

EQUUS TOTAL RETURN, INC.  
Form 10-K  
March 31, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

**(Mark One)**

**xANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the year ended December 31, 2013**

**Or**

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

**For the transition period from to**

**Commission File Number 814-00098**

**EQUUS TOTAL RETURN, INC.**

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

**Delaware** **76-0345915**  
**(State or other jurisdiction of** **(I.R.S. Employer Identification No.)**  
**incorporation or organization)**

**8 Greenway Plaza, Suite 930, Houston, Texas 77046**  
**(Address of principal executive offices) (Zip Code)**  
**(713) 529-0900**

**Registrant's telephone number, including area code:**

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

**Name of each exchange**  
**Title of each class**  
**on which registered**  
**Common Stock New York Stock Exchange**  
**Securities registered pursuant to Section 12(g) of the Act: None**

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

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

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

Indicate by check mark 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 the definitive proxy or information statement incorporated by reference in Part III of this 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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

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

Approximate aggregate market value of common stock held by non-affiliates of the registrant: \$11,904,684 computed on the basis of \$1.91 per share, closing price of the common stock on the New York Stock Exchange on June 30, 2013. For purposes of calculating this amount only, all directors and executive officers of the registrant have been treated as affiliates. There were 10,561,646 shares of the registrant's common stock, \$.001 par value, outstanding as of March 28, 2014. The net asset value of a share of the Registrant as of December 31, 2013 was \$3.14

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files).

Portions of the Proxy Statement (to be filed) for the 2014 Annual Shareholder's meeting are incorporated by reference in Parts II and III.

[Table of Contents](#)

**TABLE OF CONTENTS**

	<b>Page</b>
<b><u>PART I</u></b>	
<b><u>Item 1</u></b> Business	3
<b><u>Item 1A</u></b> Risk Factors	9
<b><u>Item 1B</u></b> Unresolved Staff Comments	17
<b><u>Item 2</u></b> Properties	17
<b><u>Item 3</u></b> Legal Proceedings	17
<b><u>Item 4</u></b> Mine Safety Disclosures	18
<b><u>PART II</u></b>	
<b><u>Item 5</u></b> Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	19
<b><u>Item 6</u></b> Selected Financial Data	20
<b><u>Item 7</u></b> Management’s Discussion and Analysis of Financial Condition and Results of Operations	20
<b><u>Item 7A</u></b> Quantitative and Qualitative Information About Market Risk	33
<b><u>Item 8</u></b> Financial Statements and Supplementary Data	34
<b><u>Item 9</u></b> Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	60
<b><u>Item 9A</u></b> Controls and Procedures	60
<b><u>Item 9B</u></b> Other Information	61
<b><u>PART III</u></b>	
<b><u>Item 10</u></b> Directors and Executive Officers and Corporate Governance	61
<b><u>Item 11</u></b> Executive Compensation	61
<b><u>Item 12</u></b> Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	61
<b><u>Item 13</u></b> Certain Relationships and Related Transactions and Director Independence	62

<u>Item 14</u> Principal Accountant Fees and Services	62
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PART IV

<u>Item 15</u> Exhibits and Financial Statement Schedules	62
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<u>Table of Contents</u> 2	
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## PART I

### Item 1. *Business*

Equus Total Return, Inc. (“we,” “us,” “our,” “Equus” the “Company” or the “Fund”), a Delaware corporation, was formed by Equus Investments II, L.P. (the “Partnership”) on August 16, 1991. On July 1, 1992, the Partnership was reorganized and all of the assets and liabilities of the Partnership were transferred to the Fund in exchange for shares of common stock of the Fund. On August 11, 2006, our shareholders approved the change of the Fund’s investment strategy to a total return investment objective. This strategy seeks to provide the highest total return, consisting of capital appreciation and current income. In connection with this strategic investment change, the shareholders also approved the change of name from Equus II Incorporated to Equus Total Return, Inc.

We attempt to maximize the return to stockholders in the form of current investment income and long-term capital gains by investing in the debt and equity securities of companies with a total enterprise value of between \$5.0 million and \$75.0 million, although we may engage in transactions with smaller or larger investee companies from time to time. We seek to invest primarily in companies pursuing growth either through acquisition or organically, leveraged buyouts, management buyouts and recapitalizations of existing businesses or special situations. Our income-producing investments consist principally of debt securities including bonds, subordinated debt, debt convertible into common or preferred stock, or debt combined with warrants and common and preferred stock. Debt and preferred equity financing may also be used to create long-term capital appreciation through the exercise and sale of warrants received in connection with the financing. We seek to achieve capital appreciation by making investments in equity and equity-oriented securities issued by privately-owned companies in transactions negotiated directly with such companies. Given market conditions over the past several years and the performance of our portfolio, our management and board of directors believe it prudent to continue to review alternatives to refine and further clarify the current strategies.

Equus is a closed-end management investment company that has elected to be treated as a business development company (hereafter, “BDC”) under the Investment Company Act of 1940 (“1940 Act”). In order to remain a business development company, we must meet certain specified requirements under the 1940 Act, including investing at least 70% of our assets in eligible portfolio companies and limiting the amount of leverage we incur. Equus is also a regulated investment company (“RIC”) under Subchapter M of the U.S. Internal Revenue Code of 1986. As such, we are not required to pay corporate-level income tax on the Fund’s investment income. We intend to maintain our RIC status, which requires that we qualify annually as a RIC by meeting certain specified requirements. For a discussion of these requirements necessary to maintain our status as a BDC and as a RIC, please see “Business Development Company Requirements” and “Regulated Investment Company Tax Status,” respectively.

Our principal office is located at Eight Greenway Plaza, Suite 930, Houston, Texas, 77046, and the telephone number is 1-888-358-7575. Our corporate website is located at [www.equuscap.com](http://www.equuscap.com). We make available free of charge on our

website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed or furnished to the Securities and Exchange Commission (“SEC”). Our shares are traded on The New York Stock Exchange under the ticker symbol “EQS”.

## Significant Developments

Our Board of Directors (sometimes referred to as the “Board”) and management of the Fund (“Management”) continue to believe that current market conditions and recent portfolio performance dictate the need to pursue a more active role in the management of these investments and to seek liquidity events at the appropriate time to protect and enhance shareholder value. These activities include continuous monitoring and intensive reviews of portfolio company performance and expectations, providing follow-on capital when necessary, exploration of liquidity events for certain portfolio companies to position the Fund to maximize investment returns, and actively pursuing suitable new investments for the Fund. Consistent with that strategy, the following is a summary of significant developments during 2013:

- On December 27, 2012, we invested an additional \$6.8 million in Equus Energy, LLC (“Equus Energy”), a wholly-owned subsidiary of the Fund, for the purpose of additional working capital and to fund the purchase of \$6.6 million in working interests in 129 producing and non-producing oil and gas wells, including associated development rights of approximately 21,120 acres situated on 13 separate properties in Texas and Oklahoma. The working interests range from a *de minimus* amount to 50% of the leasehold production of these wells. The wells are operated by a number of experienced operators such as Apache, Chesapeake, and Chevron, which has
- (i) operating responsibility for leasehold interests in the Conger Field, representing approximately half of the producing well interests. The assets were purchased from Warren American Oil Company, LLC, a Tulsa-based oil & gas firm. Due to improved operating performance in the fourth quarter of 2013, an increase in proved developed producing reserves, and the estimated value of the acreage rights associated with certain working interests held in the Eagle Ford trend, the fair value of this holding increased from approximately \$6.9 million at December 31, 2012 to \$8.0 million at December 31, 2013.

Table of Contents 3

On November 7, 2013, we made a short-term working capital loan of \$0.5 million to Security Monitor Holdings, LLC (“SMH”). The loan matures in May 2014 and bears interest at the rate of 14% per annum. Located just (ii) outside of Boston, MA, SMH specializes in managing and improving operations of distressed companies. SMH has been engaged by Spectrum Management, LLC (“Spectrum”), a portfolio company of the Fund, to turn around its operations and position the company for a possible sale.

Due to a more stable operating performance and improved customer retention for Spectrum during 2013, the fair (iii) value of our holdings in Spectrum increased from \$0.4 million at December 31, 2012 to approximately \$2.9 million at December 31, 2013.

### **Investment Objective**

Our investment objective is to maximize the total return to our stockholders in the form of current investment income and long-term capital gains by investing in the debt and equity securities of small and middle market capitalization companies that are generally not publicly traded at the time of our investment. As a result of our endeavors in the energy sector, we also seek to purchase working interests and revenue leasehold interests in oil and gas properties, although we remain open to exploring investment opportunities in a variety of other sectors, such as real estate. As we grow and develop the Fund, we intend to include investments in progressively larger enterprises.

### **Investment Strategy**

Beginning in 2006, we implemented a revised investment strategy to attempt to strike a balance between the potential for gain and the risk of loss. With respect to capital appreciation, Equus is a “growth-at-reasonable-price” investor that seeks to identify and acquire securities that meet our criteria for selling at reasonable prices. We give priority to cash producing investments wherein we invest principally in debt or preferred equity financing with the objective of generating regular interest and dividend income back to the Fund. Debt and preferred equity financing may also be used to create long-term capital appreciation through the exercise and sale of warrants received in connection with the financing. Given market conditions over the past several years and the performance of our portfolio, our Management and Board of Directors believe it prudent to continue to review alternatives to refine and further clarify the current strategies.

### **Investment Criteria**

Consistent with our investment objective and strategy, Management evaluates prospective investments based upon the criteria set forth below. We may modify some or all of these criteria from time to time.

*Management Competency and Ownership.* We seek to invest in companies with experienced management teams who have demonstrated a track record of successful performance. Further, we desire to invest in companies with significant management ownership. We believe that significant management ownership in small capitalization and middle market companies provides appropriate incentives and an alignment of interests for management to maximize shareholder value. In addition, we will seek to design compensation and incentive arrangements that align the interests of the portfolio company's management with those of the Fund to enhance potential returns.

*Substantial Target Market.* We desire to focus on companies whose products or services have favorable growth potential and strong competitive positions in their respective markets. These positions may be as leadership positions within a given industry or market niche positions in which the product or service has a demonstrated competitive advantage. The market in which a potential portfolio company operates should either be sizeable or have significant growth potential.

*History of Profitability and Favorable Growth Potential.* We target companies that have demonstrated a history of profitability or a reasonable expectation of a return to profitability in the near future.

*Ability to Provide Regular Cash Interest and Distributions.* We look for companies with strong cash flow models sufficient to provide regular and consistent interest and/or preferred dividend payments.

*Management Assistance and Substantial Equity.* Given the requirements of a BDC under the 1940 Act, we seek to invest in companies that will permit substantial managerial assistance including representation on the board of directors of the company or its equivalent. With regard to equity investments, we desire to obtain a substantial

Table of Contents 4



investment position in portfolio companies. This position may be as a minority shareholder with certain contractual rights and powers, or as a majority shareholder, and should otherwise allow us to have substantive input on the direction and strategies of the portfolio company.

