

Epizyme, Inc.  
Form 424B5  
March 06, 2019  
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Registration File No. 333-224159

**The information in this preliminary prospectus supplement is not complete and may be changed. A registration statement relating to these securities has been filed with the Securities and Exchange Commission and is effective. This preliminary prospectus supplement and the accompanying prospectus are not an offer to sell these securities and they are not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.**

**SUBJECT TO COMPLETION, DATED MARCH 6, 2019**

## **Preliminary Prospectus Supplement**

(To Prospectus Dated April 5, 2018)

### **Shares**

#### **Epizyme, Inc.**

#### **Series A Convertible Preferred Stock**

#### **\$ Per Share**

We are offering \_\_\_\_\_ shares of our Series A convertible preferred stock, or the Series A preferred stock, and the common stock issuable from time to time upon conversion of our Series A preferred stock. Our common stock is listed on The Nasdaq Global Select Market under the symbol EPZM. The last reported sale price of our common stock on The Nasdaq Global Select Market on March 5, 2019 was \$12.29 per share. There is no established trading market for the Series A preferred stock, and we do not expect a market to develop. In addition, we do not intend to list the Series A preferred stock on The Nasdaq Global Select Market, any other national securities exchange or any other nationally recognized trading system.

Each share of Series A preferred stock is convertible into \_\_\_\_\_ shares of our common stock at any time at the option of the holder, provided that the holder will be prohibited, subject to certain exceptions, from converting Series A preferred stock into shares of our common stock if, as a result of such conversion, the holder, together with its affiliates and other attribution parties, would own more than 9.99% of the total number of shares of our common stock then issued and outstanding. In the event of our liquidation, dissolution or winding up, holders of our Series A preferred stock will receive a payment equal to \$0.001 per share of Series A preferred stock before any proceeds are

distributed to the holders of our common stock. In the event of a merger, consolidation, exchange offer or similar other transaction, the holders of the Series A preferred stock will receive the same consideration as the holders of our common stock, upon conversion of the Series A preferred stock. Shares of Series A preferred stock will generally have no voting rights, except as required by law and except that the consent of holders of a majority of the outstanding Series A preferred stock will be required to amend the terms of the Series A preferred stock.

**Investing in our securities involves risks. See Risk Factors beginning on page S-7.**

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

Concurrently with this offering of Series A preferred stock, and pursuant to a separate prospectus supplement, we are also conducting a public offering (the Concurrent Offering ) of shares of our common stock.

	<b>PER SHARE</b>	<b>TOTAL</b>
Public offering price	\$	\$
Underwriting discount <sup>(1)</sup>	\$	\$
Proceeds, before expenses, to Epizyme, Inc.	\$	\$

<sup>(1)</sup> We refer you to Underwriting beginning on page S-19 of this prospectus supplement for additional information regarding total underwriter compensation.

The underwriters expect to deliver the shares of Series A preferred stock to purchasers on or about , 2019.

We have granted the underwriters an option for 30 days from the date of this prospectus supplement to purchase up to an additional shares of our Series A preferred stock. See Underwriting for more information.

*Joint Book-Running Managers*

**Jefferies**

**Citigroup**  
*Lead Manager*

**Cowen**

**Wedbush PacGrow**  
*Co-Manager*

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**H.C. Wainwright & Co.**

Prospectus Supplement dated \_\_\_\_\_, 2019

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**ABOUT THIS PROSPECTUS SUPPLEMENT**

This document is in two parts. The first part is this prospectus supplement, which describes the specific terms of this Series A preferred stock offering and also adds to and updates information contained in the accompanying prospectus and the documents incorporated by reference herein. The second part, the accompanying prospectus, provides more general information. Generally, when we refer to this prospectus, we are referring to both parts of this document combined. To the extent there is a conflict between the information contained in this prospectus supplement and the information contained in the accompanying prospectus or any document incorporated by reference therein filed prior to the date of this prospectus supplement, you should rely on the information in this prospectus supplement; provided that if any statement in one of these documents is inconsistent with a statement in another document having a later date for example, a document incorporated by reference in the accompanying prospectus the statement in the document having the later date modifies or supersedes the earlier statement.

We further note that the representations, warranties and covenants made by us in any agreement that is filed as an exhibit to any document that is incorporated by reference herein were made solely for the benefit of the parties to such agreement, including, in some cases, for the purpose of allocating risk among the parties to such agreements, and should not be deemed to be a representation, warranty or covenant to you. Moreover, such representations, warranties or covenants were accurate only as of the date when made. Accordingly, such representations, warranties and covenants should not be relied on as accurately representing the current state of our affairs.

We have not authorized anyone to provide any information other than that contained or incorporated by reference in this prospectus supplement, the accompanying prospectus or in any free writing prospectus prepared by or on behalf of us or to which we have referred you. We take no responsibility for, and can provide no assurance as to the reliability of, any other information that others may give you. This prospectus supplement and the accompanying prospectus do not constitute an offer to sell, or a solicitation of an offer to purchase, the securities offered by this prospectus supplement and the accompanying prospectus in any jurisdiction to or from any person to whom or from whom it is unlawful to make such offer or solicitation of an offer in such jurisdiction. The information contained in this prospectus supplement or the accompanying prospectus, or incorporated by reference herein or therein is accurate only as of the respective dates thereof, regardless of the time of delivery of this prospectus supplement and the accompanying prospectus or of any sale of our securities. It is important for you to read and consider all information contained in this prospectus supplement and the accompanying prospectus, including the documents incorporated by reference herein and therein, in making your investment decision. You should also read and consider the information in the documents to which we have referred you in the sections entitled **Where You Can Find More Information** and **Incorporation of Certain Information by Reference** in this prospectus supplement and in the accompanying prospectus.

We are offering to sell, and seeking offers to buy, shares of our Series A preferred stock (and the underlying shares of common stock) only in jurisdictions where offers and sales are permitted. The distribution of this prospectus supplement and the accompanying prospectus and the offering of the Series A preferred stock (and the underlying shares of common stock) in certain jurisdictions may be restricted by law. Persons outside the United States who come into possession of this prospectus supplement and the accompanying prospectus must inform themselves about, and observe any restrictions relating to, the offering of the Series A preferred stock (and the underlying shares of common stock) and the distribution of this prospectus supplement and the accompanying prospectus outside the United States. This prospectus supplement and the accompanying prospectus do not constitute, and may not be used in connection with, an offer to sell, or a solicitation of an offer to buy, any securities offered by this prospectus supplement and the accompanying prospectus by any person in any jurisdiction in which it is unlawful for such person to make such an offer or solicitation.

Unless otherwise stated, all references in this prospectus supplement and the accompanying prospectus to we, us, our, Epizyme, the Company and similar designations refer, collectively, to Epizyme, Inc., a Delaware corporation, and its consolidated subsidiary.

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**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This prospectus supplement, the accompanying prospectus and the information incorporated by reference herein and therein contain forward-looking statements that involve substantial risks and uncertainties. All statements, other than statements of historical fact, contained in this prospectus supplement, the accompanying prospectus and the information incorporated by reference herein and therein, including statements regarding our strategy, future operations, future financial position, future revenue, projected costs, prospects, plans and objectives of management, are forward-looking statements. The words anticipate, believe, estimate, expect, intend, may, plan, predict, target, potential, will, would, could, should, continue, and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words.

