion of purchase discount	—	922	10,095	11,017
Repayments and sales of portfolio investments	(68,710)	(26,676)	(836,023)	(931,409)
Transfers within Level 3	—	—	—	—
Transfers in (out) of Level 3	—	—	—	—
Fair value as of June 30, 2013	$811,634	$42,443	$ 3,318,663	$4,172,740

	Fair Value Measurements Using Unobservable Inputs (Level 3)							
	Revolver	Senior Secured Debt	Subordinated Secured Debt	Unsecured Debt	CLO Debt	CLO Residual Interest	Equity	Total
Fair value as of June 30, 2012	$868	$1,080,053	$488,113	$73,195	$27,717	$218,009	$206,137	$2,094,092
Total realized loss (gain), net	—	(21,545)	(22,001)	—	—	—	17,186	(26,360)
Change in unrealized (depreciation) appreciation	(232)	3,197	19,265	(222)	464	(5,981)	(94,308)	(77,817)
Net realized and unrealized (loss) gain	(232)	(18,348)	(2,736)	(222)	464	(5,981)	(77,122)	(104,177)
Purchases of portfolio investments	21,143	1,626,172	812,025	133,700	—	440,050	59,180	3,092,270
Payment-in-kind interest	—	4,401	3,687	2,859	—	—	—	10,947
Amortization of discounts and premiums	—	1,747	2,346	508	408	6,008	—	11,017
Repayments and sales of portfolio investments	(13,050)	(499,900)	(265,568)	(121,213)	—	—	(31,678)	(931,409)

Transfers within Level 3	—	12,966	(12,966)	—	—	—	—	—
Transfers in (out) of Level 3	—	—	—	—	—	—	—	—
Fair value as of June 30, 2013	$8,729	$2,207,091	$1,024,901	$88,827	$28,589	$658,086	$156,517	$4,172,740

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 3. Portfolio Investments (Continued)

The aggregate values of Level 3 portfolio investments changed during the year ended June 30, 2012 as follows:

	Fair Value Measurements Using Unobservable Inputs (Level 3)			
	Control Investments	Affiliate Investments	Non-Control/ Non-Affiliate Investments	Total
Fair value as of June 30, 2011	$310,072	$72,337	$1,080,421	$1,462,830
Total realized loss (gain), net	42,267	4,445	(10,115)	36,597
Change in unrealized appreciation (depreciation)	6,776	(13,617)	(25,476)	(32,317)
Net realized and unrealized gain (loss)	49,043	(9,172)	(35,591)	4,280
Purchases of portfolio investments	332,156	2,300	780,556	1,115,012
Payment-in-kind interest	219	467	4,961	5,647
Accretion of purchase discount	81	4,874	2,329	7,284
Repayments and sales of portfolio investments	(118,740)	(24,690)	(357,531)	(500,961)
Transfers within Level 3	(8,342)	—	8,342	—
Transfers in (out) of Level 3	—	—	—	—
Fair value as of June 30, 2012	$564,489	$46,116	$1,483,487	$2,094,092

	Fair Value Measurements Using Unobservable Inputs (Level 3)							
	Revolver	Senior Secured Debt	Subordinated Secured Debt	Subordinated Unsecured Debt	CLO Debt	CLO Residual Interest	Equity	Total
Fair value as of June 30, 2011	$7,278	$789,981	$448,675	$55,336	$—	$—	$161,560	$1,462,830
Total realized loss (gain), net	—	2,686	(14,606)	—	—	—	48,517	36,597
Change in unrealized (depreciation) appreciation	(412)	(26,340)	(13,737)	(67)	459	3,450	4,330	(32,317)
Net realized and unrealized (loss) gain	(412)	(23,654)	(28,343)	(67)	459	3,450	52,847	4,280
Purchases of portfolio investments	1,500	582,566	227,733	17,000	27,072	214,559	44,582	1,115,012
Payment-in-kind interest	—	304	4,485	858	—	—	—	5,647
Accretion of purchase discount	80	3,449	3,501	68	186	—	—	7,284
Repayments and sales of portfolio investments	(7,578)	(272,593)	(167,938)	—	—	—	(52,852)	(500,961)
Transfers within Level 3	—	—	—	—	—	—	—	—

Transfers in (out) of Level 3	—	—	—	—	—	—	—	—
Fair value as of June 30, 2012	$868	$1,080,053	$488,113	$73,195	$27,717	$218,009	$206,137	$2,094,092

For the year ended June 30, 2013 and 2012, the net change in unrealized appreciation on the investments that use Level 3 inputs was $77,488 and $18,866 for assets still held as of June 30, 2013 and 2012, respectively.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 3. Portfolio Investments (Continued)

The ranges of unobservable inputs used in the fair value measurement of our Level 3 investments as of June 30, 2013 were as follows:

			Unobservable Input			
Asset Category	Fair Value	Primary Valuation Technique	Input	Range	Weighted Average	
Senior	$2,215,820	Yield Analysis	Market Yield	5.7% - 20.8%	10.7	%
Subordinated Secured	1,024,901	Yield Analysis	Market Yield	7.7% - 19.8%	11.6	%
Subordinated Unsecured	88,827	Yield Analysis	Market Yield	6.1% - 14.6%	10.7	%
CLO Debt	28,589	Discounted Cash Flow	Discount Rate	12.10% - 20.1%	15.7	%
CLO Residual Interest	658,086	Discounted Cash Flow	Discount Rate	11.3% - 19.8%	15.3	%
Equity	151,855	EV Market Multiple Analysis	EV Market Multiple Analysis	3.3x - 8.8x	6.2x	
Escrow	4,662	Discounted Cash Flow	Discount Rate	6.5% - 7.5%	7.0	%
Total	$4,172,740					

The ranges of unobservable inputs used in the fair value measurement of our Level 3 investments as of June 30, 2012 were as follows:

			Unobservable Input			
Asset Category	Fair Value	Primary Valuation Technique	Input	Range	Weighted Average	
Senior	$1,080,921	Yield Analysis	Market Yield	6.7% - 30.0%	11.1	%
Subordinated Secured	488,113	Yield Analysis	Market Yield	7.0% - 30.0%	12.6	%
Subordinated Unsecured	73,195	Yield Analysis	Market Yield	8.7% - 13.5%	11.8	%
CLO Debt	27,717	Discounted Cash Flow	Discount Rate	13.0%	13.0	%
CLO Residual Interest	218,009	Discounted Cash Flow	Discount Rate	8.0% - 14.0%	10.2	%
Equity	188,451	EV Market Multiple Analysis	EV Market Multiple Analysis	3.3x - 9.0x	6.6x	
Escrow	17,686	Discounted Cash Flow	Discount Rate	6.5% - 8.5%	7.7	%
Total	$2,094,092					

The significant unobservable inputs used in the market approach of fair value measurement of our investments are the market multiples of earnings before income tax, depreciation and amortization ("EBITDA") of the comparable guideline public companies. The independent valuation firm selects a population of public companies for each investment with similar operations and attributes of the subject company. Using these guideline public companies' data, a range of multiples of enterprise value to EBITDA is calculated. The independent valuation firm selects percentages from the range of multiples for purposes of determining the subject company's estimated enterprise value based on said multiple and generally the latest twelve months EBITDA of the subject company (or other meaningful measure). Significant increases or decreases in the multiple will result in an increase or decrease in enterprise value, resulting in an increase or decrease in the fair value estimate of the equity investment.