*Plausible Exit and Potential for Appreciation.* Prior to investing in a portfolio company, we will seek to analyze potential exit strategies and pursue those investments with such strategies as may be achievable.

## **Investment Operations**

Our investment operations consist principally of the following basic activities:

*Investment Selection.* We expect that many of our investment opportunities will come from Management, members of our Board, other private equity investors, direct approaches from prospective portfolio companies and referrals from investment banks, business brokers, commercial, regional and local banks, attorneys, accountants and other members of the financial community. Subject to the approval of our Board, we may compensate certain referrals with finder's fees to the extent permissible under applicable law and consistent with industry practice.

*Due Diligence.* Once a potential investment is identified, we undertake a due diligence review using information provided by the prospective portfolio companies and publicly available information. Management may also seek input from consultants, investment bankers and other knowledgeable sources. The due diligence review will typically include, but is not limited to:

- Review of historical and prospective financial information including audits and budgets;
- On-site visits;
- Interviews with management, employees, customers and vendors of the potential portfolio company;
- Review of existing loan documents, if any;
- Background checks on members of management; and
- Research relating to the company, its management, industry, markets, products and services and competitors.

*Structuring Investments.* We typically negotiate investments in private transactions directly with the owner or issuer of the securities acquired. Management structures the terms of a proposed investment, including the purchase price, the type of security to be purchased and our future involvement in the portfolio company's business. We seek to structure the terms of the investment to provide for the capital needs of the portfolio company while maximizing our opportunities for current income and capital appreciation. In addition, we may invest with other co-investors including private equity firms, business development companies, small business investment companies, venture capital groups,

institutional investors and individual investors.

*Providing Management Assistance and Monitoring of Investments.* Successful private equity investments typically require active monitoring of, and significant participation in, major business decisions of portfolio companies. In several cases, officers and directors of the Fund serve as members of the governing boards of portfolio companies. Such management assistance is required of a BDC under the 1940 Act. We seek to provide guidance and management assistance with respect to such matters as capital structure, acquisitions, budgets, profit goals, corporate strategy, portfolio management and potential sale of the company or other exit strategies. In connection with their service as directors of portfolio companies, officers and directors of the Fund may receive and retain directors' fees or reimbursement for expenses incurred, and may participate in incentive stock option plans for non-employee directors, if any. When necessary and as requested by any portfolio company, Management, on behalf of the Fund, may also assign staff professionals with financial or management expertise to assist portfolio company management.

### **Follow-On Investments**

Following our initial investment, a portfolio company may request that we make follow-on investments by providing additional equity or loans needed to fully implement their business plans to develop a new line of business or to recover from unexpected business problems or other purposes. In addition, follow-on investments may be made to exercise warrants or other preferential rights granted to the Fund or otherwise to increase our position in a portfolio company. We may make follow-on investments in portfolio companies from cash on hand or borrow all or a portion of the funds required. If we are unable to make follow-on investments due to lack of available capital, the portfolio company in need of the investment may be negatively impacted and our equity interest in the portfolio company may be diluted if outside equity capital is required.

[Table of Contents](#) 5

## **Disposition of Investments**

The method and timing of the disposition of our investments in portfolio companies are critical to our ability to realize capital gains and minimize capital losses. We may dispose of our portfolio securities through a variety of transactions, including recapitalizations, refinancings, management buy-outs, repayments from cash flow, acquisitions of portfolio companies by a third party and outright sales of the Fund's securities in a portfolio company. In addition, we may distribute our portfolio securities in-kind to our stockholders. In structuring our investments, we endeavor to reach an understanding with the management of the prospective portfolio company as to the appropriate method and timing of the disposition of the investment. In some cases, we seek registration rights for our portfolio securities at the time of investment which typically provide that the portfolio company will bear the cost of registration. To the extent not paid by the portfolio company, the Fund typically bears the costs of disposing of its portfolio investments.

## **Current Portfolio Companies**

For a description of our current portfolio company investments, see "Management's Discussion and Analysis of Financial Condition and Results of Operations—Portfolio Securities."

## **Valuation**

On at least a quarterly basis, Management values our portfolio investments. These valuations are subject to the approval and adoption of the Board. Valuations of our portfolio securities at "fair value" are performed in accordance with accounting principles generally accepted in the United States of America ("GAAP").

The fair value of investments for which no market exists (which includes most of the Fund's investments) is determined through procedures established in good faith by the Board. As a general principle, the current "fair value" of an investment is the amount the Fund might reasonably expect to receive upon its sale in an orderly manner. There are a range of values that are reasonable for such investments at any particular time.

We base our adjustments upon such factors as the portfolio company's earnings, cash flow and net worth, the market prices for similar securities of comparable companies, an assessment of the company's current and future financial prospects and various other factors and assumptions. In the case of unsuccessful or substantially declining operations, we may base a portfolio company's fair value upon the company's estimated liquidation value. Fair valuations are necessarily subjective, and our estimate of fair value may differ materially from amounts actually received upon the disposition of its portfolio securities. Also, any failure by a portfolio company to achieve its

business plan or obtain and maintain its financing arrangements could result in increased volatility and result in a significant and rapid change in its value.

Our general intent is to hold our loans to maturity when appraising our privately held debt investments. As such, we believe that the fair value will not exceed the cost of the investment. However, in addition to the previously described analysis involving allocation of value to the debt instrument, we perform a yield analysis to determine if a debt security has been impaired.

The Audit Committee of the Board of Directors may engage independent, third-party valuation firms to conduct independent appraisals and review management's preliminary valuations of each privately-held investment in order to make their own independent assessment. Any third-party valuation data would be considered as one of many factors in a fair value determination. The Audit Committee then would recommend the fair values for all privately-held securities based on all relevant factors to the Board of Directors for final approval.

To the extent that market quotations are readily available for our investments and such investments are freely transferable, we value them at the closing market price on the date of valuation. For securities which are of the same class as a class of public securities but are restricted from free trading (such as Rule 144 stock), we establish our valuation by discounting the closing market price to reflect the estimated impact of illiquidity caused by such restriction. We generally hold investments in debt securities to maturity. Accordingly, we determine the fair value of debt securities on the basis of the terms of the debt securities and the financial condition of the issuer. We value certificates of deposit at their face value, plus interest accrued to the date of valuation.

Our Board reviews the valuation policies on a quarterly basis to determine their appropriateness and reserves the right to hire and from time to time utilizes independent valuation firms to review Management's valuation methodology or to conduct an independent valuation.

[Table of Contents](#) 6

On a daily basis, we adjust net asset value for changes in the value of publicly held securities, if any, and for material changes in the value of investments in securities issued by private companies. We report these amounts to Lipper Analytical Services, Inc. Our weekly and daily net asset values appear in various publications, including *Barron's* and *The Wall Street Journal*.

### ***Competition***

We compete with a large number of public and private equity and mezzanine funds and other financing sources, including traditional financial services companies such as finance companies and commercial banks. Many of our competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. Our competitors may have a lower cost of funds and many have access to funding sources that are not available to us. In addition, certain 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 and build their market shares. In addition, many of our competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a BDC.

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. In addition, because of this competition, we may not be able to take advantage of attractive investment opportunities and may not be able to identify and make investments that satisfy our investment objectives or meet our investment goals.

### **Properties**

Our principal executive offices are located at Eight Greenway Plaza, Suite 930, Houston, Texas 77046. We believe that our office facilities are suitable and adequate for our operations as currently conducted and contemplated.

### **Business Development Company Requirements**

*Qualifying Assets.* As a BDC, we may not acquire any asset other than qualifying assets, as defined by the 1940 Act, unless, at the time the acquisition is made the value of our qualifying assets represent at least 70% of the value of our total assets. The principal categories of qualifying assets relevant to our business are the following:

- securities purchased in transactions not involving any public offering from an issuer that is an eligible portfolio company. An eligible portfolio company is any issuer that (a) is organized and has its principal place of business in the United States, (b) is not an investment company other than a small business investment company wholly-owned by the BDC, and (c) either (i) (A) does not have any class of securities with respect to which a broker or dealer may extend margin credit, (B) is controlled by the BDC either singly or as part of a group and an affiliated person of the BDC is a member of the issuer's board of directors, or (C) has total assets of not more than \$4 million and capital and surplus of at least \$2 million, or (ii) does not have any class of securities listed on a national securities exchange, unless the total market capitalization of such issuer does not exceed \$250 million. Qualifying assets may also include follow-on investments in a company that was a particular type of eligible portfolio company at the time of the BDC's initial investment, but subsequently did not meet the definition;
  
- securities received in exchange for or distributed with respect to securities described above, or pursuant to the exercise of options, warrants or rights relating to such securities; and
  
- cash, cash items, government securities, or high quality debt securities maturing in one year or less from the time of investment.

We may not change the nature of our business so as to cease to be, or withdraw our election as, a BDC unless authorized by vote of the holders of the majority of our outstanding voting securities, as defined in the 1940 Act.

To include certain securities above as qualifying assets for the purpose of the 70% test, a BDC must make available to the issuer of those securities significant managerial assistance, such as providing significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company. We offer to provide significant managerial assistance to each of our portfolio companies.

Table of Contents 7

*Temporary Investments.* Pending investment in portfolio companies, we invest our available funds in interest-bearing bank accounts, money market mutual funds, U.S. Treasury securities and/or certificates of deposit with maturities of less than one year (collectively, "Temporary Investments"). Temporary Investments may also include commercial paper (rated or unrated) and other short-term securities. Temporary Investments constituting cash, cash items, securities issued or guaranteed by the U.S. Treasury or U.S. Government agencies and high quality debt securities (commercial paper rated in the two highest rating categories by Moody's Investor Services, Inc. or Standard & Poor's Corporation, or if not rated, issued by a company having an outstanding debt issue so rated, with maturities of less than one year at the time of investment) will qualify for determining whether we have 70% of our total assets invested in qualifying assets or in qualified Temporary Investments for purposes of the BDC provisions of the 1940 Act.

*Leverage.* We are permitted by the 1940 Act, under specified conditions, to issue multiple classes of senior debt and a single class of preferred stock senior to the common stock if our asset coverage, as defined in the 1940 Act, is at least 200% after the issuance of the debt or the senior stockholders' interests. In addition, provisions must be made to prohibit any distribution to common stockholders or the repurchase of any shares unless the asset coverage ratio is at least 200% at the time of the distribution or repurchase.

*Fund Share Sales Below Net Asset Value.* We generally may sell our common stock at a price that is below the prevailing net asset value per share only upon the approval of the policy by stockholders holding a majority of our issued shares, including a majority of shares held by nonaffiliated stockholders. We may, in accordance with certain conditions established by the SEC, sell shares below net asset value in connection with the distribution of rights to all of our stockholders. We may also issue shares at less than net asset value in payment of dividends to existing stockholders.