The forward-looking statements in this prospectus supplement, the accompanying prospectus and the information incorporated by reference herein and therein include, among other things, statements about:

our plans to develop and commercialize novel epigenetic therapies for patients with cancer and other serious diseases;

our ongoing and planned clinical trials, including the timing of initiation and enrollment in the trials, the timing of availability of data from the trials and the anticipated results of the trials;

our ability to achieve anticipated milestones under our collaborations;

the timing of and our ability to apply for, obtain and maintain regulatory approvals for our product candidates;

the rate and degree of market acceptance and clinical utility of our products;

our commercialization, marketing and manufacturing capabilities and strategy;

our intellectual property position;

our expectations related to the use of proceeds for this offering and the Concurrent Offering;

the successful completion of the Concurrent Offering; and

our estimates regarding expenses, future revenue, capital requirements and needs for additional financing. We may not actually achieve the plans, intentions or expectations disclosed in our forward-looking statements, and you should not place undue reliance on our forward-looking statements. Actual results or events could differ



materially from the plans, intentions and expectations disclosed in the forward-looking statements we make. We have included important factors in the cautionary statements included in this prospectus supplement, particularly in the Risk Factors section and in the Risk Factors section of our Annual Report on Form 10-K for the year ended December 31, 2018 incorporated herein by reference, that we believe could cause actual results or events to differ materially from the forward-looking statements that we make. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make.

You should read this prospectus supplement, the accompanying prospectus and the information incorporated by reference herein and therein completely and with the understanding that our actual future results may be materially different from what we expect. We do not assume any obligation to update any forward-looking statements.

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**PROSPECTUS SUPPLEMENT SUMMARY**

*This summary highlights selected information contained elsewhere in this prospectus supplement and the accompanying prospectus and in the documents we incorporate by reference herein and therein. This summary does not contain all of the information you should consider before investing in our securities. You should read this entire prospectus supplement and the accompanying prospectus carefully, especially the risks of investing in our securities discussed under Risk Factors beginning on page S-7 of this prospectus supplement and in Part I, Item IA of our Annual Report on Form 10-K for the fiscal year ended December 31, 2018, along with our consolidated financial statements and notes to those consolidated financial statements and the other information incorporated by reference in this prospectus supplement and the accompanying prospectus, before making an investment decision.*

**Company Overview**

We are a late-stage biopharmaceutical company that is committed to rewriting treatment for people with cancer and other serious diseases through the discovery, development, and commercialization of novel epigenetic medicines. By focusing on the genetic drivers of disease, our science seeks to match targeted medicines with the patients who need them. We are developing our lead product candidate, tazemetostat, an oral, first-in-class, selective small molecule inhibitor of the EZH2 histone methyltransferase, or HMT, for the treatment of a broad range of cancer types in multiple treatment settings, and developing our novel G9a program, EZM8266, for the treatment of sickle cell disease, or SCD.

We have taken a pipeline in a product approach to developing tazemetostat with a broad clinical development program through company-sponsored studies and collaborations. This program is evaluating tazemetostat as both a monotherapy and combination treatment in hematological malignancies and solid tumors for both late and early lines of treatment. Tazemetostat has shown meaningful clinical activity as a monotherapy in multiple cancer indications and has been generally well-tolerated across clinical trials to date. Based on positive data in our two lead indications, epithelioid sarcoma and follicular lymphoma, or FL, and interactions with the United States Food and Drug Administration, or the FDA, we are planning to submit New Drug Applications, or NDAs, for accelerated approval of tazemetostat for each proposed indication in 2019, subject to the results of our ongoing trials in those indications.

In our hematological malignancy program, we are conducting a multi-cohort, global Phase 2 study evaluating tazemetostat's treatment potential in patients with relapsed or refractory non-Hodgkin lymphoma, or NHL. Two cohorts are evaluating tazemetostat as a monotherapy for patients with relapsed or refractory FL, one of the most prevalent forms of NHL, both with and without EZH2 activating mutations. In December 2018, we completed target enrollment of FL patients in our study, with 54 patients with wild-type EZH2 and 45 patients with EZH2 activating mutations. Based on interactions with the FDA, we believe we have identified a path to submission for accelerated approval of tazemetostat in FL patients with either an EZH2 activating mutation or wild-type EZH2, whose disease has progressed following two or more lines of therapy. We are targeting submission of an NDA for accelerated approval for tazemetostat for FL in this population in the fourth quarter of 2019, subject to the results of our ongoing trial in this indication.

As part of an accelerated approval strategy, we will need to conduct a confirmatory clinical program to verify clinical benefit and support the full approval of tazemetostat. We intend to review our proposed confirmatory program with the FDA, and to finalize its design in the first half of 2019. We hope to leverage the confirmatory program to expand tazemetostat into the second-line treatment setting for patients with FL, both with and without EZH2 activating mutations. In addition, we plan to evaluate tazemetostat treatment in combination with other therapies. In mid-2019, we anticipate initiating a combination study that would compare tazemetostat plus rituximab and Revlimid, a chemotherapeutic-free treatment regimen referred to as R2, versus R2 with placebo in patients with relapsed or

refractory FL, both with and without EZH2 activating mutations. In addition, we are finalizing plans for a trial of tazemetostat in combination with rituxan for the

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treatment of patients with relapsed and refractory FL. Based on clinical activity observed with tazemetostat in combination with R-CHOP as a front-line treatment for patients with diffuse large B-cell lymphoma, or DLBCL, we are evaluating the opportunity to investigate this combination as a front-line treatment for patients with FL. In collaboration with The Lymphoma Study Association, or LYSA, we are continuing to evaluate tazemetostat with R-CHOP as a front-line treatment for high-risk patients with DLBCL. In addition, Genentech Inc., or Genentech, is evaluating the combination of tazemetostat with its checkpoint inhibitor, Tecentriq (atezolizumab), for the treatment of patients with relapsed or refractory DLBCL, with preliminary data expected from that study in 2019.

In our solid tumor program, we are evaluating tazemetostat's treatment potential in adults and children with molecularly defined solid tumors, including INI1- and SMARCA4-negative tumors, which we collectively refer to as INI1-negative tumors. We are conducting a multi-cohort global Phase 2 trial of tazemetostat in adults with INI1-negative tumors, including epithelioid sarcoma or chordoma. Based on positive data that we have observed in patients with epithelioid sarcoma in the ongoing Phase 2 study, we are targeting submission of our first NDA for accelerated approval of tazemetostat for the treatment of epithelioid sarcoma in the second quarter of 2019. In connection with this submission, we will need to conduct a confirmatory program to verify clinical benefit and support the full approval of tazemetostat. We plan to explore with the FDA utilizing the natural history study in epithelioid sarcoma that we are conducting to serve as confirmatory evidence required in connection with any accelerated approval. The cohort of patients in the phase 2 study of chordoma patients is ongoing, and we are evaluating tazemetostat in the dose-expansion portion of a Phase 1 study in pediatric patients with INI1-negative tumors, with plans to report updated data in 2019.

We own the global development and commercialization rights to tazemetostat outside of Japan. Eisai Co. Ltd, or Eisai, holds the rights to develop and commercialize tazemetostat in Japan. We intend to build a focused field presence and marketing capabilities to commercialize tazemetostat for the epithelioid sarcoma and follicular lymphoma indications in the United States. We have begun building the infrastructure necessary to support the launch and marketing of tazemetostat for epithelioid sarcoma, and believe we can adequately address this patient population through a modest field force of less than 25 professionals. For geographies outside the United States, we are evaluating the most efficient path to reach patients, including through potential collaborations.

Tazemetostat is covered by claims of U.S. and European composition of matter patents, which are expected to expire in 2032, exclusive of any patent term or other extensions. Tazemetostat has been granted Fast Track designation by the FDA in patients with relapsed or refractory FL, with or without activating EZH2 mutations, relapsed or refractory DLBCL with EZH2 activating mutations and metastatic or locally advanced epithelioid sarcoma who have progressed on or following an anthracycline-based treatment regimen. The FDA has also granted orphan drug designation to tazemetostat for the treatment of patients with FL, malignant rhabdoid tumors, or MRT, soft tissue sarcoma, or STS, and mesothelioma. The orphan drug designation for the treatment of MRT applies to INI1-negative MRT as well as SMARCA4-negative malignant rhabdoid tumor of ovary, or MRTO.