The significant unobservable input used in the income approach of fair value measurement of our investments is the discount rate used to discount the estimated future cash flows expected to be received from the underlying investment, which include both future principal and interest payments. Significant increases or decreases in the discount rate would result in a

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 3. Portfolio Investments (Continued)

decrease or increase in the fair value measurement. Included in the consideration and selection of discount rates are the following factors: risk of default, rating of the investment and comparable company investments, and call provisions.

Changes in market yields, discount rates or EBITDA multiples, each in isolation, may change the fair value of certain of our investments. Generally, an increase in market yields or discount rates or decrease in EBITDA multiples may result in a decrease in the fair value of certain of our investments.

Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments may fluctuate from period to period. Additionally, the fair value of our investments may differ significantly from the values that would have been used had a ready market existed for such investments and may differ materially from the values that we may ultimately realize. Further, such investments are generally subject to legal and other restrictions on resale or otherwise are less liquid than publicly traded securities. If we were required to liquidate a portfolio investment in a forced or liquidation sale, we could realize significantly less than the value at which we have recorded it.

In addition, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the unrealized gains or losses reflected in the valuations currently assigned.

During the year ended June 30, 2013, the valuation methodology for Airmall changed to incorporate the income method (discounted cash flow analysis) in addition to the market method (public comparable company analysis) used in previous quarters. Management adopted the income method to incorporate current financial projections in recognition of the time elapsed since the initial acquisition of the company in June 2010. As a result of this change and in recognition of recent improved company performance, we increased the fair value of our investment in Airmall to $54,648 as of June 30, 2013, a premium of $3,478 from its amortized cost, compared to the $3,788 unrealized depreciation recorded at June 30, 2012.

During the year ended June 30, 2013, the valuation methodology for First Tower Delaware changed to incorporate the income method (discounted cash flow analysis) in addition to the market method (public comparable company analysis) used in previous quarters. Management adopted the income method in consideration of management forecasts not previously available. As a result of this change and in recognition of recent company performance and current market conditions we decreased the fair value of our investment in First Tower Delaware to $298,084 as of June 30, 2013, a discount of $13,869 to its amortized cost, compared to $287,953 as of June 30, 2012, equal to its amortized cost at that time.

During the year ended June 30, 2013, the valuation methodology for ICON Health & Fitness, Inc. ("ICON") changed to incorporate an enterprise value waterfall analysis in place of a trading analysis in addition to the income method (discounted cash flow analysis) used in previous quarters. Management adopted the enterprise value waterfall analysis due to the impairment of the senior term loan, and removed the trading analysis due to lack of trading activity during the quarter. As a result of this change and in recognition of recent company performance and current market conditions, we decreased the fair value of our investment in ICON to $33,929 as of June 30, 2013, a discount of $9,381 to its amortized cost, compared to the $261 unrealized depreciation recorded at June 30, 2012.

In December 2011, we completed a reorganization of Gas Solutions Holdings, Inc. renaming the company Energy Solutions and transferring ownership of other operating companies owned by us that operate within the energy industry. As part of the reorganization, our equity interests in Change Clean Energy Holdings, Inc. and Change Clean Energy, Inc., Freedom Marine Holdings, LLC, a subsidiary of Energy Solutions ("Freedom Marine") and Yatesville Coal Holdings, Inc., a subsidiary of Energy Solutions ("Yatesville"), were transferred to Energy Solutions to consolidate all of our energy holdings under one management team strategically expanding Energy Solutions across energy sectors.

On January 4, 2012, Energy Solutions sold its gas gathering and processing assets ("Gas Solutions") for a sale price of $199,805, adjusted for the final working capital settlement, including a potential earnout of $28,000 that will be paid based on the future performance of Gas Solutions. After expenses, including structuring fees of $9,966 paid to us, Energy Solutions received approximately $158,687 in cash. Currently, a loan to Energy Solutions remains outstanding and is collateralized by the cash held by Energy Solutions after the sale transaction. The sale of Gas Solutions by Energy Solutions has resulted in significant earnings and profits, as defined by the Internal Revenue Code, at Energy Solutions for calendar year 2012. As a result, distributions from Energy Solutions to us were required to be recognized as dividend income, in accordance with ASC 946, Financial Services—Investment Companies, as cash distributions are received from Energy Solutions, to the extent there are current year earnings and profits sufficient to support such recognition. During the year ended June 30, 2013, Energy Solutions repaid $28,500 of senior and subordinated secured debt. We received $19,543 of make-whole fees for early

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Note 3. Portfolio Investments (Continued)

repayment of the outstanding loan receivables, which was recorded as interest income during the year ended June 30, 2013. During the year ended June 30, 2013, we received distributions of $53,820 from Energy Solutions which were recorded as dividend income. Energy Solutions continues to hold $23,979 of cash for future investment and repayment of the remaining debt.

During the year ended June 30, 2013, we provided $125,892 and $26,648 of debt and equity financing, respectively, to APH for the acquisition of various industrial and multi-family residential real estate properties in Florida and Georgia. APH is a holding company that owns 100% of the common equity of American Property Holdings Corp. ("APHC"). APHC is a Maryland corporation and qualified REIT for federal income tax purposes. During the year ended June 30, 2013, we received $4,511 of structuring fees related to our investments in APH which were recorded as other income. As of June 30, 2013, APHC's real estate portfolio was comprised of seven investments. The following table shows the mortgages outstanding due to other parties for each of the seven properties:

No.	Property Name	City	Date of Acquisition	Purchase Price	Mortgage Outstanding
1	146 Forest Parkway	Forest Park, GA	10/24/2012	$ 7,400	$ —
2	Abbington Pointe	Marietta, GA	12/28/2012	23,500	15,275
3	Amberly Place	Tampa, FL	1/17/2013	63,400	39,600
4	Lofton Place	Tampa, FL	4/30/2013	26,000	16,965
5	Vista at Palma Sola	Bradenton, FL	4/30/2013	27,000	17,550
6	Arlington Park	Marietta, GA	5/8/2013	14,850	9,650
7	Arium Resort	Pembroke Pines, GA	6/24/2013	225,000	157,500

At June 30, 2013, eight loan investments were on non-accrual status: Borga, Freedom Marine, THS, formerly a subsidiary of Integrated Contract Services, Inc. ("ICS"), Manx, Stryker Energy, LLC ("Stryker"), Wind River Resources Corp. and Wind River II Corp. ("Wind River"), Wolf and Yatesville. At June 30, 2012, nine loan investments were on non-accrual status: Borga, Freedom Marine, H&M Oil and Gas, LLC ("H&M"), THS, formerly a subsidiary of ICS, Manx, Stryker, Wind River, Wolf and Yatesville. Principal balances of these loans amounted to $106,395 and $171,149 as of June 30, 2013 and June 30, 2012, respectively. The fair value of these loans amounted to $13,810 and $43,641 as of June 30, 2013 and June 30, 2012, respectively. The fair values of these investments represent approximately 0.5% and 2.9% of our net assets as of June 30, 2013 and June 30, 2012, respectively. For the years ended June 30, 2013, June 30, 2012 and June 30, 2011, the income foregone as a result of not accruing interest on non-accrual debt investments amounted to $25,965, $25,460 and $18,535, respectively.

On December 3, 2010, we exercised our warrants in Miller Petroleum, Inc ("Miller") and received 2,013,814 shares of Miller common stock. On December 27, 2010, we sold 1,397,510 of these shares receiving $3.95 of net proceeds per share, realizing a gain of $5,415. On January 10, 2011, we sold the remaining 616,304 shares of Miller common stock receiving $4.23 of net proceeds per share, realizing an additional gain of $2,561. The total gain was $7,976 on the sale of the Miller common stock.