*No Redemption Rights.* Since we are a closed-end BDC, our stockholders have no right to present their shares to the Fund for redemption. Recognizing the possibility that our shares might trade at a discount, our Board has determined that it would be in the best interest of our stockholders for the Fund to be authorized to attempt to reduce or eliminate a market value discount from net asset value. Accordingly, from time to time we may, but are not required to, repurchase our shares (including by means of tender offers) to attempt to reduce or eliminate any discount or to increase the net asset value of our shares.

*Affiliated Transactions.* Many of the transactions involving the Fund and its affiliates (as well as affiliates of such affiliates) require the prior approval of a majority of the independent directors and a majority of the independent directors having no financial interest in the transactions. However, certain transactions involving closely affiliated persons of the Fund require the prior approval of the SEC.

## **Regulated Investment Company Tax Status**

We operate to qualify as a regulated investment company ("RIC") under Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code"). If we qualify as a RIC and annually distribute to our stockholders in a timely manner at least 90% of our investment company taxable income, we will not be subject to federal income tax on the portion of our taxable income and capital gains we distribute to our stockholders. Taxable income generally differs from net income as defined by accounting principles generally accepted in the United States of America due to temporary and permanent timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation.

Generally, in order to maintain our status as a RIC, we must (i) continue to qualify as a BDC; (ii) distribute to our stockholders in a timely manner at least 90% of our investment company taxable income, as defined by the Code; (iii) derive in each taxable year at least 90% of our gross investment company income from dividends, interest, payments with respect to securities loans, gains from the sale of stock or other securities or other income derived with respect to our business of investing in such stock or securities as defined by the Code; and (iv) meet investment diversification requirements. The diversification requirements generally require us at the end of each quarter of the taxable year to have (a) at least 50% of the value of our assets consist of cash, cash items, government securities, securities of other regulated investment companies and other securities if such other securities of any one issuer do not represent more than 5% of our assets and 10% of the outstanding voting securities of the issuer and (b) no more than 25% of the value of our assets invested in the securities of one issuer (other than U.S. government securities and securities of other regulated investment companies), or of two or more issuers that are controlled by us and are engaged in the same or similar or related trades or businesses.

In addition, with respect to each calendar year, if we distribute or have treated as having distributed (including amounts retained but designated as deemed distributed) in a timely manner 98% of our net capital gain income for each one-year period ending on October 31, and distribute 98.2% of our investment company net ordinary income for such calendar year (as well as any ordinary income not distributed in prior years), we will not be subject to the 4% nondeductible Federal excise tax imposed with respect to certain undistributed income of regulated investment companies.

Table of Contents 8



If we fail to satisfy the 90% distribution requirement or otherwise fail to qualify as a regulated investment company in any taxable year, we will be subject to tax in such year on all of our taxable income, regardless of whether we make any distribution to our stockholders. In addition, in that case, all of our distributions to our stockholders will be characterized as ordinary income (to the extent of our current and accumulated earnings and profits). We have distributed and currently intend to distribute sufficient dividends to eliminate our investment company taxable income; however, none have been necessary in recent years.

### **Custodian**

We act as the custodian of our securities to the extent permitted under the 1940 Act and are subject to the restrictions imposed on self-custodians by the 1940 Act and the rules and regulations thereunder. We have also entered into an agreement with Amegy Bank with respect to the safekeeping of our securities. The principal business office of Amegy Bank is 4400 Post Oak Parkway, Houston, Texas 77019.

### **Transfer and Disbursing Agent**

We employ American Stock Transfer & Trust Company as our transfer agent to record transfers of our shares, maintain proxy records and to process distributions. The principal business office of our transfer agent is 6201 15th Avenue, 2nd Floor, Brooklyn, NY 11219.

### **Certifications**

In July 2013, we submitted to the New York Stock Exchange pursuant to Section 303A.12(a) of its Listed Company Manual, an unqualified certification of our Chief Executive Officer. In addition, certifications by our Chief Executive Officer and Chief Financial Officer have been filed as exhibits to this annual report on Form 10-K as required by the Securities Exchange Act of 1934, as amended, and the Sarbanes-Oxley Act of 2002.

### **Forward-Looking Statements**

*All statements contained herein that are not historical facts including, but not limited to, statements regarding anticipated activity are “forward-looking statements” within the meaning of the federal securities laws, involve a number of risks and uncertainties, and are based on the beliefs and assumptions of Management, based on*

*information currently available to Management. Actual results may differ materially. In some cases, readers can identify forward-looking statements by words such as “may,” “will,” “should,” “expect,” “objective,” “plan,” “intend,” “anticipate,” “believe,” “Management believes,” “estimate,” “predict,” “project,” “potential,” “forecast,” “continue,” “strategy,” or “position” or the negative of such terms or other variations of them or by comparable terminology. In particular, statements, express or implied, concerning future actions, conditions, or events, future operating results, or the ability to generate sales, income, or cash flow are forward-looking statements.*

*Among the factors that could cause actual results to differ materially are the following: (i) changes in the economic conditions in which we operate negatively impacting our financial resources; (ii) certain of our competitors have substantially greater financial resources than the Fund reducing the number of suitable investment opportunities offered or reducing the yield necessary to consummate the investment; (iii) there is uncertainty regarding the value of our privately held securities that require a good faith estimate of fair value for which a change in estimate could affect the Fund’s net asset value; (iv) our investments in securities of privately held companies may be illiquid which could affect our ability to realize a gain; (v) our portfolio companies could default on their loans or provide no returns on its investments which could affect the Fund’s operating results; (vi) we are dependent on external financing to grow our business; (vii) our ability to retain key management personnel; (viii) an economic downturn or recession could impair our portfolio companies and therefore harm our operating results; (ix) our borrowing arrangements impose certain restrictions; (x) changes in interest rates may affect our cost of capital and net operating income; (xi) we cannot incur additional indebtedness unless the Fund maintains an asset coverage of at least 200%, which may affect returns to our stockholders; (xii) we may fail to continue to qualify for our pass-through treatment as a RIC which could have an effect on stockholder returns; (xiii) our common stock price may be volatile; and (xiv) general business and economic conditions and other risk factors described in its reports filed from time to time with the Securities and Exchange Commission. We caution readers not to place undue reliance on any such forward-looking statements, which statements are made pursuant to the Private Securities Litigation Reform Act of 1995 and, as such, speak only as of the date made.*

## **Item 1A. Risk Factors**

An investment in our securities involves certain risks relating to our structure and investment objectives. The risks and uncertainties described below are not the only ones facing Equus. You should carefully consider these risks, together with all of the other information included in the annual report on Form 10-K, including our financial statements and the related notes thereto.

[Table of Contents](#) 9

Additional risks and uncertainties not presently known to us, or not presently deemed material by us, may also impair our operations and performance.

If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. If that happens, the trading price of our common stock could decline and you may lose all or part of your investment.

### **Risks Related to Our Investments**

*Investments in small capitalization companies present certain risks that may not exist to the same degree as investments in larger, more established companies and will cause such investments to be volatile and speculative.*

We have invested and may continue to invest, in private, small and/or new companies that may be in their early stages of development. Investments in these types of companies involve a number of significant risks, including the following:

- They typically have shorter operating histories, narrower product lines and smaller market shares than public companies, which tend to render them more vulnerable to competitors' actions and market conditions as well as general economic downturns;
- They may have no earnings or experienced losses or may have limited financial resources and may be unable to meet their obligations under their securities, which may be accompanied by a deterioration in the value of their equity securities or any collateral or guarantees provided with respect to their debt;
- They are more likely to depend on the management talents and efforts of a small group of persons and, as a result, the death, disability, resignation or termination of one or more of those persons could have a material adverse effect on their business and prospects and, in turn, on our investment;
- They may have difficulty accessing the capital markets to meet future capital needs;
- They generally have less predictable operating results, may from time to time be parties to litigation, may be engaged in rapidly changing businesses with products subject to a substantial risk of obsolescence and may require substantial additional capital to support their operations, finance expansion or maintain their competitive position; and
- Generally little public information exists regarding these companies, and investors in these companies generally must rely on the ability of the equity sponsor to obtain adequate information for the purposes of evaluating potential returns and making a fully informed investment decision.

*There is uncertainty regarding the value of our privately held securities.*

Our net asset value is based on the value we assign to our portfolio investments. Except for our holding of shares and notes of OPG, we determine the value of our investments in securities for which market quotations are not available as of the end of each calendar quarter, unless there is a significant event requiring a change in valuation in the interim. Because of the inherent uncertainty of the valuation of portfolio securities that do not have readily ascertainable market values, our fair value determination may differ materially from the value that would have been used had a ready market existed for the securities. We determine the fair value of investments for which no market quotations are available based upon a methodology that we believe reaches a reasonable estimation of fair value. However, we do not necessarily apply multiple valuation metrics in reaching this determination and, in some cases, we do not obtain any third party valuations before reaching this determination. Our determinations of the fair value of our investments have a material impact on our net earnings through the recording of unrealized appreciation or depreciation of investments as well as our assessment of interest income recognition. Our net asset value could be affected materially if our determinations of the fair value of our investments differ significantly from values based on a ready market for these securities.

***We depend upon Management for our future investment success.***

We depend upon the diligence and skill of Management to select, structure, close and monitor our investments. Management is responsible for identifying, structuring, evaluating, monitoring, and disposing of our investments, and the services they collectively provide significantly impact our results of operations. Our future success will depend to a significant extent on the continued service and coordination of Management. Our success will depend on our ability to retain our existing Management and to recruit additional other highly qualified individuals. If we are unable to integrate new investment and management personnel, we may be unable to achieve our desired investment results.

Table of Contents 10

***Management may not be able to implement our investment objective successfully.***

Our current portfolio represents a shift from a regional focus and a record of investing in basic manufacturing and service companies to an investment strategy focused in a variety of sectors such as energy and real estate. Given recent economic events and changes in our Board and Management, we have revised our strategy to be more opportunistic, emphasizing investments which generate regular cash income and distributions, with less regard for a particular industry sector. In order to implement our investment strategy, Management must analyze, conduct due diligence, invest in, monitor and sell investment interests in industries in which many of them have not previously been involved. Also, we expect that our investment strategy will continue to require Management to investigate and monitor investments that are much more broadly dispersed geographically. In addition, Management is required to provide valuations for investments in a broader range of securities, including debt securities, which may require expertise beyond that previously required. We cannot assure investors that the overall risk of their investment in the Fund will be reduced as a result of our investment strategy. If we cannot achieve our investment objective successfully, the value of your investment in our common stock could decline substantially.

***We may not realize gains from our equity investments.***

We frequently invest in the equity securities of our portfolio companies. Also, when we make a loan, we sometimes receive warrants to acquire stock issued by the borrower. Ultimately, our goal is to sell these equity interests and realize gains. These equity interests may not appreciate and, in fact, may depreciate in value. Several of our portfolio companies have experienced net losses in recent years or have negative net worth as of their most recent available balance sheet date. At December 31, 2013, several of our portfolio investments had estimated fair values, based upon our valuation methodologies, significantly below the initial cost of such investments. At December 31, 2013, the cost basis of our portfolio investments was \$17.5 million and our estimated fair value was \$13.5 million. Also, the market value of our equity investments may fall below our estimate of the fair value of such investments before we sell them. Given these factors, there is a risk that we will not realize gains upon the sale of those or other equity interests that we hold.