Beyond tazemetostat, we are building an early pipeline to further support our leadership in epigenetics. We are developing our wholly-owned G9a candidate, EZM8266, for the treatment of people with sickle cell disease. We have completed IND-enabling studies for this program and plan to begin clinical evaluation with a safety and dose-finding study in the second half of 2019. In November 2018, we entered a strategic collaboration with Boehringer Ingelheim International GmbH, or Boehringer Ingelheim, focused on the research, development and commercialization of novel small molecule inhibitors, discovered by us, directed toward two previously unaddressed epigenetic targets as potential therapies for people with cancer. Specifically, these targets are enzymes within the helicase and histone acetyltransferase, or HAT, families that when dysregulated have been linked to the development of cancers that currently lack therapeutic options. We also have collaborations with Glaxo Group Limited (an affiliate of GlaxoSmithKline), or GSK, focused on the development of PRMT inhibitors discovered by us, and with Celgene

Corporation and Celgene RIVOT Ltd., an affiliate of

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Celgene Corporation, which we collectively refer to as Celgene, focused on the development of pinometostat and small molecule inhibitors directed to three HMT targets.

## **Corporate Strategy**

Our goal is to become a biopharmaceutical company developing and commercializing novel epigenetic therapies for people with cancer and other serious diseases. The key elements of our corporate strategy are to:

rapidly advance the clinical development of tazemetostat in solid tumors and hematological malignancies;

collaborate closely with the FDA and other regulatory bodies to pursue the registration of tazemetostat with accelerated approval for epithelioid sarcoma and FL;

expand the treatment utility for tazemetostat through a broad development program evaluating its benefit in different combinations, in both early- and late-lines of treatment and in additional indications;

establish commercialization capabilities in the United States;

utilize our drug discovery platform to build a pipeline of inhibitors against chromatin modifying proteins, or CMPs;

develop diagnostics for use with our therapeutic candidates, where appropriate; and

leverage strategic collaborations that can contribute to our ability to rapidly advance and commercialize our product candidates.

## **Risks Associated with Our Business**

Our business is subject to a number of risks of which you should be aware before making an investment decision. These risks are discussed more fully in the Risk Factors section of this prospectus supplement immediately following this prospectus supplement summary and in Part I, Item IA of our Annual Report on Form 10-K for the fiscal year ended December 31, 2018. These risks include the following:

We have incurred significant losses since our inception. Our accumulated deficit was \$586.7 million as of December 31, 2018, representing our cumulative losses since our inception in 2007. We expect to incur losses over the next several years and may never achieve or maintain profitability.

We will need substantial additional funding. If we are unable to raise capital when needed, we could be forced to delay, reduce or eliminate our product development programs or commercialization efforts.

Our research and development is focused on the creation of novel epigenetic therapies for patients with cancer and other diseases, which is a rapidly evolving area of science, and the approach we are taking to discover and develop drugs is novel and may never lead to marketable products. The scientific evidence to support the feasibility of developing product candidates based on these discoveries is both preliminary and limited.

The outcome of preclinical testing and early clinical trials may not be predictive of the success of later clinical trials, and interim results of a clinical trial do not necessarily predict final results.

Clinical drug development involves a lengthy and expensive process, with an uncertain outcome. We may incur additional costs or experience delays in completing, or ultimately be unable to complete, the development and commercialization of our product candidates.

We cannot predict whether or when any of our product candidates will prove effective or safe in clinical trials, if we will be able to participate in any expedited review and approval programs for such product candidates, if we will be able to satisfy the criteria for any path to registration for our product candidates discussed with the FDA, if we will submit applications for approval for our product candidates on a timely basis or at all, and if any of our product candidates will receive regulatory approval on a timely basis or at all.

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If we are required to develop a companion diagnostic and if we or our collaborators are unable to successfully develop companion diagnostics for our therapeutic product candidates when needed, or experience significant delays in doing so, we may not achieve marketing approval or realize the full commercial potential of our therapeutic product candidates.

Our existing therapeutic collaborations are important to our business, and future collaborations may also be important to us. If we are unable to maintain any of these collaborations, or if these collaborations are not successful, our business could be adversely affected.

If we are unable to obtain and maintain patent protection for our technology and products or if the scope of the patent protection obtained is not sufficiently broad, our competitors could develop and commercialize technology and products similar or identical to ours, and our ability to successfully commercialize our technology and products may be impaired.

## **Company Information**

We were incorporated under the laws of the State of Delaware on November 1, 2007 under the name Epizyme, Inc. Our principal executive offices are located at 400 Technology Square, Cambridge, Massachusetts 02139 and our telephone number is (617) 229-5872. Our website address is [www.epizyme.com](http://www.epizyme.com). The information contained on, or that can be accessed through, our website is not a part of this prospectus supplement. We have included our website address in this prospectus supplement solely as an inactive textual reference.

Epizyme® and the Epizyme logo are our registered trademarks. The other trademarks, trade names and service marks appearing in this prospectus supplement are the property of their respective owners.

## **Concurrent Offering of Common Stock**

Concurrently with this offering of Series A preferred stock, we are conducting a public offering of \_\_\_\_\_ shares of our common stock, which we refer to as the Concurrent Offering. The Concurrent Offering is being conducted as a separate public offering by means of a separate prospectus supplement. This offering is not contingent upon the completion of the Concurrent Offering and the Concurrent Offering is not contingent upon the completion of this offering. We cannot assure you that either or both of the offerings will be completed.



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**THE OFFERING**

**Series A preferred stock offered by Epizyme**

shares. This prospectus supplement also relates to the offering of shares of common stock issuable upon conversion of the Series A preferred stock.

**Option to purchase additional shares**

The underwriters have an option to purchase up to an additional shares of our Series A preferred stock from us. The underwriters can exercise this option at any time within 30 days from the date of this prospectus supplement.

**Conversion**

Each share of our Series A preferred stock is convertible into shares of our common stock at any time at the option of the holder, provided that the holder will be prohibited, subject to certain exceptions, from converting Series A preferred stock if, as a result of such conversion, the holder, together with its affiliates and other attribution parties, would own more than 9.99% of the total number of shares of our common stock then issued and outstanding, which percentage may be changed at the holders election to a higher or lower percentage upon 61 days notice to us.

**Liquidation preference**

In the event of our liquidation, dissolution, or winding up, holders of our Series A preferred stock will receive a payment equal to \$0.001 per share of Series A preferred stock before any proceeds are distributed to the holders of our common stock.

**Voting rights**

Shares of Series A preferred stock will generally have no voting rights except as required by law and except that the consent of the holders of a majority of our outstanding shares of Series A preferred stock will be required to amend the terms of the Series A preferred stock or take certain other actions with respect to the Series A preferred stock.

**Dividends**

Shares of Series A preferred stock will be entitled to receive dividends equal to (on an as-if-converted-to-common stock basis), and in the same form and manner as, dividends actually paid on shares of our common stock.

**Use of proceeds**

We estimate that the net proceeds to us from this offering, after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us will be approximately

\$        million, or approximately \$        million if the underwriters exercise their option to purchase additional shares from us in full. We plan to use the net proceeds from this offering and the Concurrent Offering, together with our existing cash, cash equivalents and marketable securities, to fund global development and commercialization costs of tazemetostat outside of Japan, including the costs of our ongoing and planned clinical trials of tazemetostat, the costs of regulatory activities related to tazemetostat, including associated milestone payments, the costs of conducting confirmatory programs to verify clinical benefit and support full approval of tazemetostat to the extent required by

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regulatory authorities, and the costs associated with the commercial launch of tazemetostat for epithelioid sarcoma and follicular lymphoma, if approved; to fund research and development costs to identify and develop other product candidates, including EZM8266 for sickle cell disease; and for working capital and other general corporate purposes. See Use of Proceeds.

**Risk factors**

You should read the Risk Factors section of this prospectus supplement beginning on page S-7 and in Part I, Item IA of our Annual Report on Form 10-K for the fiscal year ended December 31, 2018 for a discussion of factors to consider carefully before deciding to invest in our securities.