On May 2, 2011, we sold our membership interests in Fischbein, LLC ("Fischbein") for $12,396 of gross proceeds, $1,479 of which is deferred revenue held in escrow, realizing a gain of $9,893, and received a repayment on the loan that was outstanding. We subsequently made a $3,334 senior secured second lien term loan and invested $875 in the common equity of Fischbein with the new ownership group.

During the year ended June 30, 2012, Deb Shops, Inc. ("Deb Shops") filed for bankruptcy and a plan for reorganization was proposed. The plan was approved by the bankruptcy court and our debt position was eliminated with no payment to us. We determined that the impairment of Deb Shops was other-than-temporary on September 30, 2011 and recorded a realized loss of $14,607 for the full amount of the amortized cost. The asset was completely written off when the plan of reorganization was approved.

On December 28, 2011, we made a secured debt investment of $37,218 to support the recapitalization of NRG Manufacturing, Inc. ("NRG"). After the financing, we received repayment of the $13,080 loan that was previously outstanding

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Note 3. Portfolio Investments (Continued)

and a dividend of $6,711 as a result of our equity holdings. In addition, we sold 392 shares of NRG common stock held by us back to NRG for $13,266, realizing a gain of $12,131.

On February 2, 2012, NRG was sold to an outside buyer for $123,258. In conjunction with the sale, the $37,218 loan that was outstanding was repaid. We also received a $26,936 make-whole fee for early repayment of the outstanding loan, which was recorded as interest income in the year ended June 30, 2012. Further, we received a $3,800 advisory fee for the transaction, which was recorded as other income in the quarter ending March 31, 2012. After expenses, including the make whole and advisory fees discussed above, $40,886 was available to be distributed to stockholders. While our 408 shares of NRG common stock represented 67.1% of the ownership, we received net proceeds of $25,991 as our contribution to the escrow amount was proportionately higher than the other shareholders. In connection with the sales, we recognized a realized gain of $24,810 during the year ended June 30, 2012. In total, we received proceeds of $93,977 at closing. In addition, there was $11,125 being held in escrow of which 80% is due to us upon release of the escrowed amounts. During the year ended June 30, 2013, we received $3,251 upon release of escrowed amounts for which we recognized a gain in the same amount. As of June 30, 2013, the fair value of the remaining escrow amounts was $3,618. This will be recognized as a gain if and when received.

On February 5, 2013, we received a distribution of $3,250 related to our investment in NRG, for which we realized a gain of the same amount. This was a partial release of the amount held in escrow.

On June 15, 2012, we acquired 80.1% of the businesses of First Tower LLC ("First Tower") for $110,200 in cash and 14,518,207 unregistered shares of our common stock. Based on our share price of $11.06 at the time of issuance, we acquired our 80.1% interest in First Tower for approximately $270,771. As consideration for our investment, First Tower Holdings of Delaware, which is 100% owned by us, recorded a secured revolving credit facility to us of $244,760 and equity of $43,193. First Tower Delaware owns 80.1% of First Tower Holdings LLC, the holding company of First Tower. The assets of First Tower acquired include, among other things, the subsidiaries owned by First Tower, which hold finance receivables, leaseholds, and tangible property associated with First Tower's businesses. We received $8,075 in structuring fee income as part of the acquisition.

In December 2012, we determined that the impairment of ICS was other-than-temporary and recorded a realized loss of $12,198 for the amount that the amortized cost exceeded the fair market value. Our remaining investment in THS, an affiliate of ICS, was valued at zero as of June 30, 2013 and continues to provide staffing solutions for health care facilities and security staffing.

On March 28, 2013, we sold our investment in New Meatco Provisions, LLC for net proceeds of approximately $1,965, recognizing a realized loss of $10,814 on the sale.

On April 30, 2013, we sold our investment in Fischbein for net proceeds of $3,168, recognizing a realized gain of $2,293 on the sale. In addition, there is $310 being held in escrow which will be recognized as additional gain if and when received.

On April 15, 2013, assets previously held by H&M were assigned to Wolf in exchange for a $66,000 term loan secured by the assets. Our cost basis in this loan of $44,632 was determined in accordance with ASC 310-40, Troubled Debt Restructurings by Creditors, and is equal to the fair value of assets at the time of transfer and we recorded a realized loss of $19,647 in connection with the foreclosure on the assets. On May 17 2013, Wolf sold certain of the assets that had been previously held by H&M that were located in Martin County to Hibernia for $66,000. Proceeds from the sale were primarily used to repay the loan and net profits interest receivable due to us and we recognized as a realized gain of $11,826 partially offsetting the previously recorded loss. We received $3,960 of structuring and advisory fees from Wolf during the year ended June 30, 2013 related to the sale and $991 under the net profits interest agreement which was recognized as other income during the fiscal year ended June 30, 2013.

In June 2013, we determined that the impairment of Manx was other-than-temporary and recorded a realized loss of $9,397 for the amount that the amortized cost exceeded the fair market value.

The original cost basis of debt placements and equity securities acquired, including follow-on investments for existing portfolio companies, totaled $3,103,217, $1,120,659 and $953,337 during the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively. Debt repayments and proceeds from sales of equity securities of $931,534, $500,952 and $285,862 were received during the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively.

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Note 3. Portfolio Investments (Continued)

During the year ended June 30, 2013, we recognized $1,481 of interest income due to purchase discount accretion from the assets acquired from Patriot. Included in the $1,481 recorded during the year ended June 30, 2013 is $1,111 of normal accretion and $370 of accelerated accretion resulting from the repayment of Hudson Products Holdings, Inc.
During the year ended June 30, 2012, we recognized $6,613 of interest income due to purchase discount accretion from the assets acquired from Patriot. Included in the $6,613 is $3,083 of normal accretion and $3,530 of accelerated accretion resulting from the repayment of Mac & Massey Holdings, LLC, Nupla Corporation, ROM Acquisition Corp and Sport Helmets Holdings, LLC.
During the year ended June 30, 2011, we recognized $22,084 of interest income due to purchase discount accretion from the assets acquired from Patriot. Included in the $22,084 is $4,912 of normal accretion, $12,035 of accelerated accretion resulting from the repayment of Impact Products, LLC, Label Corp Holdings Inc. and Prince Mineral Company, Inc., and $4,968 of accelerated accretion resulting from the recapitalization of our debt investments in Arrowhead General Insurance Agency, Inc. ("Arrowhead"), The Copernicus Inc. ("Copernicus"), Fischbein and Northwestern Management Services, LLC ("Northwestern"). The restructured loans for Arrowhead, Copernicus, Fischbein and Northwestern were issued at market terms comparable other industry transactions. In accordance with ASC 320-20-35 the cost basis of the new loan was recorded at par value, which precipitated the acceleration of original purchase discount from the loan repayment which was recognized as interest income.
As of June 30, 2013, $540 of purchase discount from the assets acquired from Patriot remains to be accreted as interest income, of which $240 is expected to be amortized during the three months ending September 30, 2013.
As of June 30, 2013, $3,005,298 of our loans bear interest at floating rates, $2,976,709 of which have Libor floors ranging from 1.00% to 5.89%.
Undrawn committed revolvers incur commitment fees ranging from 0.50% to 2.00%. As of June 30, 2013 and June 30, 2012, we had $202,518 and $180,646 of undrawn revolver commitments to our portfolio companies, respectively.