***We may not be able to make additional investments in our portfolio companies from time to time, which may dilute our interests in such companies.***

After our initial investment in a portfolio company, we may be called upon from time to time to provide additional funds to such company, or may have the opportunity to increase our investment in that company through the exercise of a warrant to purchase common stock or through follow-on investments in the debt or equity of that company. We cannot assure you that we will make, or have sufficient funds to make, any such follow-on investments. Any decision by us not to make a follow-on investment or any inability on our part to make such an investment may have a negative impact on a portfolio company in need of investment and may result in a missed opportunity for us to increase our participation in a successful operation. A decision not to make a follow-on investment may also dilute our equity

interest in, or reduce the expected yield on, our investment.

***We have invested in a limited number of portfolio companies.***

The Fund is classified as a “non-diversified” investment company under the 1940 Act, which means we are not limited in the proportion of our assets that may be invested in the securities of a single issuer. As a matter of policy, we generally have not initially invested more than 25% of the value of our net assets in a single portfolio company. In view of the net asset value of the Fund as of December 31, 2013, however, we would expect that any new investments may exceed this percentage for the immediate future. Moreover, follow-on investments, disproportionate increases or decreases in the fair value of certain portfolio companies or sales of investments may result in more than 25% of our net assets being invested in a single portfolio company at a particular time.

A consequence of a limited number of investments is that changes in business or industry trends or in the financial condition, results of operations or the market’s assessment of any single portfolio company will affect our net asset value and the market price of our common stock to a greater extent than would be the case if we were a “diversified” company holding a greater number of investments.

***The lack of liquidity of our privately held securities may adversely affect our business***

Our portfolio investments consist principally of securities that are subject to restrictions on sale because they are not listed or publicly traded securities. If any of these securities were to become publicly traded, our ability to sell them may still be restricted because we acquired them from the issuer in “private placement” transactions or because we may be deemed to be an affiliate of the issuer. We will not be able to sell these securities publicly without the expense and time required to register the

[Table of Contents](#) 11

securities under the Securities Act and applicable state securities laws, unless an exemption from such registration requirements is available. In addition, contractual or practical limitations may restrict our ability to liquidate our securities in portfolio companies because those securities are privately held and we may own a relatively large percentage of the issuer's outstanding securities. Sales also may be limited by market conditions, which may be unfavorable for sales of securities of particular issuers or generally. The illiquidity of our investments may preclude or delay any disposition of such securities, which may make it difficult for us to obtain cash equal to the value at which we record our investments if the need arises.

***We have limited public information regarding the companies in which we invest.***

Except for our holdings in respect of OPG, our portfolio consists entirely of securities issued by privately-held companies. There is generally little or no publicly available information about such companies, and we must rely on the diligence of Management to obtain the information necessary for our decision to invest in them and in order to monitor them effectively. We cannot assure you that such diligence efforts will uncover all material information about such privately held businesses necessary to make fully informed investment decisions.

***Our portfolio companies may be highly leveraged.***

Investments in leveraged buyouts and in highly leveraged companies involve a high degree of business and financial risk and can result in substantial losses. 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. The use of leverage by portfolio companies also magnifies the increase or decrease in the value of our investment as compared to the overall change in the enterprise value of a portfolio company.

Many of our portfolio companies have incurred substantial debt in relation to their equity capital. Such indebtedness generally has a term that will require that the balance of the loan be refinanced when it matures. If a portfolio company cannot generate adequate cash flow to meet the principal and interest payments on its debt or is not successful in refinancing the debt upon its maturity, our investment could be reduced or eliminated through foreclosure on the portfolio company's assets or by the portfolio company's reorganization or bankruptcy.

A substantial portion of the debt incurred by portfolio companies may bear interest at rates that fluctuate in accordance with a stated interest rate index or the prime lending rate. The cash flow of a portfolio company may not be sufficient to meet increases in interest payments on its debt. Accordingly, the profitability of our portfolio companies, as well as the value of our investments in such companies, will depend significantly upon prevailing interest rates. In recent months the level of interest rates have increased, which will have an adverse effect on the ability of our portfolio companies to service their floating rate debt and on their profits.

Leverage may impair the ability of our portfolio companies to finance their future operations and capital needs. As a result, the ability of our portfolio companies to respond to changing business and economic conditions and to business opportunities may be limited.

***The use of leverage may adversely affect our performance.***

We may utilize leverage for the Fund or its subsidiaries by borrowing or issuing preferred stock or short-term debt securities. Borrowings and other capital generated from leverage will result in lenders and other creditors with fixed dollar claims on our assets that are superior to the claims of our common shareholders. If the value of our assets increases, then leveraging would cause the net asset value attributable to our common stock 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 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. Leverage is generally considered a speculative investment technique.

***Our business depends on external financing.***

Our business requires a substantial amount of cash to operate. We may borrow funds to pay contingencies or expenses or to make investments, to maintain our pass-through tax status as a RIC under Subchapter M of the Code. We are permitted under the 1940 Act to borrow if, immediately after the borrowing, we have an asset coverage ratio of at least 200%. That is, we may borrow an amount equal to as much as 50% of the fair value of our total assets (including investments made with borrowed funds). The amount and nature of any such borrowings depend upon a number of factors over which we have no control, including general economic conditions, conditions in the financial markets and the impact of the financing on the tax treatment of our stockholders. The use of leverage, even on a short-term basis, could have the effect of magnifying increases or decreases in our net asset value.

[Table of Contents](#) 12



While the “spread” between the current yields on our investments and the cost of any loan would augment the return to our stockholders, if the spread narrows (because of an increase in the cost of debt or insufficient income on our investments), distributions to our stockholders could be adversely affected. This may render us unable to meet our obligations to our lenders, which might then require us to liquidate some or all of our investments. There can be no assurance that we would realize full value for our investments or recoup all of our capital if we needed to liquidate our portfolio investments.

Many financial institutions are unwilling to lend against a portfolio of illiquid, private securities. The make-up of our portfolio has made it more difficult for us to borrow at the level and on the terms that we desire. Our borrowings have historically consisted of a revolving line of credit, the proceeds of which we may use to provide liquidity for expenses and contingencies and to make new or follow-on investments, and a line of credit, promissory note or margin account used quarterly to enable us to achieve adequate diversification to maintain our pass-through tax status as a RIC. Although we believe the Fund’s liquidity is sufficient for our operating expenses for the next twelve months, we could be wrong. If we are wrong, we would have to obtain capital from other sources to pay Fund expenses, which could involve selling one or more of our portfolio holdings at an inopportune time and at a price that may be less than would be received if such holding were sold in a more competitive and orderly manner.

The costs of borrowing money may exceed the income from the portfolio securities we purchase with the borrowed money. We will suffer a decline in net asset value if the investment performance of the additional securities purchased with borrowed money fails to cover their cost to the Fund (including any interest paid on the money borrowed). A decline in net asset value could affect our ability to make distributions on our common stock. Our failure to distribute a sufficient portion of our net investment income and net realized capital gains could result in a loss of pass-through tax status or subject us to a 4% excise tax. If the asset coverage for debt securities issued by the Fund declines to less than 200% (as a result of market fluctuations or otherwise), we may be required to sell a portion of our investments when it is disadvantageous to do so. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

***Our net assets have declined substantially since 2009 and we have had net investment losses in four out of the past five years.***

Our net assets have declined from \$50.9 million as of December 31, 2009 to \$33.2 million as of December 31, 2013. Moreover, we have had net investment losses in four out of the past five years, with a net investment loss of \$3.1 million for the year ended December 31, 2013. We cannot assure you that we will be able to increase our net assets or generate net investment income. If we fail to increase the Fund’s net assets or generate net investment income, such failure will likely have a material adverse effect upon the Fund, its results of operation, and its financial condition. You could lose all or a substantial amount of your investment in the Fund as a result.

***We may not be able to recommence our managed distribution policy and you might not receive dividends on your shares.***

On March 24, 2009, we announced a suspension of our managed distribution policy and payment of quarterly dividends for an indefinite period, following the distribution of the first quarter 2009 dividend paid on March 30, 2009. As originally implemented, the policy provided for quarterly dividends at an annualized rate equal to 10% of the Fund's market value per share as at the end of the preceding calendar year. We subsequently undertook certain changes in our Board and Management. These changes have been pursued, in part, with the objective of increasing the number of attractive investment opportunities to us and revising our investment strategy to include more recurrent cash income producing investments, all of which could ultimately result in the resumption of our managed distribution policy at some time in the future. The implementation of these revisions to our investment strategy and the recurrent generation of cash income from our investments, however, cannot be guaranteed. If we were unable to resume our managed distribution policy and were further unable to profitably sell or otherwise dispose of our portfolio company investments, you might not receive dividends on your shares.

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

We compete with a large number of private equity funds and mezzanine funds, investment banks and other equity and non-equity based investment funds, investment entities, foreign investors and individuals and other sources of financing, including traditional financial services companies such as commercial banks. In recent years, the number of investment vehicles seeking small capitalization investments has increased dramatically. Many of our competitors are substantially larger and have considerably greater financial resources than we do, and some may be subject to different and frequently less stringent regulation. As our portfolio size increases, we expect that some of our investments will be larger. We believe that we will face increased competition to participate in these larger transactions. These competitors may have a lower cost of funds and many have 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 and build their

[Table of Contents](#) 13

market shares. As a result of this competition, we may not be able to take advantage of attractive investment opportunities from time to time. 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.

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

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

Although most of our investments are denominated in U.S. dollars, any investments that are denominated in a foreign currency are subject to the risk that the value of a particular currency may change in relation to one or more other currencies. Among the factors that may affect currency values are trade balances, the level of short-term interest rates, differences in relative values of similar assets in different currencies, long-term opportunities for investment and capital appreciation and political developments. We may employ hedging techniques to minimize these risks, but we can offer no assurance that we will, in fact, hedge currency risk or that, if we do, such strategies will be effective.

***An economic downturn could affect our operating results.***

An economic downturn may adversely affect companies having an enterprise value varying from \$5 to \$75 million, which are our primary market for investments. During periods of volatile economic conditions such as presently exists generally in the United States, these companies often experience decreased revenues, financial losses, difficulty in obtaining access to financing and increased funding costs. During such periods, these companies also may have difficulty expanding their businesses and operations and may be unable to meet their debt service obligations or other expenses as they become due. Any of the foregoing developments could cause the value of our investments in these companies to decline. In addition, during periods of adverse economic conditions, we may have difficulty accessing financial markets, which could make it more difficult or impossible for us to obtain funding for additional investments. Any of these events could have a material adverse effect on our business, financial condition and results of operations.