**Concurrent Offering**

Concurrently with this offering, we are conducting a public offering of \_\_\_\_\_ shares of our common stock. The Concurrent Offering is being conducted as a separate public offering by means of a separate prospectus supplement. This offering is not contingent upon the completion of the Concurrent Offering, and the Concurrent Offering is not contingent upon the completion of this offering.

**Listing**

There is no established public trading market for the Series A preferred stock, and we do not expect a market to develop. In addition, we do not intend to apply for listing of the Series A preferred stock on The Nasdaq Global Select Market or on any national securities or other nationally recognized trading system. Our common stock is listed on The Nasdaq Global Select Market under the symbol EPZM.

There are no shares of Series A preferred stock issued or outstanding prior to this offering. The number of shares of our common stock outstanding as of February 28, 2019 was 79,230,173 shares and excludes:

6,991,600 shares of common stock issuable upon the exercise of stock options outstanding as of February 28, 2019, at a weighted average exercise price of \$12.67 per share;

220,666 shares of common stock issuable upon the vesting of restricted stock units outstanding as of February 28, 2019;

6,323,587 shares of common stock that have been reserved for issuance in connection with future grants under our equity compensation plans as of February 28, 2019;

shares of our common stock being offered in the Concurrent Offering; and

shares of our common stock issuable upon the conversion of the Series A preferred stock being offered by us in connection with this offering.

Unless otherwise indicated, all information in this prospectus supplement assumes no exercise by the underwriters of their option to purchase additional shares of our common stock in this offering or in the Concurrent Offering.

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**RISK FACTORS**

*Investing in our securities involves a high degree of risk. Before you decide to invest in our securities, you should carefully consider the risks and uncertainties described below and in Part I, Item IA of our Annual Report on Form 10-K for the fiscal year ended December 31, 2018, together with all other information contained in this prospectus supplement, the accompanying prospectus and in our filings with the SEC that we have incorporated by reference in this prospectus supplement and the accompanying prospectus. If any of the following risks actually occurs, our business, prospects, operating results and financial condition could suffer materially. In such event, the trading price of our common stock (including the common stock issuable upon conversion of the Series A preferred stock issued in this offering) could decline and you might lose all or part of your investment.*

**Risks Related to Our Securities and This Offering**

*The price of our common stock has been and may in the future be volatile and fluctuate substantially.*

Our stock price has been and may in the future be volatile. The stock market in general and the market for smaller biopharmaceutical companies in particular have experienced extreme volatility that has often been unrelated to the operating performance of particular companies. From January 1, 2016 until February 28, 2019, the sale price of our common stock as reported on the Nasdaq Global Select Market ranged from a high of \$28.48 to a low of \$5.14. The market price for our common stock may be influenced by many factors, including:

the success of competitive products or technologies;

results of clinical trials of our product candidates or those of our competitors;

regulatory or legal developments in the United States and other countries;

developments or disputes concerning patent applications, issued patents or other proprietary rights;

the recruitment or departure of key personnel;

the level of expenses related to any of our product candidates or clinical development programs;

the results of our efforts to discover, develop, acquire or in-license additional product candidates or products;

actual or anticipated changes in estimates as to financial results, development timelines or recommendations by securities analysts;

variations in our financial results or the financial results of companies that are perceived to be similar to us;

changes in the structure of healthcare payment systems;

market conditions in the pharmaceutical and biotechnology sectors;

general economic, industry and market conditions; and

the other factors described in this Risk Factors section and in Part I, Item IA of our Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

***If you purchase shares of Series A preferred stock in this offering, assuming the conversion into shares of our common stock, you will suffer immediate dilution of your investment.***

The public offering price per share attributable to each share of common stock issuable upon conversion of our Series A preferred stock being offered in this offering is substantially higher than the net tangible book value per share of our common stock. Therefore, if you purchase shares of our Series A preferred stock in this offering you will suffer immediate and substantial dilution in the net tangible book value of the common stock issuable upon the conversion of Series A preferred stock you purchase in this offering. Based on the public offering price of \$      per share and our net tangible book value as of December 31, 2018, assuming the conversion of shares of our Series A preferred stock to be issued in this offering into      shares of common stock, but excluding the effect of shares of common stock to be issued in the Concurrent Offering, you will experience immediate dilution of \$      per share, representing the difference between our as adjusted net tangible book value per share after giving effect to this offering and the public offering price. To the extent outstanding options are exercised at prices below the public offering price, you will incur further dilution.

***There is no public market for the Series A preferred stock in this offering.***

There is no established public trading market for the Series A preferred stock being offered in this offering, and we do not expect a market to develop. In addition, we do not intend to apply for listing of the Series A preferred stock

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on The Nasdaq Global Select Market, any other national securities exchange or any other nationally recognized trading system. Without an active market, the liquidity of the Series A preferred stock will be limited.

### ***An active trading market for our common stock may not be sustained following this offering.***

Although our common stock is listed on The Nasdaq Global Select Market, an active trading market for our shares may not be sustained. If an active market for our common stock does not continue, it may be difficult for you to sell any shares of common stock issuable upon conversion of shares of Series A preferred stock purchased in this offering. Any inactive trading market for our common stock may also impair our ability to raise capital to continue to fund our operations by selling shares and may impair our ability to acquire other companies or technologies by using our shares as consideration.

### ***We have broad discretion over the use of our cash and cash equivalents and marketable securities, including the net proceeds we receive in this offering and the Concurrent Offering, and may not use them effectively.***

Our management has broad discretion to use our cash and cash equivalents and marketable securities, including the net proceeds we receive in this offering and the Concurrent Offering, to fund our operations and could spend these funds in ways that do not improve our results of operations or enhance the value of our common stock. The failure by our management to apply these funds effectively could result in financial losses that could have a material adverse effect on our business, cause the price of our common stock to decline and delay the development of our product candidates. Pending their use to fund operations, we may invest our cash and cash equivalents in a manner that does not produce income or that loses value.

### ***We will continue to incur increased costs as a result of operating as a public company, and our management will be required to devote substantial time to compliance initiatives and corporate governance practices.***

As a public company, and particularly now that we are no longer an emerging growth company as of January 1, 2019, we will continue to incur significant legal, accounting and other expenses. The Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act, the listing requirements of The Nasdaq Global Select Market and other applicable securities rules and regulations impose various requirements on public companies, including establishment and maintenance of effective disclosure and financial controls and corporate governance practices. Our management and other personnel will need to continue to devote a substantial amount of time to these compliance initiatives. Moreover, these rules and regulations will increase our legal and financial compliance costs and make some activities more time-consuming and costly.

We cannot predict or estimate the amount of additional costs we may incur to continue to operate as a public company, nor can we predict the timing of such costs. These rules and regulations are often subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies which could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, or Section 404, we are required to furnish a report by our management on our internal control over financial reporting. Now that we are no longer an emerging growth company, we are also required to include an attestation report on internal control over financial reporting issued by our independent registered public accounting firm. To achieve compliance with Section 404 within the prescribed period, we are engaged in a process to document and evaluate our internal control over financial reporting, which is both costly and challenging. In this regard, we have and will need to continue to dedicate internal resources, engage

outside consultants and adopt a detailed work plan to assess and document the adequacy of internal control over financial reporting, continue steps to improve control processes as appropriate, validate through testing that controls are functioning as documented and implement a continuous reporting and improvement process for internal control over financial reporting. If we or our auditors identify one or more material weaknesses, it could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements.

***Because we do not anticipate paying any cash dividends on our capital stock in the foreseeable future, capital appreciation, if any, will be the sole source of gain for our stockholders.***

We have never declared or paid cash dividends on our capital stock. We currently intend to retain all of our future earnings, if any, to finance the growth and development of our business. In addition, the terms of any future debt agreements may preclude us from paying dividends. As a result, capital appreciation, if any, of our common stock will be the sole source of gain for our stockholders for the foreseeable future.