Note 4. Revolving Credit Agreements

On June 11, 2010, we closed an extension and expansion of our existing credit facility with a syndicate of lenders through PCF (the "2010 Facility"). The 2010 Facility, which had $325,000 total commitments as of June 30, 2011, included an accordion feature which allowed the 2010 Facility to accept up to an aggregate total of $400,000 of commitments, a limit which was met on September 1, 2011. Interest on borrowings under the 2010 Facility was one-month Libor plus 325 basis points, subject to a minimum Libor floor of 100 basis points. Additionally, the lenders charged a fee on the unused portion of the 2010 Facility equal to either 75 basis points if at least half of the credit facility was used or 100 basis points otherwise.
On March 27, 2012, we renegotiated the 2010 Facility and closed on an expanded five-year $650,000 revolving credit facility (the "2012 Facility"). The lenders have extended commitments of $552,500 under the 2012 Facility as of June 30, 2013. The 2012 Facility includes an accordion feature which allows commitments to be increased up to $650,000 in the aggregate. The revolving period of the 2012 Facility extends through March 2015, with an additional two year amortization period (with distributions allowed) after the completion of the revolving period. During such two year amortization period, all principal payments on the pledged assets will be applied to reduce the balance. At the end of the two year amortization period, the remaining balance will become due, if required by the lenders.
The 2012 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 2012 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 2012 Facility. The 2012 Facility also requires the maintenance of a minimum liquidity requirement. At June 30, 2013, we were in compliance with the applicable covenants.

Interest on borrowings under the 2012 Facility is one-month Libor plus 275 basis points with no minimum Libor floor. Additionally, the lenders charge a fee on the unused portion of the 2012 Facility equal to either 50 basis points if at least half of the credit facility is drawn or 100 basis points otherwise. The 2012 Facility requires us to pledge assets as collateral in order to borrow under the credit facility. As of June 30, 2013 and June 30, 2012, we had $473,508 and $418,980, respectively, available to us for borrowing under our 2012 Facility, of which the amount outstanding was $124,000 and $96,000, respectively. As

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Note 4. Revolving Credit Agreement (Continued)

additional investments that are eligible are transferred to PCF and pledged under the 2012 Facility, PCF will generate additional availability up to the commitment amount of $552,500. At June 30, 2013, the investments used as collateral for the 2012 Facility had an aggregate market value of $833,310, which represents 31.37% of our net assets. These assets have been transferred to PCF, a bankruptcy remote special purpose entity, which owns these investments and as such, these investments are not available to our general creditors. PCF, a bankruptcy remote special purpose entity and our wholly-owned subsidiary, holds all of these investments at market value as of June 30, 2013. The release of any assets from PCF requires the approval of the facility agent.
In connection with the origination and amendments of the 2012 Facility, we incurred $11,150 of fees, including $1,319 of fees carried over from the previous facility, which are being amortized over the term of the facility in accordance with ASC 470-50, Debt Modifications and Extinguishments, of which $6,722 remains to be amortized.
During the years ended June 30, 2013, June 30, 2012 and June 30, 2011, we recorded $9,082, $14,883 and $8,507 of interest costs, unused fees and amortization of financing costs on our credit facility as interest expense, respectively.
Note 5. Senior Convertible Notes
On December 21, 2010, we issued $150,000 in aggregate principal amount of our 6.25% senior convertible notes due 2015 ("2015 Notes") for net proceeds following underwriting expenses of approximately $145,200. Interest on the 2015 Notes is paid semi-annually in arrears on June 15 and December 15, at a rate of 6.25% per year, commencing June 15, 2011. The 2015 Notes mature on December 15, 2015 unless converted earlier. The 2015 Notes are convertible into shares of common stock at an initial conversion rate and conversion rate at June 30, 2013 of 88.0902 and 88.1429 shares of common stock, respectively, per $1 principal amount of 2015 Notes, which is equivalent to a conversion price of approximately $11.35 per share of common stock, subject to adjustment in certain circumstances. The conversion price in effect at June 30, 2013 was last calculated on the anniversary of the issuance (December 21, 2012) and will next be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary. The conversion rate for the 2015 Notes is increased if monthly cash dividends paid to common shares exceed the rate of $0.101125 cents per share, subject to adjustment.
On February 18, 2011, we issued $172,500 in aggregate principal amount of our 5.50% senior convertible notes due 2016 ("2016 Notes") for net proceeds following underwriting expenses of approximately $167,325. Between January 30, 2012 and February 2, 2012, we repurchased $5,000 of our 2016 Notes at a price of 97.5, including commissions. The transactions resulted in our recognizing $10 of loss in the year ended June 30, 2012. Interest on the remaining $167,500 of 2016 Notes is paid semi-annually in arrears on February 15 and August 15, at a rate of 5.50% per year, commencing August 15, 2011. The 2016 Notes mature on August 15, 2016 unless converted earlier. The 2016 Notes are convertible into shares of common stock at an initial conversion rate and conversion rate at June 30, 2013 of 78.3699 and 78.5395 shares, respectively, of common stock per $1 principal amount of 2016 Notes, which is equivalent to a conversion price of approximately $12.73 per share of common stock, subject to adjustment in certain circumstances. The conversion price in effect at June 30, 2013 was last calculated on the anniversary of the issuance (February 14, 2012) and will next be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary. The conversion rate for the 2016 Notes is increased when monthly cash dividends paid to common shares exceed the monthly dividend rate of $0.101150 per share.
On April 16, 2012, we issued $130,000 in aggregate principal amount of our 5.375% senior convertible notes due 2017 ("2017 Notes") for net proceeds following underwriting expenses of approximately $126,035. Interest on the 2017 Notes is paid semi-annually in arrears on October 15 and April 15, at a rate of 5.375% per year, commencing October 15, 2012. The 2017 Notes mature on October 15, 2017 unless converted earlier. The 2017 Notes are convertible into shares of common stock at an initial conversion rate and conversion rate at June 30, 2013 of 85.8442 and 86.1162 shares of common stock, respectively, per $1 principal amount of 2017 Notes, which is equivalent to a conversion price of approximately $11.61 per share of common stock, subject to adjustment in certain circumstances. The conversion price in effect at June 30, 2013 was last calculated on the anniversary of the issuance (April 16, 2012)

and will next be adjusted on the next anniversary, unless the exercise price shall have changed by more than 1% before the anniversary. The conversion rate for the 2017 Notes is increased when monthly cash dividends paid to common shares exceed the monthly dividend rate of $0.10150 per share.
On August 14, 2012, we issued $200,000 in aggregate principal amount of our 5.75% senior convertible notes due 2018 ("2018 Notes") for net proceeds following underwriting expenses of approximately $193,600. Interest on the 2018 Notes is paid semi-annually in arrears on March 15 and September 15, at a rate of 5.75% per year, commencing March 15, 2013. The 2018 Notes mature on March 15, 2018 unless converted earlier. The 2018 Notes are convertible into shares of common stock at an

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Note 5. Senior Convertible Notes (Continued)

initial conversion rate and conversion rate at June 30, 2013 of 82.3451 shares of common stock per $1 principal amount of 2018 Notes, which is equivalent to a conversion price of approximately $12.07 per share of common stock, subject to adjustment in certain circumstances. The conversion price has not been adjusted since the issuance (August 14, 2012) and will next be adjusted on the first anniversary, unless the exercise price shall have changed by more than 1% before the anniversary. The conversion rate for the 2018 Notes is increased when monthly cash dividends paid to common shares exceed the monthly dividend rate of $0.101600 per share.