***We may experience fluctuations in our quarterly results.***

We may experience fluctuations in our quarterly operating results due to a number of factors, including variations in, and the timing of, the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets, the ability to find and close suitable investments and general economic conditions. The volatility of our results is exacerbated by our relatively small number of investments. As a result of these factors, you should not rely on our results for any period as being indicative of performance in future periods.

***The due diligence process that we undertake in connection with our investments may not reveal all facts that may be relevant in connection with an investment.***

Before making our investments, we conduct due diligence that we deem reasonable and appropriate based on the facts and circumstances applicable to each investment. The objective of the due diligence process is to identify attractive investment opportunities based on the facts and circumstances surrounding an investment and to prepare a framework that may be used from the date of an acquisition to drive operational achievement and value creation. When conducting due diligence, we evaluate a number of important business, financial, tax, accounting, environmental and legal issues in determining whether or not to proceed with an investment. Our due diligence review with respect to a potential portfolio company typically includes, but is not limited to, a review of historical and prospective financial information including audits and budgets, on-site visits and interviews with management, employees, customers and vendors, a review of business plans and an analysis of the consistency of operations with those plans, and other research relating to the company, management, industry, markets, products and services, and competitors. Outside consultants, legal advisers, accountants and investment banks are expected to be involved in the due diligence process in varying degrees depending on the type of investment. Nevertheless, when conducting due diligence and making an assessment regarding an investment, we are required to rely on resources available to us, including information provided by the portfolio company and, in some circumstances, third party investigations. The due diligence process may at times be subjective, including with respect to newly organized companies for which only limited information is available. Accordingly, we cannot assure you that the due diligence investigation that we will carry out with respect to any investment opportunity will reveal or highlight all relevant facts that may be necessary or helpful in evaluating such investment opportunity. We also cannot assure you that such an investigation will result in an investment being successful.

Table of Contents 14

## **Risks Related to Our Business and Structure**

### ***Our ability to invest in private companies may be limited in certain circumstances.***

If we are to maintain our status as a BDC, we must 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. A principal category of qualifying assets relevant to our business is securities purchased in transactions not involving any public offer from issuers that are eligible portfolio companies under the 1940 Act. Investments in companies organized outside of the United States or having a principal place of business outside of the United States are not eligible portfolio companies.

### ***Any failure on our part to maintain the Fund’s status as a BDC could reduce our operating flexibility.***

If we do not maintain the Fund’s status as a BDC, we might be regulated as a closed-end investment company under the 1940 Act, which would subject us to substantially more regulatory restrictions under the 1940 Act. This could impose tighter limitations on Equus in terms of the use of leverage and transactions with affiliated entities. Such developments could correspondingly decrease our operating flexibility.

### ***We may not continue to qualify as a RIC under the Code.***

To remain entitled to the tax benefits accorded to RICs under the Code, we must meet certain income source, asset diversification and annual distribution requirements. To qualify as a RIC, we must derive each taxable year at least 90% of our gross income from dividends, interest, payments with respect to certain securities loans, gains from the sale of stock or other securities or foreign currencies, or other income derived with respect to our business of investing in such stock or securities or currencies and net income from interests in certain “qualified” publicly traded partnerships. The annual distribution requirement for a RIC is satisfied if we distribute at least 90% of our ordinary net taxable income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to our stockholders on an annual basis. As discussed above in “Our business is dependent on external financing,” we historically have borrowed funds necessary to make qualifying investments to satisfy the Subchapter M diversification requirements. If we fail to satisfy such diversification requirements and cease to qualify for conduit tax treatment, we will be subject to income tax on our income and gains and will not be permitted to deduct distributions paid to stockholders. In addition, our distributions will be taxable as dividends to the extent paid from earnings and profits. We may also cease to qualify as a RIC, or be subject to income tax and/or a 4% excise tax, if we fail to distribute a sufficient portion of our net investment income and net realized capital gains. The loss of our RIC qualification would have a material adverse effect on the total return, if any, obtainable from an investment in our common stock.

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

In order to qualify as a RIC, to avoid payment of excise taxes and to minimize or avoid payment of income taxes, we intend to distribute to our stockholders substantially all of our net ordinary income and realized net capital gains except for certain net long-term capital gains (which we may retain, pay applicable income taxes with respect thereto, and elect to treat as deemed distributions to our stockholders). As a BDC, we are generally required to meet a coverage ratio of total assets to total senior securities, which includes all of our borrowings and any preferred stock we may issue in the future, of at least 200%. This requirement limits the amount that we may borrow. Because we will continue to need capital to grow our investment portfolio, this limitation may prevent us from incurring debt and require us to issue additional equity at a time when it may be disadvantageous to do so. We cannot assure you that debt and equity financing will be available to us on favorable terms, or at all, and debt financings may be restricted by the terms of any of our outstanding borrowings. In addition, as a BDC, except for limited situations such as this offering, we are generally not permitted to issue equity securities priced below net asset value without stockholder approval. If additional funds are not available to us, we could be forced to curtail or cease new lending and investment activities, and our net asset value could decline.

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

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

[Table of Contents](#) 15

## **Risks Related to Our Operation as a BDC**

### ***Our management team has limited experience managing a BDC.***

The 1940 Act imposes numerous constraints on the operations of BDCs. For example, BDCs are required to invest at least 70% of their total assets in specified types of securities, primarily in private companies or thinly traded U.S. public companies, cash, cash equivalents, U.S. government securities and other high quality debt investments that mature in one year or less. See “Regulation as a Business Development Company.” Our management team’s limited experience in managing a portfolio of assets under such constraints may hinder our ability to take advantage of attractive investment opportunities and, as a result, achieve our investment objective. Furthermore, any failure to comply with the requirements imposed on BDCs by the 1940 Act could cause the SEC to bring an enforcement action against us and/or expose us to claims of private litigants. If we do not remain a BDC, we might be regulated as a closed-end investment management company under the 1940 Act, which would further decrease our operating flexibility and may prevent us from operating our business as described in this prospectus. See “Regulation as a Business Development Company.”

Furthermore, our management team’s limited experience in managing a BDC that qualifies as a RIC, which is subject to operating limitations under the Code, may hinder our ability to invest in certain assets that might otherwise be part of our investment strategy, thus reducing the return on your investment. For a description of the requirements to maintain RIC pass-through tax treatment, please see “Certain U.S. Federal Income Tax Considerations.”

### ***Our ability to enter into transactions with our affiliates is restricted.***

We are prohibited under the 1940 Act from participating in certain transactions with certain of our affiliates without the prior approval of our independent directors and, in some cases, the SEC. 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 generally are prohibited from buying or selling any security from or to such affiliate, absent the prior approval of our independent directors. The 1940 Act also prohibits certain “joint” transactions with certain of our affiliates, which could include investments in the same portfolio company (whether at the same or different times), without prior approval of our independent directors and, in some cases, the SEC. If a person acquires more than 25% of our voting securities, we are prohibited from buying or selling any security from or to such person or certain of that person’s affiliates, or entering into prohibited joint transactions with such persons, absent the prior approval of the SEC. Similar restrictions limit our ability to transact business with our officers or directors or their affiliates.

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

Our business requires a substantial amount of additional capital. We may acquire additional capital from the issuance of senior securities or other indebtedness, the issuance of additional shares of our common stock or from securitization transactions. However, we may not be able to raise additional capital in the future on favorable terms or at all. We may issue debt securities or preferred securities, which we refer to collectively as “senior securities,” and we may borrow money from banks or other financial institutions, up to the maximum amount permitted by the 1940 Act. The 1940 Act permits us to issue senior securities or incur indebtedness only in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after such issuance or incurrence. Our ability to pay dividends or issue additional senior securities would be restricted if our asset coverage ratio were not at least 200%. If the value of our assets declines, we may be unable to satisfy this test. If that happens, we may be required to liquidate a portion of our investments and repay a portion of our indebtedness at a time when such sales may be disadvantageous.

· *Senior Securities.* As a result of issuing senior securities, we would also be exposed to typical risks associated with leverage, including an increased risk of loss. If we issue preferred securities they would rank “senior” to common stock in our capital structure. Preferred stockholders would have separate voting rights and may have rights, preferences or privileges more favorable than that of our common stockholders. Furthermore, the issuance of preferred securities could have the effect of delaying, deferring or preventing a transaction or a change of control that might involve a premium price for our common stockholders or otherwise be in your best interest.

· *Additional Common Stock.* Our Board of Directors may decide to issue common stock to finance our operations rather than issuing debt or other senior securities. As a BDC, we are generally not able to issue our common stock at a price below net asset value without first obtaining required approvals from our stockholders and our independent directors. In any such case, the price at which our securities are to be issued and sold may not be less than a price, that in the determination of our Board of Directors, closely approximates the market value of such securities (less any commission or discount). We may also make rights offerings to our stockholders at prices per share less than the net asset value per share,

[Table of Contents](#) 16



subject to the 1940 Act. If we raise additional funds by issuing more common stock or senior securities convertible into, or exchangeable for, our common stock, the percentage ownership of our stockholders at that time would decrease, and you may experience dilution.

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

Changes in the laws or regulations or the interpretations of the laws and regulations that govern BDCs, 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, results of operations or financial condition.

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

None.

#### **Item 2. Properties**

We do not own any real estate or other physical properties. Our principal executive offices are located at Eight Greenway Plaza, Suite 930, Houston, Texas 77046. We believe that these leased office facilities are suitable and adequate for the business as it is contemplated to be conducted.

#### **Item 3. Legal Proceedings**

**Champion Window Arbitration Claim**—In January 2006, we sold our 31.5% ownership interest in Champion Window, Inc. (“Champion”), a portfolio company of the Fund, to Atrium Companies Inc. (“Atrium”) pursuant to a Stock Purchase Agreement (“SPA”) dated December 22, 2005. The SPA contained certain limited rights of indemnification for Atrium in connection with its purchase of such ownership interest.

More than five years after the closing of the sale of our Champion interest, Atrium filed suit in the District Court of Harris County, Texas against two former officers of Atrium’s subsidiary, Champion, alleging, amongst other matters, that the former officers breached their fiduciary duties to Champion by hiring undocumented workers. This action was commenced primarily as a result of an investigation by the U.S. Immigration and Customs Enforcement agency (“ICE”) into Atrium’s hiring practices. On March 12, 2012, to protect its interests, we filed a Petition in Intervention in the State Court Action seeking a declaration from the Court that Equus did not owe any obligation to indemnify Atrium or Champion for any penalties, costs or fees associated with the investigation by ICE.

On March 16, 2012, Atrium and Champion filed a claim with the American Arbitration Association in Dallas, Texas, against Equus and a number of the other sellers under the SPA. In September 2013, all of Atrium and Champion’s claims including claims against its former officers described above, were also consolidated in the Arbitration Action.