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***If securities or industry analysts do not continue to publish research or publish inaccurate or unfavorable research about our business, our share price and trading volume could decline.***

The trading market for our common stock may be impacted, in part, by the research and reports that securities or industry analysts publish about us or our business. There can be no assurance that analysts will cover us, continue to cover us or provide favorable coverage. If one or more analysts downgrade our stock or change their opinion of our stock, our share price may decline. In addition, if one or more analysts cease coverage of our company or fail to regularly publish reports on us, we could lose visibility in the financial markets, which could cause our share price or trading volume to decline.

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**USE OF PROCEEDS**

We estimate that the net proceeds to us from our issuance and sale of shares of our Series A preferred stock in this offering will be approximately \$      million, or approximately \$      million if the underwriters exercise their option to purchase additional shares in full, in each case after deducting underwriting discounts and commissions and estimated offering expenses payable by us. In addition, we estimate that the net proceeds to us from our issuance and sale of common stock in the Concurrent Offering will be approximately \$      million, or approximately \$      million if the underwriters exercise their option to purchase additional shares of common stock in full, in each case after deducting underwriting discounts and commissions and estimated offering expenses payable by us. This offering is not contingent upon the completion of the Concurrent Offering, and the Concurrent Offering is not contingent upon the completion of this offering.

As of December 31, 2018, we had cash, cash equivalents and marketable securities of \$240.3 million. We intend to use the net proceeds from this offering and the Concurrent Offering, together with our existing cash, cash equivalents and marketable securities, as follows:

to fund global development costs of tazemetostat outside of Japan, including the costs of the following clinical trials and regulatory activities:

our global Phase 2 trial in patients with certain molecularly defined solid tumors, including our epithelioid sarcoma cohort in the trial, the preparation and submission of an NDA for accelerated approval for epithelioid sarcoma, and the initiation of a confirmatory clinical program, including the potential use of a natural history study, to verify clinical benefit and support the full approval of tazemetostat in patients with epithelioid sarcoma that could serve as a confirmatory trial as part of an accelerated approval strategy;

our global Phase 2 trial in patients with NHL, including our relapsed or refractory FL cohorts in the trial, continuing engagement with the FDA regarding the registration pathway in FL and preparation and submission of an NDA for accelerated approval for FL, and the initiation of a confirmatory clinical program to verify clinical benefit and support the full approval of tazemetostat for FL as part of an accelerated approval strategy and planned clinical trials to assess tazemetostat in earlier lines of treatment for FL; and

our planned clinical trials of tazemetostat in combination with other anti-cancer agents in multiple hematological malignancies and solid tumor indicators, including in castration-resistant prostate cancer and platinum-resistant solid tumors;

to fund the necessary pre-commercialization and launch related activities for tazemetostat and the execution of the initial commercial launch of tazemetostat for epithelioid sarcoma and relapsed and/or refractory follicular lymphoma, if approved;

to fund any milestone payments due under our amended and restated collaboration and license agreement with Eisai, including up to an aggregate of \$70 million in milestone payments associated with submission of NDAs in epithelioid sarcoma and FL and upon regulatory approval of tazemetostat for the treatment of epithelioid sarcoma and FL in the United States;

to fund research and development costs to develop other product candidates, including the costs of our planned initial clinical trial of EZM8266 for sickle cell disease; and

for working capital and other general corporate purposes.

This expected use of our net proceeds from this offering and the Concurrent Offering represents our intentions based upon our current plans and business conditions, which could change in the future as our plans and business conditions evolve. The amounts and timing of our actual expenditures may vary significantly depending on numerous factors, including the progress of our development, the status of and results from clinical trials, as well as any collaborations that we may enter into with third parties for our product candidates, and any unforeseen cash needs. As a result, our management will retain broad discretion over the allocation of the net proceeds from this offering. We may find it necessary or advisable to use the net proceeds from this offering and the Concurrent Offering for other purposes, and we will have broad discretion in the application of net proceeds.

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Based on our research and development plans and our timing expectations related to the progress of our programs, we expect that the net proceeds from this offering and the Concurrent Offering, together with our existing cash, cash equivalents and marketable securities as of December 31, 2018, will enable us to fund our operating expenses and capital expenditure requirements at least into the first quarter of 2021. We believe that our available funds following this offering and the Concurrent Offering will be sufficient to enable us to complete our global Phase 2 trials in NHL and certain INI1-negative tumors, including the FL and epithelioid sarcoma cohorts in those trials; to submit NDAs to the FDA for tazemetostat for the treatment of epithelioid sarcoma and FL and to initiate confirmatory programs in both epithelioid sarcoma and FL; and to perform pre-commercialization activities and commercially launch tazemetostat for the treatment of epithelioid sarcoma and FL, if approved. However, it is possible that we will not achieve the progress that we expect with these funds because the actual costs and timing of clinical development, regulatory and commercial activities are difficult to predict and are subject to substantial risks and delays, and that we will use our capital resources sooner than we currently expect.

Pending our use of the net proceeds from this offering and the Concurrent Offering, we intend to invest the net proceeds in a variety of capital preservation investments, including short-term, investment-grade, interest-bearing instruments and U.S. government securities.

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**DILUTION**

Our historical net tangible book value as of December 31, 2018 was \$233 million, or \$2.94 per share of common stock. Historical net tangible book value per share represents the amount of our total tangible assets less total liabilities, divided by the number of shares of our common stock outstanding as of December 31, 2018.

After giving effect to our issuance and sale of \_\_\_\_\_ shares of our Series A preferred stock in this offering at the public offering price of \$ \_\_\_\_\_ per share, assuming the conversion of all shares of our Series A preferred stock sold in this offering into \_\_\_\_\_ shares of our common stock, and after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us, our as adjusted net tangible book value as of December 31, 2018 would have been \$ \_\_\_\_\_ million, or \$ \_\_\_\_\_ per share. This represents an immediate increase of \$ \_\_\_\_\_ in as adjusted net tangible book value per share to existing stockholders and immediate dilution of \$ \_\_\_\_\_ in as adjusted net tangible book value per share of common stock to new investors purchasing common stock into which the shares of Series A preferred stock are convertible. Dilution per share to new investors is determined by subtracting as adjusted net tangible book value per share after this offering from the public offering price per share current and accumulated earnings and profits would be treated first as a return of capital to the extent of the stockholder's tax basis, and any remaining distributions would be treated as a capital gain.

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

**Regulation as a Business Development Company**

*General*

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

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

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*Qualifying Assets*

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

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- (1) Securities purchased in transactions not involving any public offering from the issuer of such securities, which issuer (subject to certain limited exceptions) is an eligible portfolio company, or from any person who is, or has been during the preceding 13 months, an affiliated person of an eligible portfolio company, or from any other person, subject to such rules as may be prescribed by the SEC. An "eligible portfolio company" is defined in the 1940 Act as any issuer which:
  - (a) is organized under the laws of, and has its principal place of business in, the United States;
  - (b) is not an investment company (other than a small business investment company wholly owned by the business development company) or a company that would be an investment company but for certain exclusions under the 1940 Act; and
  - (c) satisfies any of the following:
    1. does not have any class of securities with respect to which a broker or dealer may extend margin credit;
    2. is controlled by a business development company or a group of companies including a business development company and the business development company has an affiliated person who is a director of the eligible portfolio company; or
    3. is a small and solvent company having total assets of not more than \$4 million and capital and surplus of not less than \$2 million;
    4. does not have any class of securities listed on a national securities exchange; or
    5. has a class of securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity of less than \$250 million.
- (2) Securities in companies that were eligible portfolio companies when we made our initial investment if certain other requirements are satisfied.
- (3) Securities of any eligible portfolio company which we control.
- (4) Securities purchased in a private transaction from a U.S. issuer that is not an investment company or from an affiliated person of the issuer, or in transactions incident thereto, if the issuer is in bankruptcy and subject to reorganization or if the issuer, immediately prior to the purchase of its securities was unable to meet its obligations as they came due without material assistance other than conventional lending or financing agreements.
- (5) Securities of an eligible portfolio company purchased from any person in a private transaction if there is no ready market for such securities and we already own 60% of the outstanding equity of the eligible portfolio company.
- (6) Securities received in exchange for or distributed on or with respect to securities described in (1) through (4) above, or pursuant to the exercise of warrants or rights relating to such securities.
- (7) Cash, cash equivalents, U.S. government securities or high-quality debt securities maturing in one year or less from the time of investment.