On December 21, 2012, we issued $200,000 in aggregate principal amount of 5.875% senior convertible notes due 2019 (the "2019 Notes") for net proceeds following underwriting and other expenses of approximately $193,600. Interest on the 2019 Notes is paid semi-annually in arrears on January 15 and July 15, at a rate of 5.875% per year, commencing July 15, 2013. The 2019 Notes mature on January 15, 2019 unless converted earlier. The 2019 Notes are convertible into shares of common stock at an initial conversion rate and conversion rate at June 30, 2013 of 79.7766 shares of common stock per $1 principal amount of 2019 Notes, which is equivalent to a conversion price of approximately $12.54 per share of common stock, subject to adjustment in certain circumstances. The conversion price has not been adjusted since the issuance (December 21, 2012) and will next be adjusted on the first anniversary, unless the exercise price shall have changed by more than 1% before the anniversary. The conversion rate for the 2019 Notes is increased when monthly cash dividends paid to common shares exceed the monthly dividend rate of $0.110025 per share.

In no event will the total number of shares of common stock issuable upon conversion exceed 96.8992 per $1 principal amount of the 2015 Notes (the "conversion rate cap"), except that, to the extent we receive written guidance or a no-action letter from the staff of the Securities and Exchange Commission (the "Guidance") permitting us to adjust the conversion rate in certain instances without regard to the conversion rate cap and to make the 2015 Notes convertible into certain reference property in accordance with certain reclassifications, business combinations, asset sales and corporate events by us without regard to the conversion rate cap, we will make such adjustments without regard to the conversion rate cap and will also, to the extent that we make any such adjustment without regard to the conversion rate cap pursuant to the Guidance, adjust the conversion rate cap accordingly. We will use our commercially reasonable efforts to obtain such Guidance as promptly as practicable.

Prior to obtaining the Guidance, we will not engage in certain transactions that would result in an adjustment to the conversion rate increasing the conversion rate beyond what it would have been in the absence of such transaction unless we have engaged in a reverse stock split or share combination transaction such that in our reasonable best estimation, the conversion rate following the adjustment for such transaction will not be any closer to the conversion rate cap than it would have been in the absence of such transaction.

Upon conversion, unless a holder converts after a record date for an interest payment but prior to the corresponding interest payment date, the holder will receive a separate cash payment with respect to the Notes surrendered for conversion representing accrued and unpaid interest to, but not including the conversion date. Any such payment will be made on the settlement date applicable to the relevant conversion on the 2015 Notes and 2016 Notes (collectively, "Senior Convertible Notes").

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

Subject to certain exceptions, holders may require us to repurchase, for cash, all or part of their Notes upon a fundamental change at a price equal to 100% of the principal amount of the Notes being repurchased plus any accrued and unpaid interest up to, but excluding, the fundamental change repurchase date. In addition, upon a fundamental change that constitutes a non-stock change of control we will also pay holders an amount in cash equal to the present value of all remaining interest payments (without duplication of the foregoing amounts) on such Senior Convertible Notes through and including the maturity date.

In connection with the issuance of the Senior Convertible Notes, we incurred $27,032 of fees which are being amortized over the terms of the notes in accordance with ASC 470-50, Debt Modifications and Extinguishments, of which $20,254

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Note 5. Senior Convertible Notes (Continued)

remains to be amortized and is included within deferred financing costs on the consolidated statements of assets and liabilities as of June 30, 2013.

During the years ended June 30, 2013, June 30, 2012 and June 30, 2011, we recorded $45,878, $22,197 and $9,090 of interest costs and amortization of financing costs on the Senior Convertible Notes as interest expense.

Note 6. Senior Unsecured Notes

On May 1, 2012, we issued $100,000 in aggregate principal amount of 6.95% senior unsecured notes due 2022 for proceeds net of offering expenses of $97,000 (the "2022 Notes"). Interest on the 2022 Notes is paid quarterly in arrears on August 15, November 15, February 15 and May 15, at a rate of 6.95% per year, commencing on August 15, 2012. The 2022 Notes mature on November 15, 2022. These notes will be our direct unsecured obligations and rank equally with all of our unsecured senior indebtedness from time to time outstanding.

On March 15, 2013, we issued $250,000 in aggregate principal amount of 5.875% senior unsecured notes due 2023 (the "2023 Notes") for net proceeds following underwriting and other expenses of approximately $245,885. Interest on the 2023 Notes is paid semi-annually. The 2023 Notes mature on March 15, 2023. These notes will be our direct unsecured obligations and rank equally with all of our unsecured senior indebtedness from time to time outstanding.

In connection with the issuance of the 2022 Notes and 2023 Notes (collectively the "Senior Unsecured Notes"), we incurred $7,480 of fees which are being amortized over the term of the notes in accordance with ASC 470-50, Debt Modifications and Extinguishments, of which $7,114 remains to be amortized and is included within deferred financing costs on the consolidated statements of assets and liabilities.

During the years ended June 30, 2013 and June 30, 2012, we recorded $11,672 and $1,178 of interest costs and amortization of financing costs on the Senior Unsecured Notes as interest expense, respectively.

Note 7. Prospect Capital InterNotes®

On February 16, 2012, we entered into a Selling Agent Agreement (the "Selling Agent Agreement") with Incapital LLC, as purchasing agent for our issuance and sale from time to time of up to $500,000 of Prospect Capital InterNotes® (the "InterNotes® Offering"), which was subsequently increased to $1,000,000. Additional agents appointed by us from time to time in connection with the InterNotes Offering may become parties to the Selling Agent Agreement.

These notes are direct unsecured senior obligations and will rank equally with all of our unsecured senior indebtedness outstanding. Each series of notes will be issued by a separate trust. These notes bear interest at fixed interest rates and offer a variety of maturities no less than twelve months from the original date of issuance.

During the year ended June 30, 2013, we issued $343,139 in aggregate principal amount of our Prospect Capital InterNotes® for net proceeds of approximately $334,243. These notes were issued with stated interest rates ranging from 3.28% to 6.63% with a weighted average rate of 5.59%. These notes mature between July 15, 2019 and June 15, 2043.

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Note 7. Prospect Capital InterNotes® (Continued)

The bonds outstanding as of June 30, 2013 are:

Date of Issuance	Principal Amount	Interest Rate Range	Weighted Average Interest Rate	Maturity Date
March 1, 2012 - March 8, 2012	$5,465	6.90% - 7.00%	6.97%	March 15, 2022
April 5, 2012 - April 26, 2012	8,516	6.50% - 6.85%	6.72%	April 15, 2022
June 14, 2012	2,657	6.95%	6.95%	June 15, 2022
June 28, 2012	4,000	6.55%	6.55%	June 15, 2019
July 6, 2012 - July 26, 2012	20,928	6.20% - 6.45%	6.31%	July 15, 2019
August 2, 2012 - August 23, 2012	17,545	6.05% - 6.15%	6.09%	August 15, 2019
September 7, 2012 - September 27, 2012	29,406	5.85% - 6.00%	5.92%	September 15, 2019
October 4, 2012	7,172	5.70%	5.70%	October 19, 2019
November 23, 2012 - November 29, 2012	13,754	5.00% - 5.13%	5.09%	November 15, 2019
November 29, 2012	1,979	5.75%	5.75%	November 15, 2032
November 23, 2012 - November 29, 2012	16,437	6.50% - 6.63%	6.58%	November 15, 2042
December 6, 2012 - December 28, 2012	9,339	4.50% - 4.86%	4.73%	December 15, 2019
December 6, 2012	1,127	5.63%	5.63%	December 15, 2032
December 13, 2012 - December 28, 2012	3,702	5.00% - 5.13%	5.11%	December 15, 2030
December 6, 2012 - December 28, 2012	22,966	6.00% - 6.38%	6.21%	December 15, 2042
January 4, 2013 - January 31, 2013	4,427	4.00% - 4.375%	4.15%	January 15, 2020
January 4, 2013 - January 31, 2013	2,388	4.50% - 4.875%	4.74%	January 15, 2031
January 4, 2013 - January 31, 2013	9,338	5.50% - 5.875%	5.63%	January 15, 2043
February 4, 2013 - February 28, 2013	2,619	4.00%	4.00%	February 15, 2031
February 4, 2013 - February 28, 2013	664	4.50%	4.50%	February 15, 2031
February 4, 2013 - February 28, 2013	4,623	5.50%	5.50%	February 15, 2043
March 4, 2013 - March 28, 2013	3,832	4.00%	4.00%	March 15, 2020
March 4, 2013 - March 28, 2013	984	4.125% - 4.50%	4.24%	March 15, 2031
March 4, 2013 - March 28, 2013	4,308	5.50%	5.50%	March 15, 2043
March 14, 2013 - March 28, 2013	1,225	L+3.00%	3.27%	March 15, 2023
April 4, 2013 - April 25, 2013	29,528	4.50% - 5.00%	4.96%	April 15, 2020
April 4, 2013 - April 25, 2013	264	L+3.50%	3.78%	April 15, 2023
April 4, 2013 - April 25, 2013	5,164	4.63% - 5.50%	5.34%	April 15, 2031
April 4, 2013 - April 25, 2013	12,280	6.00%	6.00%	April 15, 2043
May 2, 2013 - May 31, 2013	42,482	5.00%	5.00%	May 15, 2020
May 2, 2013 - May 31, 2013	10,000	5.00%	5.00%	May 15, 2028
May 2, 2013 - May 31, 2013	7,548	5.75%	5.75%	May 15, 2031
May 2, 2013 - May 31, 2013	33,641	6.25%	6.25%	May 15, 2043
June 6, 2013 - June 27, 2013	9,905	5.00% - 5.25%	5.04%	June 15, 2020
June 6, 2013 - June 27, 2013	5,000	5.00%	5.00%	June 15, 2028
June 6, 2013 - June 27, 2013	1,707	5.75% - 6.00%	5.85%	June 15, 2031
June 6, 2013 - June 27, 2013	6,857	6.25% - 6.50%	6.31%	June 15, 2043
	$363,777			

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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Note 7. Prospect Capital InterNotes® (Continued)

In connection with the issuance of the Prospect Capital InterNotes®, we incurred $10,598 of fees which are being amortized over the term of the notes in accordance with ASC 470-50, Debt Modifications and Extinguishments, of which $10,248 remains to be amortized and is included within deferred financing costs on the consolidated statements of assets and liabilities.

During the years ended June 30, 2013 and June 30, 2012, we recorded $9,707 and $276 of interest costs and amortization of financing costs on the Prospect Capital InterNotes® as interest expense, respectively.

Note 8. Financial Instruments Disclosed, But Not Carried, At Fair Value

The fair values of our financial liabilities disclosed, but not carried, at fair value as of June 30, 2013 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Fair Value Hierarchy			
	Level 1	Level 2	Level 3	Total
Credit facility payable(1)	$—	$ 124,000	$—	$ 124,000
Senior convertible notes(2)	—	886,210	—	886,210
Senior unsecured notes(2)	101,800	242,013	—	343,813
Prospect Capital InterNotes®(3)	—	336,055	—	336,055
Total	$ 101,800	$ 1,588,278	$—	$ 1,690,078

(1) The carrying value of our credit facility payable approximates the fair value.
(2) We use available market quotes to estimate the fair value of the Senior Convertible Notes and Senior Unsecured Notes.
(3) The fair value of our Prospect Capital InterNotes® is estimated by discounting remaining payments using estimated current market rates.

The fair values of our financial liabilities disclosed, but not carried, at fair value as of June 30, 2012 disaggregated into the three levels of the ASC 820 valuation hierarchy are as follows:

	Fair Value Hierarchy			
	Level 1	Level 2	Level 3	Total
Credit facility payable(1)	$—	$ 96,000	$—	$ 96,000
Senior convertible notes(2)	—	456,671	—	456,671
Senior unsecured notes(2)	99,560	—	—	99,560
Prospect Capital InterNotes ®(3)	—	20,280	—	20,280
Total	$ 99,560	$ 572,951	$—	$ 672,511

(1) The carrying value of our credit facility payable approximates the fair value.
(2) We use available market quotes to estimate the fair value of the Senior Convertible Notes and Senior Unsecured Notes.
(3) The fair value of our Prospect Capital InterNotes® is estimated by discounting remaining payments using estimated current market rates.

Note 9. Equity Offerings, Offering Expenses, and Distributions

We issued 106,752,517 and 30,970,696 shares of our common stock during the years ended June 30, 2013 and June 30, 2012, respectively. The proceeds raised, the related underwriting fees, the offering expenses and the prices at which these shares were issued are as follows:

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 9. Equity Offerings, Offering Expenses, and Distributions (Continued)

Issuances of Common Stock	Number of Shares Issued	Gross Proceeds Raised	Underwriting Fees	Offering Expenses	Average Offering Price
During the year ended June 30, 2013:					
July 2, 2012 - July 12, 2012(1)	2,247,275	$26,040	$260	$—	$11.59
July 16, 2012	21,000,000	$234,150	$2,100	$300	$11.15
July 27, 2012	3,150,000	$35,123	$315	$—	$11.15
September 13, 2012 - October 9, 2012(2)	8,010,357	$94,610	$946	$638	$11.81
November 7, 2012	35,000,000	$388,500	$4,550	$814	$11.10
December 13, 2012(3)	467,928	$5,021	$—	$—	$10.73
December 28, 2012(3)	897,906	$9,581	$—	$—	$10.67
December 31, 2012(3)	4,141,547	$44,650	$—	$—	$10.78
January 7, 2013 - February 5, 2013(4)	10,248,051	$115,315	$1,153	$—	$11.25
February 14, 2013 - May 3, 2013(5)	17,230,253	$191,897	$1,788	$—	$11.14
May 14, 2013 - May 31, 2013(6)	4,359,200	$47,532	$399	$245	$10.90
During the year ended June 30, 2012:					
June 12, 2012 - June 29, 2012(1)	2,952,489	$33,130	$331	$184	$11.220
June 15, 2012(7)	14,518,207	$160,571	$—	$—	$11.060
February 28, 2012	12,000,000	$131,400	$1,560	$360	$10.950
July 18, 2011	1,500,000	$15,225	$165	$165	$10.150

(1) On June 1, 2012, we established an at-the-market program through which we may sell, from time to time and at our sole discretion 9,500,000 shares of our common stock. Through this program we issued 5,199,764 shares of our common stock at an average price of $11.38 per share, raising $59,170 of gross proceeds, from June 12, 2012 through July 12, 2012.

(2) On September 10, 2012, we established an at-the-market program through which we may sell, from time to time and at our sole discretion 9,750,000 shares of our common stock. Through this program we issued 8,010,357 shares of our common stock at an average price of $11.81 per share, raising $94,610 of gross proceeds, from September 13, 2012 through October 9, 2012.

(3) On December 13, 2012, December 28, 2012 and December 31, 2012, we issued 467,928, 897,906 and 4,141,547 shares of our common stock, respectively, in conjunction with investments in controlled portfolio companies.

(4) On December 21, 2012, we established an at-the-market program through which we may sell, from time to time and at our sole discretion 17,500,000 shares of our common stock. Through this program we issued 10,248,051 shares of our common stock at an average price of $11.25 per share, raising $115,315 of gross proceeds.

(5) On February 11, 2013, we established an at-the-market program through which we may sell, from time to time and at our sole discretion 45,000,000 shares of our common stock. Through this program we issued 17,230,253 shares of our common stock at an average price of $11.14 per share, raising $191,897 of gross proceeds.