In the Arbitration Action, Atrium and Champion seek damages arising from Equus’ and the other sellers’ indemnity obligations set forth in the SPA. Atrium claims it is entitled to indemnification under the SPA for costs it has incurred in responding to an ongoing investigation by ICE. Atrium entered into a Non-Prosecution Agreement with ICE. It appears that one condition of the Non-Prosecution Agreement required Atrium to pay ICE \$2,000,000. Atrium and Champion asserted two counts of breach of contract against Equus, both arising out of the alleged obligation to indemnify Atrium and Champion pursuant to certain provisions of the SPA. Atrium and Champion also asserted claims for fraudulent inducement against two former officers and directors of Champion. Through the arbitration, Atrium and Champion seek to recover an unspecified amount in the form of alleged “losses, damages, assessments, penalties, interest, reasonable attorneys’ and accountants’ fees, settlement costs, and other costs and expenses arising directly or indirectly out of or incident to,” the alleged breach of the indemnity provisions in the SPA. As a consequence of their fraudulent inducement claim against the two former officers and directors, Atrium and Champion alternatively seek equitable rescission of the SPA and exemplary damages from the two former officers and directors.

[Table of Contents](#) 17

Atrium and Champion have yet to specify the amount of damages they seek from Equus or the other sellers pursuant to the alleged indemnity obligations under the SPA. Atrium and Champion have disclosed the payment of \$2 million to ICE to resolve the investigation and avoid prosecution for their hiring practices.

We filed an answer to Atrium and Champion's claims on December 6, 2013. In our answer, we denied that we owed any indemnity obligations to Atrium or Champion under the SPA and further denied that the Fund is in any way liable to Atrium or Champion. To the extent Atrium and Champion are able to establish a right to an indemnity, we will further contest the amount of the claimed indemnity, inasmuch as we believe (among other defenses) that the indemnity obligation can only exist, if at all, with respect to damages arising as a direct and proximate result of employees who were hired prior to the closing date of the 2006 sale of Champion and remained in continuous employment after the 2006 sale, and not to any employee who may have been hired in the six years after the sale.

While we believe the Atrium claim is without merit and we intend to continue to vigorously dispute the claim, there is a reasonable possibility of an adverse ruling which may require the Fund to indemnify Atrium. If Equus is required to indemnify Atrium and Champion, we estimate that such indemnity obligation could vary from \$2.0 million to \$3.0 million. Pursuant to the SPA, the indemnification obligation of Equus and the other sellers is several and not joint, and any such indemnity, however uncertain, would likely be reduced proportionately to our percentage ownership in Champion at the time of sale, which was 31.5% of Champion's shares outstanding.

**Indemnification Settlement**—Effective June 13, 2013, the Fund entered into a settlement agreement with Sam Douglass, a former director and executive officer of the Fund, in respect of a claim for indemnification pursuant to the General Corporation Law of Delaware and an indemnification agreement entered into by the Fund with Mr. Douglass on May 3, 2001. The settlement agreement provides for the reimbursement to Mr. Douglass of actual expenses incurred, excluding any fines or penalties, in connection with an enforcement action initiated by the Securities and Exchange Commission against Mr. Douglass in 2009. The settlement payment of \$125,000 was made on June 24, 2013.

**Lawsuit Settlement**—On August 12, 2012, Paula Douglass filed a lawsuit against the Fund and members of the Board of Directors in the District Court of Harris County, Texas. Ms. Douglass' complaint alleged various causes of action, including minority shareholder oppression, dilution, and breach of fiduciary duty, and sought unspecified damages and attorney's fees. Effective June 13, 2013, the Fund entered into a settlement agreement with Ms. Douglass, Sam Douglass, as well as certain trusts controlled by them. Pursuant to the settlement agreement and in view of the estimated costs of protracted litigation and the associated disruption to the operations of the Fund, the Board of Directors approved a payment of \$402,254, in complete settlement of the lawsuit, as being in the best interests of the Fund and its shareholders. The settlement payment was made on July 30, 2013. Ms. Douglass filed a motion to dismiss the lawsuit with prejudice on August 8, 2013.

**Lawsuit Settlement**—On June 9, 2011, RNR Production, Land and Cattle Company, Inc. (“RNR”) filed a lawsuit against the Fund and members of the Board of directors in the district Court of Harris County, Texas, seeking various monetary and equitable remedies, including a motion for a temporary restraining order against the Fund from holding its annual meeting of shareholders. The Fund prevailed against the motion but agreed to a nuisance settlement with RNR in exchange for a one-time payment of \$200,000 which was paid on September 2, 2011,

**Lawsuit Settlement**—On March 10, 2010, American General Life Insurance Company (“American General”) filed a complaint against the Fund in the District Court of Harris County, Texas in connection with an office lease entered into by our former administrator with American General. The complaint by American General sought to hold the Fund liable for unpaid rent, improvements, and attorneys’ fees totaling approximately \$450,000. We agreed to a settlement with American General in exchange for a one-time payment of \$120,000, which was paid on June 7, 2011.

From time to time, the Fund is also a party to certain proceedings incidental to the normal course of our business including the enforcement of our rights under contracts with our portfolio companies. While the outcome of these legal proceedings cannot at this time be predicted with certainty, we do not expect that these proceedings will have a material effect upon the Fund’s financial condition or results of operations.

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

Not applicable.

[Table of Contents](#) 18

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

Our common stock is listed on the New York Stock Exchange under the symbol "EQS". We had approximately 2,800 stockholders as of December 31, 2013, 766 of whom were registered holders. Registered holders do not include those stockholders whose stock has been issued in street name. As of December 31, 2013, our net asset value was \$3.14 per share of our common stock.

The following table reflects the high and low closing sales prices per share of our common stock on the New York Stock Exchange, net asset value, or NAV and quarterly dividends declared per share for the two years ended December 31, 2013, by quarter:

	2013				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
High	\$2.40	\$2.24	\$2.02	\$2.07	\$2.27	\$2.44	\$2.46	\$2.49
Low	\$2.10	\$1.86	\$1.82	\$1.67	\$1.96	\$1.96	\$2.11	\$2.05
NAV	\$2.97	\$2.86	\$2.78	\$3.14	\$3.56	\$3.16	\$3.00	\$3.11
Dividends Declared	\$—	\$—	\$—	\$—	\$—	\$—	\$—	\$—

As a RIC, we are required to distribute to our stockholders, in a timely manner, at least 90% of our taxable net investment income each year. If we do not distribute, in a timely manner, 98.2% of our taxable net capital gains and 90% of our taxable net investment income each year (as well as any portion of the respective 2% balances not distributed in the previous year), we will be subject to a 4% non-deductible federal excise tax on certain undistributed income of regulated investment companies. Under the 1940 Act, we are not permitted to pay dividends to stockholders unless we meet certain asset coverage requirements. If taxable net investment income is retained, we will be subject to federal income and excise taxes. We reserve the right to retain net long-term capital gains in excess of net short-term capital losses for reinvestment or to pay contingencies and expenses. Such retained amounts, if any, will be taxable to the Fund as long-term capital gains and our stockholders will be able to claim their proportionate share of the federal income taxes paid by the Fund on such gains as a credit against their own federal income tax liabilities. Stockholders will also be entitled to increase the adjusted tax basis of their fund shares by the difference between their undistributed capital gains and their tax credit.

We invest in companies that are believed to have a high potential for capital appreciation, and we intend to realize the majority of our profits upon the sale of our investments in portfolio companies. Consequently, most of the companies

in which we invest do not have established policies of paying annual dividends. However, a portion of the investments in portfolio securities held by the Fund consists of interest-bearing subordinated debt securities or dividend-paying preferred stock.

Table of Contents 19

**Item 6. Selected Financial Data**

The following is a summary of selected financial data and per share data of the Fund for the five years ended December 31, 2013 (in thousands, except per share data):

	2013	2012	2011	2010	2009
Total investment income	\$7	\$516	\$539	\$2,904	\$3,771
Net investment (loss) income	\$(3,130 )	\$(2,653 )	\$(3,500 )	\$(770 )	\$195
Net realized gain (loss) of portfolio securities	\$(9,795 )	\$(2,797 )	\$(10,930 )	\$(7 )	\$(15,555)
Net change in unrealized appreciation (depreciation) of portfolio securities	\$13,267	\$177	\$9,901	\$(12,073)	\$(12,172)
Net increase (decrease) in net assets resulting from operations	\$342	\$(5,273 )	\$(4,529 )	\$(12,850)	\$(27,532)
Distribution from net investment income	\$—	\$—	\$—	\$—	\$(195 )
Return of capital distribution	\$—	\$—	\$—	\$—	\$(726 )
Distribution of realized gains	\$—	\$—	\$—	\$—	\$—
Total assets	\$48,349	\$33,283	\$44,301	\$53,454	\$81,007
Total net assets	\$33,217	\$32,875	\$38,148	\$38,051	\$50,901
Net cash (used in) provided by operating activities	\$(19,622)	\$12,874	\$18,596	\$16,599	\$12,361
Shares outstanding at end of year	10,562	10,562	10,562	8,862	8,862
Weighted average shares outstanding, basic	10,562	10,562	10,049	8,862	8,790

**Per Share Data:**

	2013	2012	2011	2010	2009
Net investment (loss) income	\$(0.30 )	\$(0.25 )	\$(0.35 )	\$(0.09 )	\$0.02
Net realized loss of portfolio securities	\$(0.93 )	\$(0.27 )	\$(1.09 )	\$—	\$(1.77 )
Net change in unrealized appreciation (depreciation) of portfolio securities	\$1.26	\$0.02	\$0.99	\$(1.36 )	\$(1.38 )
Net increase (decrease) in net amounts resulting from operations per share, basic and diluted	\$0.03	\$(0.50 )	\$(0.45 )	\$(1.45 )	\$(3.13 )
Return of capital distribution	\$—	\$—	\$—	\$—	\$(0.09 )
Net asset value (including unrealized appreciation (depreciation))	\$3.14	\$3.11	\$3.61	\$4.29	\$5.74

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

Equus is a BDC that provides financing solutions for privately held middle market and small capitalization companies. We began operations in 1983 and have been a publicly traded closed-end fund since 1991. Our investment objective is to seek the highest total return, consisting of capital appreciation and current income.

As a BDC, we are required to comply with certain regulatory requirements. For instance, we generally have to invest at least 70% of the Fund's total assets in "qualifying assets," including securities of private U.S. companies, certain public U.S. companies with a total market capitalization not in excess of \$250 million, cash, cash equivalents, U.S. government securities and short-term high-quality debt investments. Equus is a RIC under Subchapter M of the Code. To qualify as a RIC, we must meet certain source of income and asset diversification requirements. If we comply with the provisions of Subchapter M, the Fund generally does not have to pay corporate-level income taxes on any income that distributed to our stockholders.