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

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### *Managerial Assistance to Portfolio Companies*

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

### *Temporary Investments*

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

### *Senior Securities*

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

### **Investment Concentration**

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

### **Compliance Policies and Procedures**

We and our Investment Adviser have adopted and implemented written policies and procedures reasonably designed to prevent violation of the federal securities laws, and are required to review these compliance policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a Chief Compliance Officer to be responsible for administering the policies and procedures. William E. Vastardis served as our Chief Compliance Officer until September 30, 2008. Brian H. Oswald has served as our Chief

Compliance Officer since October 1, 2008.

### **Proxy Voting Policies and Procedures**

We have delegated our proxy voting responsibility to Prospect Capital Management. The guidelines are reviewed periodically by Prospect Capital Management and if required, our independent directors, and, accordingly, are subject to change. As an investment adviser registered under the Advisers Act, Prospect Capital Management has a fiduciary duty to act in the best interests of its clients. As part of this duty, Prospect Capital Management recognizes that it must vote client securities in a timely manner free of conflicts of interest and in the best interests of its clients.

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

### **Sarbanes-Oxley Act of 2002**

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

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

### **Available Information**

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

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

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

### **Forward Looking Information**



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

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

- our future operating results;
- our business prospects and the prospects of our portfolio companies;
- the impact of investments that we expect to make;
- our contractual arrangements and relationships with third parties;
- the dependence of our future success on the general economy and its impact on the industries in which we invest;
- the ability of our portfolio companies to achieve their objectives;
- difficulty in obtaining financing or raising capital, especially in the current credit and equity environment;
- the level and volatility of prevailing interest rates and credit spreads, magnified by the current turmoil in the credit markets;
- adverse developments in the availability of desirable loan and investment opportunities whether they are due to competition, regulation or otherwise;
- a compression of the yield on our investments and the cost of our liabilities, as well as the level of leverage available to us;
- our regulatory structure and tax treatment, including our ability to operate as a business development company and a regulated investment company;

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- the adequacy of our cash resources and working capital;
  - the timing of cash flows, if any, from the operations of our portfolio companies;
  - the ability of our investment adviser to locate suitable investments for us and to monitor and administer our investments.;
  - authoritative generally accepted accounting principles or policy changes from such standard-setting bodies as the Financial Accounting Standards Board, the Securities and Exchange Commission, Internal Revenue Service, the New York Stock Exchange, and other authorities that we are subject to, as well as their counterparts in any foreign jurisdictions where we might do business; and
  - the risk factors set forth below.

## Risks Relating To Our Business

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

Prospect Capital Management has been registered as an investment adviser since March 31, 2004, and we have been organized as a closed-end investment company since April 13, 2004. As such, each entity is subject to the business risks and uncertainties associated with any young business enterprise, including the limited experience in managing or operating a business development company under the 1940 Act. Our ability to achieve our investment objective depends on our ability to grow, which depends, in turn, on our Investment Adviser's ability to continue to identify, analyze, invest in and monitor companies that meet our investment criteria. Accomplishing this result on a cost-effective basis is largely a function of our Investment Adviser's structuring of

investments, its ability to provide competent, attentive and efficient services to us and our access to financing on acceptable terms. As we continue to grow, Prospect Capital Management will need to continue to hire, train, supervise and manage new employees. Failure to manage our future growth effectively could have a materially adverse effect on our business, financial condition and results of operations.

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

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

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

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

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

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

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

A large percentage of our portfolio investments consist of securities of privately held companies. Hence, market quotations are generally not readily available for determining the fair values of such investments. The determination of fair value, and thus the amount of unrealized losses we may incur in any year, is to a degree subjective, and the Investment Adviser has a conflict of interest in making the determination. We value these securities quarterly at fair value as determined in good faith by our Board of Directors based on input from our Investment Adviser, a third party independent valuation firm and our audit committee. Our Board of Directors utilizes the services of an independent valuation firm to aid it in determining the fair value of any securities. The types of factors that may be considered in determining the fair values of our investments include the nature and

realizable value of any collateral, the portfolio company's ability to make payments and its earnings, the markets in which the portfolio company does business, comparison to publicly traded companies, discounted cash flow, current market interest rates and other relevant factors. Because such valuations, and particularly valuations of private securities and private companies, are inherently uncertain, the valuations may fluctuate significantly over short periods of time due to changes in current market conditions. The determinations of fair value by our Board of Directors may differ materially from the values that would have been used if an active market and market quotations existed for these investments. Our net asset value could be adversely affected if the determinations regarding the fair value of our investments were materially higher than the values that we ultimately realize upon the disposal of such securities.

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

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

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

- A likelihood of greater volatility in the net asset value and market price of our common stock;
- Diminished operating flexibility as a result of asset coverage or investment portfolio composition requirements required by lenders or investors that are more stringent than those imposed by the 1940 Act;
- The possibility that investments will have to be liquidated at less than full value or at inopportune times to comply with debt covenants or to pay interest or dividends on the leverage;
- Increased operating expenses due to the cost of leverage, including issuance and servicing costs;
- Convertible or exchangeable securities issued in the future may have rights, preferences and privileges more favorable than those of our common stock; and
- Subordination to lenders' superior claims on our assets as a result of which lenders will be able to receive proceeds available in the case of our liquidation before any proceeds are distributed to our stockholders.

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

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

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

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

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

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

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

Our portfolio consists primarily of level 3 assets for which there is no actively traded market. The illiquidity of our investments may make it difficult for us to sell such investments if the need arises. During the period beginning August 28, 2007 until August 27, 2009, the S&P/LSTA Index (comprising approximately the largest 1,000 leveraged loans outstanding from time to time) declined by 13%. If we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded our investments.

*We may experience fluctuations in our quarterly results.*

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

*Our most recent net asset value was calculated on June 30, 2009 and our NAV when calculated effective September 11, 2009 may be higher or lower.*

Our most recently estimated NAV per share is \$11.36 on an as adjusted basis solely to give effect to our payment of the July dividend recorded on ex-dividend date of July 6, 2009 and issuance of common shares on July 20, 2009 in connection with our dividend reinvestment plan, and issuances on July 7, 2009 and August 20, 2009 in underwritten common and unregistered direct common stock offerings, respectively, versus \$12.40 determined by us as of June 30, 2009. NAV as of September 11, 2009 may be higher or lower than \$11.36 based on potential changes in valuations. Our Board of Directors has not yet determined the fair value of portfolio investments subsequent to June 30, 2009. Our Board of Directors determines the fair value of our portfolio investments on a quarterly basis in connection with the preparation of quarterly financial statements and based on input from an independent valuation firm, our Investment Advisor and the audit committee of our Board of Directors.

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

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

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

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

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

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

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

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

The incentive fee payable by us to Prospect Capital Management could create an incentive for our Investment Adviser to invest on our behalf in instruments, such as zero coupon bonds, that have a deferred interest feature. Under these investments, we would accrue interest income over the life of the investment but would not receive payments in cash on the investment until the end of the term. Our net investment income used to calculate the income incentive fee, however, includes accrued interest. For example, accrued interest, if any, on our investments in zero coupon bonds will be included in the calculation of our incentive fee, even though we will not receive any cash interest payments in respect of payment on the bond until its maturity date. Thus, a portion of

this incentive fee would be based on income that we may not have yet received in cash.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

As a BDC regulated under provisions of the 1940 Act, we are not generally able to issue and sell our common stock at a price below the current net asset value per share. We may, however, sell our common stock, or warrants, options or rights to acquire our common stock, at a price below the current net asset value of our common stock in a rights offering to our stockholders or if (1) our Board of Directors determines that such sale is in the Company's and our stockholders' best interests, (2) our stockholders approve the sale of our common stock at a price that is less than the current net asset value, and (3) the price at which our common stock is to be issued and sold may not be less than a price which, in the determination of our Board of Directors, closely approximates the market value of these securities (less any sales load). If our common stock trades at a discount to net asset value, this restriction could adversely affect our ability to raise capital. At our annual meeting of stockholders held February 12, 2009, we obtained such approval from our shareholders. See ["If we sell common stock at a discount to our net asset value per share, stockholders who do not participate in such sale will experience immediate dilution in an amount that may be material"](#) discussed below.