(6) On May 8, 2013, we established an at-the-market program through which we may sell, from time to time and at our sole discretion 45,000,000 shares of our common stock. Through this program we issued 4,539,200 shares of our common stock at an average price of $10.90 per share, raising $47,532 of gross proceeds.

(7) On June 15, 2012, we completed the acquisition of the businesses of First Tower. We acquired 80.1% of First Tower's businesses for $110,200 in cash and 14,518,207 unregistered shares of our common stock.

Our shareholders' equity accounts at June 30, 2013 and June 30, 2012 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 August 24, 2011, our Board of Directors approved a share repurchase plan under which we may repurchase up to $100,000 of our common stock at prices below our net asset value. We have not made any purchases of our common stock

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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Note 9. Equity Offerings, Offering Expenses, and Distributions (Continued)

during the period from August 24, 2011 to June 30, 2013 pursuant to this plan. Prior to any repurchase we are required to notify shareholders of our intention to purchase our common stock. This notice lasts for six months after notice is given. The last notice was more than six months ago, therefore notice would be necessary before such repurchase could be effected.

On October 29, 2012, our Registration Statement on Form N-2 was declared effective by the SEC. Under this Shelf Registration Statement, as of June 30, 2013 we can issue up to $1,743,217 of additional debt and equity securities in the public market.

On May 6, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110125 per share for May 2013 to holders of record on May 31, 2013 with a payment date of June 20, 2013;
- $0.110150 per share for June 2013 to holders of record on June 28, 2013 with a payment date of July 18, 2013;
- $0.110175 per share for July 2013 to holders of record on July 31, 2013 with a payment date of August 22, 2013; and
- $0.110200 per share for August 2013 to holders of record on August 30, 2013 with a payment date of September 19, 2013.

On June 17, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110225 per share for September 2013 to holders of record on September 30, 2013 with a payment date of October 24, 2013;
- $0.110250 per share for October 2013 to holders of record on October 31, 2013 with a payment date of November 21, 2013;
- $0.110275 per share for November 2013 to holders of record on November 29, 2013 with a payment date of December 19, 2013; and
- $0.110300 per share for December 2013 to holders of record on December 31, 2013 with a payment date of January 23, 2014.

During the years ended June 30, 2013 and June 30, 2012, we issued 1,450,578 and 1,056,484 shares, respectively, of our common stock in connection with the dividend reinvestment plan.

At June 30 2013, we have reserved 70,246,258 shares of our common stock for issuance upon conversion of the Senior Convertible Notes (See Note 5).

Note 10. Other Investment Income

Other investment income consists of structuring fees, overriding royalty interests, revenue receipts related to net profit interests, deal deposits, administrative agent fee, and other miscellaneous and sundry cash receipts. Income from such sources was $58,176, $36,493 and $19,930 for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively.

	For The Year Ended		
Income Source	June 30, 2013	June 30, 2012	June 30, 2011
Structuring, advisory and amendment fees (Note 3)	$ 53,708	$ 35,976	$ 19,589
Overriding royalty interests	4,122	224	154
Administrative agent fee	346	293	187
Other Investment Income	$ 58,176	$ 36,493	$ 19,930

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PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 11. 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, 2013, 2012 and 2011, respectively.

	For The Year Ended		
	June 30, 2013	June 30, 2012	June 30, 2011
Net increase in net assets resulting from operations	$ 220,856	$ 190,904	$ 118,238
Weighted average common shares outstanding	207,069,971	114,394,554	85,978,757
Net increase in net assets resulting from operations per common share	$ 1.07	$ 1.67	$ 1.38

Note 12. 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, the 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.
The total base management fees earned by and paid to Prospect Capital Management for the years ended June 30, 2013, June 30, 2012 and June 30, 2011 were $69,800, $35,836 and $22,496, 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;

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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Note 12. Related Party Agreements and Transactions (Continued)

- 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.

Income incentive fees totaling $81,231, $46,671 and $23,555 were earned for the years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively. No capital gains incentive fees were earned for years ended June 30, 2013, June 30, 2012 and June 30, 2011, respectively.

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 financial officer and chief compliance officer and his staff. For the years ended June 30, 2013, 2012 and 2011, the reimbursement was approximately $8,737, $6,848 and $4,979, 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 the 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

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Note 12. Related Party Agreements and Transactions (Continued)

reasonably paid in settlement) arising from the rendering of Prospect Administration's services under the Administration Agreement or otherwise as administrator for us.

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. As of June 30, 2013 and June 30, 2012, $1,291 and $165 of managerial assistance fees remain on the consolidated statements of assets and liabilities as a payable to the Administrator for reimbursement of its cost in providing such assistance.

Note 13. 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. We are not aware of any such material litigation as of the date of this report.

Note 14. Financial Highlights

	Year Ended June 30, 2013	Year Ended June 30, 2012	Year Ended June 30, 2011	Year Ended June 30, 2010	Year Ended June 30, 2009
Per Share Data(1):					
Net asset value at beginning of period	$10.83	$10.36	$10.30	$12.40	$14.55
Net investment income	1.57	1.63	1.10	1.13	1.87
Realized (loss) gain	(0.13)	0.32	0.19	(0.87)	(1.24)
Net unrealized (depreciation) appreciation	(0.37)	(0.28)	0.09	0.07	0.48
Net increase (decrease) in net assets as a result of public offering	0.13	0.04	(0.08)	(0.85)	(2.11)
Net increase in net assets as a result of shares issued for Patriot acquisition	—	—	—	0.12	—
Dividends to shareholders	(1.31)	(1.24)	(1.24)	(1.70)	(1.15)
Net asset value at end of period	$10.72	$10.83	$10.36	$10.30	$12.40
Per share market value at end of period	$10.80	$11.39	$10.11	$9.65	$9.20
Total return based on market value(2)	6.24%	27.21%	17.22%	17.66%	(18.60)%
Total return based on net asset value(2)	10.91%	18.03%	12.54%	(6.82)%	(0.61)%
Shares outstanding at end of period	247,836,965	139,633,870	107,606,690	69,086,862	42,943,084
Average weighted shares outstanding for period	207,069,971	114,394,554	85,978,757	59,429,222	31,559,905

Ratio / Supplemental Data:										
Net assets at end of period (in thousands)	$2,656,494		$1,511,974		$1,114,357		$711,424		$532,596	
Portfolio turnover rate	29.24	%	29.06	%	27.63	%	21.61	%	4.99	%
Annualized ratio of operating expenses to average net assets	11.50	%	10.73	%	8.47	%	7.54	%	9.03	%
Annualized ratio of net investment income to average net assets	14.86	%	14.92	%	10.60	%	10.69	%	13.14	%

(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.

Note 15. Selected Quarterly Financial Data (Unaudited)

	Investment Income		Net Investment Income		Net Realized and Unrealized Gains (Losses)		Net Increase (Decrease) in Net Assets from Operations	
Quarter Ended	Total	Per Share(1)	Total	Per Share(1)	Total	Per Share(1)	Total	Per Share(1)
September 30, 2010	35,212	0.47	20,995	0.28	4,585	0.06	25,580	0.34
December 31, 2010	33,300	0.40	19,080	0.23	12,861	0.16	31,940	0.38
March 31, 2011	44,573	0.51	23,956	0.27	9,803	0.11	33,759	0.38
June 30, 2011	56,391	0.58	30,190	0.31	(3,232)	(0.03)	26,959	0.28
September 30, 2011	55,342	0.51	27,877	0.26	12,023	0.11	39,900	0.37
December 31, 2011	67,263	0.61	36,508	0.33	27,984	0.26	64,492	0.59
March 31, 2012	95,623	0.84	58,072	0.51	(7,863)	(0.07)	50,209	0.44
June 30, 2012	102,682	0.82	64,227	0.52	(27,924)	(0.22)	36,303	0.29
September 30, 2012	123,636	0.76	74,027	0.46	(26,778)	(0.17)	47,249	0.29
December 31, 2012	166,035	0.85	99,216	0.51	(52,727)	(0.27)	46,489	0.24
March 31, 2013	120,195	0.53	59,585	0.26	(15,156)	(0.07)	44,429	0.20
June 30, 2013	166,470	0.68	92,096	0.38	(9,407)	(0.04)	82,689	0.34

(1) Per share amounts are calculated using weighted average shares during period.
(2) As adjusted for increase in earnings from Patriot.