*Investment Income.* We generate investment income from interest payable on the debt securities that the Fund holds, dividends received on equity interests in our portfolio companies and capital gains, if any, realized upon sales of equity and, to a lesser extent, debt securities in the investment portfolio. Our equity investments may include shares of common and

[Table of Contents](#) 20



preferred stock, membership interests in limited liability companies and warrants to purchase additional equity interests. These equity securities may or may not pay dividends, and the exercise prices of warrants that we acquire in connection with debt investments, if any, vary by investment. Our debt investments in portfolio companies may be in the form of senior or subordinated loans and may be unsecured or have a first or second lien on some or all of the assets of the borrower. Our loans typically have a term of three to seven years and bear interest at fixed or floating rates. Interest on these debt securities is generally payable either quarterly or semiannually. Some promissory notes held by the Fund provide that a portfolio company may elect to pay interest in cash or provide that discount interest may accrete in the form of original issue discount or payment-in-kind (PIK) over the life of the notes by adding unpaid interest amounts to the principal balance. Amortization of principal on our debt investments is generally deferred for several years from the date of initial investment. The principal amount of these debt securities and any accrued but unpaid interest generally will become due at maturity. We also earn interest income at market rates on investments in short-term marketable securities. From time to time, we generate income from time to time in the form of commitment, origination and structuring fees in connection with our investments. We recognize all such fees when earned.

*Expenses.* Currently, our primary operating expenses include director fees and expenses, professional fees, compensation expense, and general and administrative fees. During 2013, we incurred non-recurring expenses, including settlement expenses of \$0.5 million, and legal expenses of \$0.2 million related to the various legal proceedings described in Item 3 above. During 2012, we did not incur any non-recurring expenses. During 2011, we incurred non-recurring expenses, including settlement expenses, related to various legal proceedings of \$0.3 million, as well as offering costs of \$0.4 million.

*Operating Activities.* We use cash to make new investments and follow-on investments in our existing portfolio companies. We record these investments at cost on the applicable trade date. Realized gains or losses are computed using the specific identification method. On an ongoing basis, we carry our investments in our financial statements at fair value, as determined by our board of directors. See “—Critical Accounting Policies – Valuation of Investments” below. As of December 31, 2013, we had invested 40.7% of our net assets in securities of portfolio companies that constituted qualifying investments under the 1940 Act. At that time, we had invested 1.3% by value in shares of common stock, 24.7% in membership interests in limited liability companies, and 14.7% in various debt instruments.

Under certain circumstances, we make follow-on investments in some of our portfolio companies. As of December 31, 2013, we had no outstanding commitments to our portfolio company investments.

*Financing Activities.* From time to time, we use leverage to finance a portion of our investments. We then repay such debt from the sale of portfolio securities. Under the 1940 Act, we have the ability to borrow funds and issue debt securities or preferred stock that are referred to as senior securities, subject to certain restrictions including an overall limitation on the amount of outstanding debt, or leverage, relative to equity of 1:1. Because of the nature and size of our portfolio investments, we periodically borrow funds to make qualifying investments in order to maintain our qualification as a RIC. During 2013 and 2012, we borrowed such funds by accessing a margin account with a securities brokerage firm. We invest the proceeds of these margin loans in high-quality securities such as U.S.

Treasury securities until they are repaid. We refer to these high-quality investments as “restricted assets” because they are not generally available for investment in portfolio companies under the terms of borrowing. If, in the future, we cannot borrow funds to make such qualifying investments at the end of any future quarter, we may not qualify as a RIC and would become subject to corporate-level income tax on our net investment income and realized capital gains, if any. In addition, our distributions to stockholders would be taxable as ordinary dividends to the extent paid from earnings and profits. See “Federal Income Tax Considerations.”

*Distributions.* On March 24, 2009, we announced that we suspended our managed distribution policy and payment of quarterly distributions for an indefinite period, following the distribution of the first quarter dividend to be paid on March 30, 2009. As originally implemented, the policy provided for quarterly dividends at an annualized rate equal to 10% of the Fund’s market value per share as at the end of the preceding calendar year. We will continue to pay out net investment income and/or realized capital gains, if any, on an annual basis as required under the 1940 Act.

*Possible Share Repurchase.* As a closed-end BDC, our shares of common stock are not redeemable at the option of stockholders, and our shares currently trade at a discount to their net asset value. Our Board has determined that it would be in the best interests of our stockholders to reduce or eliminate this market value discount. Accordingly, we have been authorized to, and may from time to time, repurchase shares of our outstanding common stock (including by means of tender offers or privately negotiated transactions) in an effort to reduce or eliminate this market discount or to increase the net asset value of our shares. We are not required to undertake any such share repurchases, nor do we anticipate taking such action in 2014.

Table of Contents 21

## Critical Accounting Policies

Our financial statements are based on the selection and application of significant accounting policies, which require management to make significant estimates and assumptions. We believe that the following are some of the more critical judgment areas in the application of our accounting policies that currently affect our financial condition and results of operations.

**Valuation of Investments**—Portfolio investments are carried at fair value with the net change in unrealized appreciation or depreciation included in the determination of net assets. Valuations of portfolio securities are performed in accordance with GAAP and the financial reporting policies of the Securities and Exchange Commission (“SEC”). The applicable methods prescribed by such principles and policies are described below:

*Publicly-traded portfolio securities*—Investments in companies whose securities are publicly traded are generally valued at their quoted market price at the close of business on the valuation date.

*Privately-held portfolio securities*—The fair value of investments for which no market exists is determined on the basis of procedures established in good faith by our Board of Directors. As a general principle, the current “fair value” of an investment would be the amount we might reasonably expect to receive for it upon its current sale, in an orderly manner. Appraisal valuations are necessarily subjective and the estimated values arrived at by the Fund may differ materially from amounts actually received upon the disposition of portfolio securities.

*Thinly Traded and Over-the-Counter Securities*—Generally, we value securities that are traded in the over-the-counter market or on a stock exchange at the average of the prevailing bid and ask prices on the date of the relevant period end. However, we may apply a discount to the market value of restricted or thinly traded public securities to reflect the impact that these restrictions have on the value of these securities. We review factors, including the trading volume, total securities outstanding and our percentage ownership of securities to determine whether the trading levels are active (Level 1) or inactive (Level 2) or unobservable (Level 3). As of December 31, 2013, these securities, consisting of our holdings in the OPG Notes, represented 11% of our investments in portfolio securities. We utilized independent pricing services with certain of our fair value estimates. To corroborate “bid/ask” quotes from independent pricing services, we perform a market-yield approach to validate prices obtained or obtain other evidence.

During the first twelve months after an investment is made, we rely on the original investment amount to determine the fair value unless significant developments have occurred during this 12 month period which would indicate a material effect on the portfolio company (such as results of operations or changes in general market conditions). After the 12 month period, or if material events have occurred within the twelve month period, we consider a two step process when appraising investments of privately held companies. The first step involves determining the enterprise

value of the portfolio company. During this step, we consider three different valuation approaches: a market approach, an income approach, and an asset approach. The particular facts and circumstances of each portfolio company determine which approach, or combination of approaches, will be utilized. The second step when appraising equity investments of privately held companies involves allocating value to the various debt and equity securities of the company. We allocate value to these securities based on their relative priorities. For equity securities such as warrants, we may also incorporate alternative methodologies including the Black-Scholes Option Pricing Model.

**Market approach** – The market approach typically employed by Management calculates the enterprise value of a company as a multiple of earnings before interest, taxes, depreciation and amortization (“EBITDA”) generated by the company for the trailing twelve month period. Adjustments to the company’s EBITDA, including those for non-recurring items, may be considered. Multiples are estimated based on current market conditions and past experience in the private company marketplace and are subjective in nature. We will apply liquidity and other discounts we deem appropriate to equity valuations where applicable. We may also use, when available, third-party transactions in a portfolio company’s securities as the basis of valuation (the “private market method”). The private market method will be used only with respect to completed transactions or firm offers made by sophisticated, independent investors.

**Income approach** – The income approach typically utilized by Management calculates the enterprise value of a company utilizing a discounted cash flow model incorporating projected future cash flows of the company. Projected future cash flows consider the historical performance of the company as well as current and projected market participant performance. Discount rates are estimated based on current market conditions and past experience in the private company marketplace and are subjective in nature. We will apply liquidity and other discounts we deem appropriate to equity valuations where applicable.

**Asset approach** – We consider the asset approach to determine the fair value of significantly deteriorated investments demonstrating circumstances indicative of a liquidation analysis. This situation may arise when a portfolio company: 1) cannot generate adequate cash flow to meet the principal and interest payments on its indebtedness; 2) is not successful in refinancing its

[Table of Contents](#) 22

debt upon maturity; 3) we believe the credit quality of a loan has deteriorated due to changes in the business and underlying asset or market conditions may result in the company's inability to meet future obligations; or 4) the portfolio company's reorganization or bankruptcy. Consideration is also given as to whether a liquidation event would be orderly or forced.

Our general intent is to hold our loans to maturity when appraising our privately held debt investments. As such, we believe that the fair value will not exceed the cost of the investment. However, in addition to the previously described analysis involving allocation of value to the debt instrument, we perform a yield analysis to determine if a debt security has been impaired.

Certificates of deposit purchased by the Fund generally will be valued at their face value, plus interest accrued to the date of valuation.

The Audit Committee of the Board of Directors may engage independent, third-party valuation firms to conduct independent appraisals and review Management's preliminary valuations of each privately-held investment that the Fund (a) has held for more than one year and (b) holds on its books at a fair value of at least \$2.0 million in order to make their own independent assessment. Any third-party valuation data would be considered as one of many factors in a fair value determination. The Audit Committee then would recommend the fair values for all privately-held securities based on all relevant factors to the Board of Directors for final approval.

Because of the inherent uncertainty of the valuation of portfolio securities which do not have readily ascertainable market values, amounting to \$13.3 million and \$9.0 million as of December 31, 2013 and 2012, respectively, our fair value determinations may materially differ from the values that would have been used had a ready market existed for the securities. As of December 31, 2013, one of our portfolio investments, consisting of 73,666 ordinary shares of OPG, was publicly listed on the NYSE Euronext Paris Exchange, along with €1,200,790 in newly-issued 6-year OPG Notes. However, there had been no recent trading activity in the OPG Notes.

On a daily basis, we adjust our net asset value for the changes in the value of our publicly held securities, if applicable, and material changes in the value of private securities, generally determined on a quarterly basis or as announced in a press release, and reports those amounts to Lipper Analytical Services, Inc. Weekly and daily net asset values appear in various publications, including *Barron's* and *The Wall Street Journal*.

### ***Federal Income Taxes***

We intend to comply with the requirements of the Code necessary for us to qualify as a RIC. So long as we comply with these requirements, we generally will not be subject to corporate-level federal income taxes on otherwise taxable income (including net realized capital gains) distributed to stockholders. Therefore, we did not record a provision for federal income taxes in our financial statements. As of December 31, 2013, we had a capital loss carry forward of \$39.1 million which may be used to offset future capital gains. We may borrow money from time to time to maintain our status as a RIC under the Code. See “—Overview – Financing Activities” above.