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

Alternatively, we may securitize our future loans to generate cash for funding new investments. To securitize loans, we may create a wholly owned subsidiary and contribute a pool of loans to such subsidiary. This could include the sale of interests in the loans by the subsidiary on a non-recourse basis to purchasers who we would expect to be willing to accept a lower interest rate to invest in investment grade loan pools. We would retain a portion of the equity in the securitized pool of loans. An inability to successfully securitize our loan portfolio could

limit our ability to grow our business and fully execute our business strategy, and could decrease our earnings, if any. Moreover, the successful securitization of our loan portfolio exposes us to a risk of loss for the equity we retain in the securitized pool of loans and might expose us to losses because the residual loans in which we do not sell interests may tend to be those that are riskier and more likely to generate losses. A successful securitization may also impose financial and operating covenants that restrict our business activities and may include limitations that could hinder our ability to finance additional loans and investments or to make the distributions required to maintain our status as a RIC under Subchapter M of the Code. The 1940 Act may also impose restrictions on the structure of any securitizations.

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

Common stock of BDCs, like that of closed-end investment companies, frequently trades at a discount to current net asset value. Recently, our common stock has traded at a discount to our net asset value, adversely affecting our ability to raise capital. The risk that our common stock may continue to trade at a discount to our net asset value is separate and distinct from the risk that our net asset value per share may decline.

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

At our annual meeting of stockholders held on February 12, 2009, our stockholders approved our ability to sell an unlimited number of shares of our common stock at any level of discount from net asset value per share during the 12 month period following such approval in accordance with the exception described above in ☐☐ Regulations governing our operation as a business development company affect our ability to raise, and the way in which we raise, additional capital.☐ The issuance or sale by us of shares of our common stock at a discount to net asset value poses a risk of dilution to our stockholders. In particular, stockholders who do not purchase additional shares at or below the discounted price in proportion to their current ownership will experience an immediate decrease in net asset value per share (as well as in the aggregate net asset value of their shares if they do not participate at all). These stockholders will also experience a disproportionately greater decrease in their participation in our earnings and assets and their voting power than the increase we experience in our assets, potential earning power and voting interests from such issuance or sale. They may also experience a reduction in the market price of our common stock.

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

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

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

Since in some cases we may recognize taxable income before or without receiving cash representing such income, we may have difficulty meeting the tax requirement to distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to maintain RIC tax treatment. Accordingly, we may have to sell some of our investments at times we would not consider advantageous, raise additional debt or equity capital or reduce new investment originations to meet these



distribution requirements. If we are not able to obtain cash from other sources, we may fail to qualify for RIC treatment and thus become subject to corporate-level income tax. See [Regulation Senior Securities] and [Material U.S. Federal Income Tax Considerations].

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

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

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

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

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

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

As of June 30, 2009, we had invested in a number of companies in the energy and energy related industries. A consequence of this lack of diversification is that the aggregate returns we realize may be significantly and adversely affected if a small number of such investments perform poorly or if we need to write down the value of any one investment. Beyond our income tax diversification requirements, we do not have fixed guidelines for diversification, and our investments are concentrated in relatively few portfolio companies. In addition, to date we have concentrated on making investments in the energy industry. While we expect to be less focused on the energy and energy related industries in the future, we anticipate that we will continue to have significant holdings in the energy and energy related industries. As a result, a downturn in the energy industry could materially and adversely affect us.

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*The energy industry is subject to many risks.*

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

- **Commodity Pricing Risk.** Energy companies in general are directly affected by energy commodity prices, such as the market prices of crude oil, natural gas and wholesale electricity, especially for those that own the underlying energy commodity. In addition, the volatility of commodity prices can affect other energy companies due to the impact of prices on the volume of commodities transported, processed, stored or distributed and on the cost of fuel for power generation companies. The volatility of commodity prices can also affect energy companies' ability to access the capital markets in light of market perception that their performance may be directly tied to commodity prices. Historically, energy commodity prices have been

cyclical and exhibited significant volatility. Although we generally prefer risk controls, including appropriate commodity and other hedges, by certain of our portfolio companies, if available, some of our portfolio companies may not engage in hedging transactions to minimize their exposure to commodity price risk. For those companies that engage in such hedging transactions, they remain subject to market risks, including market liquidity and counterparty creditworthiness. In addition, such companies may also still have exposure to market prices if such companies do not produce volumes or other contractual obligations in accordance with such hedging contracts.

- **Regulatory Risk.** The profitability of energy companies could be adversely affected by changes in the regulatory environment. The businesses of energy companies are heavily regulated by federal, state and local governments in diverse ways, such as the way in which energy assets are constructed, maintained and operated and the prices energy companies may charge for their products and services. Such regulation can change over time in scope and intensity. For example, a particular by-product of an energy process may be declared hazardous by a regulatory agency, which can unexpectedly increase production costs. Moreover, many state and federal environmental laws provide for civil penalties as well as regulatory remediation, thus adding to the potential liability an energy company may face. In addition, the deregulation of energy markets and the unresolved regulatory issues related to some power markets such as California create uncertainty in the regulatory environment as rules and regulations may be adopted on a transitional basis. We cannot assure you that the deregulation of energy markets will continue and if it continues, whether its impact on energy companies' profitability will be positive.
- **Production Risk.** The profitability of energy companies may be materially impacted by the volume of crude oil, natural gas or other energy commodities available for transporting, processing, storing, distributing or power generation. A significant decrease in the production of natural gas, crude oil, coal or other energy commodities, due to the decline of production from existing facilities, import supply disruption, depressed commodity prices, political events, OPEC actions or otherwise, could reduce revenue and operating income or increase operating costs of energy companies and, therefore, their ability to pay debt or dividends.
- **Demand Risk.** A sustained decline in demand for crude oil, natural gas, refined petroleum products and electricity could materially affect revenues and cash flows of energy companies. Factors that could lead to a decrease in market demand include a recession or other adverse economic conditions, an increase in the market price of the underlying commodity, higher taxes or other regulatory actions that increase costs, or a shift in consumer demand for such products.
- **Depletion and Exploration Risk.** A portion of any one energy company's assets may be dedicated to natural gas, crude oil and/or coal reserves and other commodities that naturally deplete over time. Depletion could have a materially adverse impact on such company's ability to maintain its revenue. Further, estimates of energy reserves may not be accurate and, even if accurate, reserves may not be fully utilized at reasonable costs. Exploration of energy resources, especially of oil and gas, is inherently risky and requires large amounts of capital.

- **Weather Risk.** Unseasonable extreme weather patterns could result in significant volatility in demand for energy and power. In addition, hurricanes, storms, tornados, floods, rain, and other significant weather events could disrupt supply and other operations at our portfolio companies as well as customers or suppliers to such companies. This volatility may create fluctuations in earnings of energy companies.
- **Operational Risk.** Energy companies are subject to various operational risks, such as failed drilling or well development, unscheduled outages, underestimated cost projections, unanticipated operation and maintenance expenses, failure to obtain the necessary permits to operate and failure of third-party contractors (for example, energy producers and shippers) to perform their contractual obligations. In addition, energy companies employ a variety of means of increasing cash flow, including increasing utilization of existing facilities, expanding operations through new construction, expanding operations through acquisitions, or securing additional long-term contracts. Thus, some energy companies may be subject to construction risk, acquisition risk or other risk factors arising from their specific business strategies.