Note 16. Subsequent Events

During the period from July 1, 2013 to October 11, 2013, we issued $115,110 in aggregate principal amount of our Prospect Capital InterNotes® for net proceeds of $112,713.

During the period from July 1, 2013 to August 21, 2013, we sold 9,818,907 shares of our common stock at an average price of $10.97 per share, and raised $107,725 of gross proceeds, under the ATM Program. Net proceeds were $106,822 after commissions to the broker-dealer on shares sold and offering costs.

On August 23, 2013, we entered into an ATM Program with BMO Capital Markets, Goldman, Sachs & Co., RBC Capital Markets and KeyBanc through which we could sell, by means of at-the-market offerings from time to time, of up to 45,000,000 shares of our common stock. During the period from August 26, 2013 to October 11, 2013 (with settlements August 29, 2013 through October 16, 2013), we sold 17,444,710 shares of our common stock at an average price of $11.26 per share, and raised $196,513 of gross proceeds, under the ATM Program. Net Proceeds were $194,579 after commissions to BMO Capital Markets, Goldman, Sachs & Co., RBC Capital Markets and KeyBanc on shares sold.

On July 1, 2013, Pre-Paid Legal Services, Inc. repaid the $5,000 loan receivable to us.

On July 9, 2013, Southern Management Corporation repaid the $17,565 loan receivable to us.

On July 12, 2013, we provided $11,000 of secured second lien financing to Water PIK, Inc., a leader in developing innovative personal and oral healthcare products.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
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(in thousands, except share and per share data)

Note 16. Subsequent Events (Continued)

On July 23, 2013, we made a $2,000 investment in Carolina Beverage Group, LLC ("Carolina Beverage"), a contract beverage manufacturer.
On July 24, 2013, we sold our $2,000 investment in Carolina Beverage and realized a gain of $45 on this investment.
On July 26, 2013, we made a $2,000 follow-on senior secured debt investment in Spartan Energy Services, LLC, a leading provider of thru tubing and flow control services to oil and gas companies.
On July 26, 2013, we made a $20,000 follow-on secured second lien investment in Royal Adhesives & Sealants, LLC ("Royal"), a leading producer of proprietary, high-performance adhesives and sealants.
On July 31, 2013, we made a $5,100 follow-on investment in Coverall North America, Inc., a leading franchiser of commercial cleaning businesses.
On July 31, 2013, Royal repaid the $28,364 subordinated unsecured loan receivable to us.
On July 31, 2013, Cargo Airport Services USA, LLC repaid the $43,399 loan receivable to us.
On August 1, 2013, Medical Security Card Company, LLC repaid the $13,214 loan receivable to us.
On August 2, 2013, we made an investment of $44,100 to purchase 90% of the subordinated notes in CIFC Funding 2013-III, Ltd.
On August 2, 2013, we funded a recapitalization of CP Energy Services, Inc. ("CP Energy") with $81,273 of debt and $12,741 of equity financing. Through the recapitalization, we acquired a controlling interest in CP Energy for $73,009 in cash and 1,918,342 unregistered shares of our common stock. After the financing, we received repayment of the $18,991 loan previously outstanding.
On August 12, 2013, we provided $80,000 in senior secured loans and a senior secured revolving loan facility, of which $70,000 was funded at closing, for the recapitalization of Matrixx Initiatives, Inc., owner of Zicam, a leading developer and marketer of OTC cold remedy products under the Zicam brand.
On August 14, 2013, we announced the revised conversion rate on the 2018 Notes of 82.8631 shares of common stock per $1 principal amount of 2018 Notes, which is equivalent to a conversion price of approximately $12.07.
On August 15, 2013, we announced an increase of $15,000 to our commitments to our credit facility. The commitments to the credit facility now stand at $567,500.
On August 15, 2013, we made a $14,000 follow-on investment in Totes Isotoner Corporation, a leading designer, distributer and retailer of high quality, branded functional accessories.
On August 21, 2013, we announced the declaration of monthly dividends in the following amounts and with the following dates:

- $0.110325 per share for January 2014 to holders of record on January 31, 2014 with a payment date of February 20, 2014;
- $0.110350 per share for February 2014 to holders of record on February 28, 2014 with a payment date of March 20, 2014; and
- $0.110375 per share for March 2014 to holders of record on March 31, 2014 with a payment date of April 17, 2014.

On August 30, 2013, we made a $16,000 follow-on investment in System One Holdings, LLC, a leading provider of professional staffing services.
On September 5, 2013, we provided $50,000 of floating rate senior secured financing to a leading payments processor.
On September 10, 2013, we made a $12,500 first lien secured investment in Photonis SAS, a world leader in the development, manufacture and sale of electro-optic components for the detection and intensification of very faint light sources.
On September 11, 2013, Seaton Corp. repaid the $13,310 loan receivable to us.

PROSPECT CAPITAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(in thousands, except share and per share data)

Note 16. Subsequent Events (Continued)

On September 12, 2013, we provided a $75,000 floating-rate senior secured term loan to support the recapitalization of American Broadband Communications, LLC, a leading provider of voice, video, and high-speed internet services.
On September 13, 2013, we made an investment of $36,515 to purchase 83.56% of the subordinated notes in Apidos CLO XV, Ltd.
On September 19, 2013, we provided $47,985 of combined senior secured floating rate debt and equity to support the recapitalization of Mity Enterprises, Inc., a leading designer, manufacturer and seller of multipurpose room furniture and specialty healthcare seating products.
On September 25, 2013, we made a $12,000 senior secured investment in NCP Finance, a lender to short term loan providers in the alternative financial services industry.
On September 25, 2013, we received payment of $5,000 in settlement of a lawsuit related to the loan to Integrated Contract Services, Inc., which was previously written off.
On September 30, 2013, we made an investment of $22,575 to purchase 51.02% of the subordinated notes in Galaxy XVI CLO, Ltd.
On September 30, 2013, we sold our investment in ADAPCO, Inc. for net proceeds of $553, recognizing a realized gain of $413 on the sale.
On September 30, 2013, we made an $18,818 follow-on investment in JHH Holdings, Inc., a leading provider of home healthcare services in Texas.
On October 1, 2013, we made a $2,600 follow-on investment in AIRMALL USA, Inc., a leading developer and manager of airport retail operations.
On October 7, 2013, Evanta Ventures, Inc. repaid the $10,506 loan receivable to us.
On October 11, 2013, we made a $5,846 follow-on senior debt and equity investment in CP Energy Services, Inc., an energy services company based in western Oklahoma.
On October 11, 2013, we provided $25,000 in preferred equity for the recapitalization of Ajax Rolled Ring & Machine, Inc. After the financing, we received repayment of the $20,009 loan previously outstanding.

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PROSPECTUS SUPPLEMENT

February 3, 2014

Incapital LLC
BofA Merrill Lynch
Citigroup
RBC Capital Markets