### ***Interest Income Recognition***

We record interest income, adjusted for amortization of premium and accretion of discount, on an accrual basis to the extent that we expect to collect such amounts. We stop accruing interest on investments when we determine that interest is no longer collectible. We may also impair the accrued interest when we determine that all or a portion of the current accrual is uncollectible. If we receive any cash after determining that interest is no longer collectible, we treat such cash as payment on the principal balance until the entire principal balance has been repaid, before we recognize any additional interest income. We accrete or amortize discounts and premiums on securities purchased over the life of the respective security using the effective yield method. The amortized cost of investments represents the original cost adjusted for the accretion of discount and/or amortization of premium on debt securities.

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

We have loans in our portfolio that may pay PIK interest. We add PIK interest, if any, computed at the contractual rate specified in each loan agreement, to the principal balance of the loan and recorded as interest income. To maintain the Fund’s status as a RIC, we must pay out to our stockholders this non-cash source of income in the form of dividends even if we have not yet collected any cash in respect of such investments.

Table of Contents 23

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

In June 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2013-08, Financial Services—Investment Companies. ASU 2013-08 provides clarifying guidance to determine if an entity qualifies as an investment company. ASU 2013-08 also requires an investment company to measure non-controlling interests in other investment companies at fair value. The following disclosures will also be required upon adoption of ASU 2013-08: (i) whether an entity is an investment company and is applying the accounting and reporting guidance for investment companies; (ii) information about changes, if any, in an entity’s status as an investment company; and (iii) information about financial support provided or contractually required to be provided by an investment company to any of its investees. The requirements of ASU 2013-08 are effective for the Fund beginning in the first quarter of 2014. We are currently evaluating the impact, if any, that these updates will have on our financial condition or results of operations.

### ***Current Market Conditions***

Overall economic conditions in the United States have improved, albeit marginally. However, the economic recovery has been hampered by slower growth and persistent high unemployment levels. The U.S. Congressional Budget Office is forecasting higher growth in 2014 (3.1%), with a projected unemployment rate exceeding 6.0% until 2017.

Further, the banking industry continues to experience additional bank failures as regulators continue to impose strict capital requirements. Additionally, future economic expansion and business investment is threatened by perceptions of higher taxes and healthcare costs, as well as the high levels of government deficit spending.

Market conditions for business transactions including mergers and acquisitions and private equity investments improved significantly in 2013 compared with previous years, as corporations have been deleveraging and are holding significant amounts of cash and many have begun to focus on acquisitions as part of future growth plans. Private equity firms as a group enjoyed more success in 2013 in monetizing their investments through sales and public listings.

During 2013, our net asset value increased from \$3.11 per share to \$3.14 per share, an increase of 1.0%. As of December 31, 2013, our common stock is trading at a 36.6% discount to our net asset value.

Over the past several years, we have executed certain initiatives to enhance liquidity, achieve a lower operational cost structure, provide more assistance to portfolio companies and realize certain of our portfolio investments. Specifically,

we changed the composition of our Board of Directors and Management, terminated certain of our follow-on investments, internalized the management of the Fund, suspended our managed distribution policy, modified our investment strategy to pursue shorter term liquidation opportunities, pursued non-cash investment opportunities, and sold certain of our legacy and underperforming investment holdings. We believe these actions continue to be necessary to protect capital and liquidity during this turbulent economic period in order to preserve and enhance shareholder value. Because our Management is internalized, certain of our expenses should not increase commensurate with an increase in the size of the Fund and, therefore, we expect to achieve efficiencies in our cost structure if we are able to grow the Fund.

## **Liquidity and Capital Resources**

We generate cash primarily from maturities, sales of securities and borrowings, as well as capital gains realized upon the sale of portfolio investments. We use cash primarily to make additional investments, either in new companies or as follow-on investments in the existing portfolio companies and to pay the dividends to our stockholders.

We are currently evaluating the impact of current market conditions on our portfolio company valuations and their ability to provide current income. We have followed valuation techniques in a consistent manner; however, we are cognizant of current market conditions that might effect future valuations of portfolio securities. We believe that our operating cash flow and cash on hand will be sufficient to meet operating requirements and to finance routine capital expenditures through the next twelve months.

### ***Year Ended December 31, 2013***

As of December 31, 2013, we had total assets of \$48.3 million, of which \$13.5 million were invested in portfolio investments and \$19.1 million were invested in cash and cash equivalents. Among our portfolio investments, \$4.9 million (at fair value) or 14.7% of net asset value were in the form of notes receivable from portfolio companies as of December 31, 2013. We continue to impair accrued interest for certain promissory notes issued by Spectrum, having a fair value of \$2.9 million.

As of December 31, 2013, we also had \$15.2 million of restricted cash and cash equivalents, including primarily the proceeds of a quarter-end margin loan that we incurred to maintain the diversification requirements applicable to a RIC. Of this amount, \$15.0 million was invested in U.S. Treasury bills and \$0.2 million represented a required 1% brokerage margin deposit.

Table of Contents 24



These securities were held by a securities brokerage firm and pledged along with other assets to secure repayment of the margin loan. The U.S. Treasury bills were sold on January 2, 2014 and we subsequently repaid this margin loan. The margin interest was paid on January 22, 2014.

*Operating Activities.* We used \$19.6 million in cash for operating activities in 2013, including \$15.1 million for the purchase of U.S. Treasury bills. In 2013, we made investments in portfolio companies of \$0.8 million and paid fees to our advisers, directors, banks and others of \$2.6 million, while realizing a loss of \$9.8 million from the disposition of portfolio securities. During 2013, we incurred non-recurring expenses including settlement expenses of \$0.5 million and legal expenses of \$0.2 million related to the various legal proceedings described in Item 3.

*Financing Activities.* We provided \$15.0 million in cash from financing activities for 2013. We did not declare any dividends in 2013.

#### ***Year Ended December 31, 2012***

As of December 31, 2012, we had total assets of \$33.3 million, of which \$9.2 million were invested in portfolio investments and \$23.7 million were invested in cash and cash equivalents. Among our portfolio investments, \$1.8 million (at fair value) or 5.6% of net asset value were in the form of notes receivable from portfolio companies as of December 31, 2012. We continue to impair certain promissory notes issued by Spectrum, having a fair value of \$0.4 million.

As of December 31, 2012, we had no RIC borrowings or restricted cash.

*Operating Activities.* We provided \$12.9 million in cash for operating activities in 2012. In 2012, we made investments in portfolio companies of \$6.9 million and paid fees to our advisers, directors, banks and others of \$3.0 million, while realizing a loss of \$2.8 million from the disposition of portfolio securities.

*Financing Activities.* We used \$6.0 million in cash from financing activities for 2012. We did not declare any dividends in 2012.

#### ***Year Ended December 31, 2011***

As of December 31, 2011, we had total assets of \$44.3 million, of which \$19.2 million were invested in portfolio investments and \$16.8 million were invested in cash and cash equivalents. Among our portfolio investments, \$14.1 million (at fair value) or 37.1% of net asset value were in the form of notes receivable from portfolio companies as of December 31, 2011. We impaired certain promissory notes issued by Spectrum, having a fair value of \$0.3 million.

As of December 31, 2011, we also had \$6.1 million of restricted cash and temporary cash investments, including primarily the proceeds of a quarter-end margin loan that we incurred to maintain the diversification requirements applicable to a RIC. Of this amount, \$6.0 million was invested in U.S. Treasury bills and \$0.1 million represented a required 1% brokerage margin deposit. These securities were held by a securities brokerage firm and pledged along with other assets to secure repayment of the margin loan. The U.S. Treasury bills were sold on January 3, 2012 and we subsequently repaid this margin.

*Operating Activities.* We provided \$18.6 million in cash for operating activities in 2011. In 2011, we made investments in portfolio companies of \$0.6 million and incurred compensation expense and paid fees to our consultants, legal counsel, directors, banks and others of \$3.1 million, while realizing a loss of \$10.9 million from the disposition of portfolio securities. During 2011, we incurred non-recurring expenses including settlement expenses, related to the various legal proceedings described in Item 3 above of \$0.3 million and offering costs of \$0.4 million.

*Financing Activities.* We used \$9.2 million in cash from financing activities for 2011. We issued 1,700,000 additional shares of our common stock at an effective price of \$4.29 per share. On April 27, 2011, we announced that we had entered into two separate transactions involving the purchase of an aggregate of 11,408 4% bonds due May 2012 (“Bonds”) issued by Orco Germany S.A., a commercial and multi-family residential real estate holding company and developer based in Berlin. The consideration provided to the selling bondholders consisted of an aggregate of 1,700,000 newly issued shares of common stock of the Fund. These shares are unregistered under the Securities Act of 1933. We received 8,890 of the Bonds on April 27, 2011 and, on June 23, 2011, we received \$1.6 million in cash in lieu of the 2,518 Bonds which were not delivered as required. We incurred a quarter-end margin loan in the amount of \$6.0 million to maintain the diversification requirement applicable to a RIC.

Table of Contents 25

## **Results of Operations**

### **Investment Income and Expense**

#### ***Year Ended December 31, 2013 as compared to Year Ended December 31, 2012***

Total income from portfolio securities decreased \$0.5 million in 2013 due to the impairment of the interest receivable from Spectrum and the decline in interest-bearing investments.

Professional fees decreased to \$1.0 from \$1.3 million during 2012. These decreases were due to the decreases in consulting fees and legal fees associated with various legal proceedings.

Compensation expense was \$0.9 million for 2013 and \$1.1 million for 2012, respectively. The \$0.2 million decrease was largely due to a decrease in compensation paid to existing personnel.

Settlement expense was \$0.5 million for 2013 related to the various legal proceedings described in Item 3.

As a result of the factors described above, net investment loss after expenses was \$3.1 million for 2013 as compared to a net investment loss of \$2.7 million for 2012.

#### ***Year Ended December 31, 2012 as compared to Year Ended December 31, 2011***

Total income from portfolio securities remained relatively unchanged from 2011. However, there was a significant decline in interest bearing promissory notes during 2012, with the sale of our interests in ConGlobal Industries Holding, Inc. ("ConGlobal") and Sovereign Business Forms, Inc. ("Sovereign").

Professional fees increased to \$1.3 million for 2012 from \$1.2 million for 2011. These increases were due to the increases in legal fees associated with various legal proceedings.

Compensation expense was \$1.1 million for 2012 and \$1.3 million in 2011, respectively. The \$0.2 million decrease was largely due to the salary and accrued bonus for our Chief Investment Officer, whose position was vacated in November 2011.

As a result of the factors described above, net investment loss after expenses was \$2.7 million for 2012 as compared to a net investment loss of \$3.5 million for 2011.

### **Summary of Portfolio Investment Activity**

#### ***Year Ended December 31, 2013***

During the year ended December 31, 2013, we had investment activity of \$0.8 million in two portfolio companies. We capitalized consulting expenses of \$0.3 million relating to Spectrum. We made a short-term working capital loan of \$0.5 million to Security Monitor Holdings, LLC (“SMH”). SMH is a company which specializes in managing and improving operations of distressed companies.

The following table includes significant investment activity during the year ended December 31, 2013 (in thousands):

Investment  
Activity