- **Competition Risk.** The progress in deregulating energy markets has created more competition in the energy industry. This competition is reflected in risks associated with marketing and selling energy in the evolving energy market and a competitor's development of a lower-cost energy or power source, or of a lower cost means of operations, and other risks arising from competition.
- **Valuation Risk.** Since mid-2001, excess power generation capacity in certain regions of the United States has caused substantial decreases in the market capitalization of many energy companies. While such prices have recovered to some extent, we can offer no assurance that such decreases in market capitalization will not recur, or that any future decreases in energy company valuations will be insubstantial or temporary in nature.
- **Terrorism Risk.** Since the September 11th attacks, the United States government has issued public warnings indicating that energy assets, specifically those related to pipeline infrastructure, production facilities and transmission and distribution facilities, might be specific targets of terrorist activity. The continued threat of terrorism and related military activity will likely increase volatility for prices of natural gas and oil and could affect the market for products and services of energy companies. In addition, any future terrorist attack or armed conflict in the United States or elsewhere may undermine economic conditions in the United States in general.
- **Financing Risk.** Some of our portfolio companies rely on the capital markets to raise money to pay their existing obligations. Their ability to access the capital markets on attractive terms or at all may be affected by any of the risks associated with energy companies described above, by general economic and market conditions or by other factors. This may in turn affect their ability to satisfy their obligations with us.

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

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

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

- these companies may have limited financial resources and may be unable to meet their obligations under their securities that we hold, which may be accompanied by a deterioration in the value of their securities or of any collateral with respect to any securities and a reduction in the likelihood of our realizing on any guarantees we may have obtained in connection with our investment;

- they may have shorter operating histories, narrower product lines and smaller market shares than larger businesses, which tend to render them more vulnerable to competitors' actions and market conditions, as well as general economic downturns;
- because many of these companies are privately held companies, public information is generally not available about these companies. As a result, we will depend on the ability of our Investment Adviser to obtain adequate information to evaluate these companies in making investment decisions. If our Investment Adviser is unable to uncover all material information about these companies, it may not make a fully informed investment decision, and we may lose money on our investments;
- they are more likely to depend on the management talents and efforts of a small group of persons; therefore, the death, disability, resignation or termination of one or more of these persons could have a materially adverse impact on our portfolio company and, in turn, on us;
- they may have less predictable operating results, may from time to time be parties to litigation, may be engaged in changing businesses with products subject to a risk of obsolescence and may require

substantial additional capital to support their operations, finance expansion or maintain their competitive position; and

- they have difficulty accessing the capital markets to meet future capital needs.

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

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

The U.S. and most other economies have entered a recessionary period, which may be prolonged and severe. Our portfolio companies will generally be affected by the conditions and overall strength of the national, regional and local economies, including interest rate fluctuations, changes in the capital markets and changes in the prices of their primary commodities and products. These factors also impact the amount of residential, industrial and commercial growth in the energy industry. Additionally, these factors could adversely impact the customer base and customer collections of our portfolio companies.

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

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

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

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

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

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

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

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

*Our portfolio companies may incur debt or issue equity securities that rank equally with, or senior to, our investments in such companies.*

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

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

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

- our debt investments are primarily made in the form of mezzanine loans, therefore our liens on the collateral, if any, are subordinated to those of the senior secured debt of the portfolio companies, if any. As a result, we may not be able to control remedies with respect to the collateral;
- the collateral may not be valuable enough to satisfy all of the obligations under our secured loan, particularly after giving effect to the repayment of secured debt of the portfolio company that ranks senior to our loan;
- bankruptcy laws may limit our ability to realize value from the collateral and may delay the realization process;
- our rights in the collateral may be adversely affected by the failure to perfect security interests in the collateral;
- the need to obtain regulatory and contractual consents could impair or impede how effectively the collateral would be liquidated and could affect the value received; and
- some or all of the collateral may be illiquid and may have no readily ascertainable market value. The liquidity and value of the collateral could be impaired as a result of changing economic conditions, competition, and other factors, including the availability of suitable buyers.

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

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

Although currently all of our investments are, and we expect that most of our investments will be, U.S. dollar-denominated, investments that are denominated in a foreign currency will be subject to the risk that the value of a particular currency will change in relation to one or more other currencies. Among the factors that may affect currency values are trade balances, the level of short-term interest rates, differences in relative values of similar assets in different currencies, long-term opportunities for investment and capital appreciation, and political developments.

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

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

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

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

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

## **Risks Relating To Our Securities**

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

The investments we make in accordance with our investment objective may result in a higher amount of risk than alternative investment options and volatility or loss of principal. Our investments in portfolio companies may

be speculative and aggressive, and therefore, an investment in our shares may not be suitable for someone with low risk tolerance.

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

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

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

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

As of September 11, 2009, we have 51,865,044 shares of common stock outstanding. Sales of substantial amounts of our securities or the availability of such securities for sale could adversely affect the prevailing market price for our securities. If this occurs and continues it could impair our ability to raise additional capital through the sale of securities should we desire to do so.

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

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

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

Our charter and bylaws and the Maryland General Corporation Law contain provisions that may have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for our stockholders or otherwise be in their best interest.

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

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

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

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

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

As permitted by Maryland law, our bylaws contain a provision exempting from the Maryland Control Share Acquisition Act any and all acquisitions by any person of our common stock. Although our bylaws include such a provision, such a provision may also be amended or eliminated by our Board of Directors at any time in the future.

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

Not applicable



**Item 2. Properties.**

We do not own any real estate or other physical properties materially important to our operation. Our offices are located at 10 East 40th Street, New York, New York 10016, where we occupy our office space pursuant to our Administration Agreement with Prospect Administration. The office facilities, which are shared with our Investment Adviser and Administrator, consist of approximately 8,987 square feet, of which 3,087 square feet were added subsequent to June 30, 2009, and are leased through October 2014. We believe that our office facilities are suitable and adequate for our business as currently conducted.

**Item 3. Legal Proceedings.**

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

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

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

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

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended June 30, 2009.

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

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

<b>Year Ended June 30, 2009</b>	<b>Net Asset Value Per Share (1)</b>	<b>High</b>	<b>Low</b>	<b>Premium (Discount) of High Sales Price to Net Asset Value</b>	<b>Premium (Discount) of Low Sales Price to Net Asset Value</b>
First quarter	\$14.63	\$14.24	\$11.12	(2.7%)	(24.0%)
Second quarter	\$14.43	\$13.08	\$6.29	(9.4%)	(56.4%)
Third quarter	\$14.19	\$12.89	\$6.38	(9.2%)	(55.0%)
Fourth quarter	\$12.40	\$10.48	\$7.95	(15.5%)	(35.9%)
<b>Year Ended June 30, 2008</b>					
First quarter	\$15.08	\$18.68	\$14.16	23.9%	(6.1%)
Second quarter	\$14.58	\$17.17	\$11.22	17.8%	(23.0%)
Third quarter	\$14.15	\$16.00	\$13.55	13.1%	(4.2%)
Fourth quarter	\$14.55	\$16.12	\$13.18	10.8%	(9.4%)
<b>Year Ended June 30, 2007</b>					
First quarter	\$14.86	\$16.77	\$15.30	12.9%	2.3%
Second quarter	\$15.24	\$18.97	\$15.10	24.5%	(0.9%)
Third quarter	\$15.18	\$17.68	\$16.40	16.5%	8.0%
Fourth quarter	\$15.04	\$18.68	\$16.91	24.2%	12.4%

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

On August 31, 2009, the last reported sales price of our common stock was \$10.20 per share. As of August 31, 2009, we had approximately 58 stockholders of record, and we had approximately 31,368 beneficial owners whose shares are held in the names of brokers, dealers and clearing agencies.

**Dividends**

We have paid and intend to continue to distribute quarterly distributions to our stockholders out of assets legally available for distribution. Our distributions, if any, will be determined by our Board of Directors. Certain amounts of the quarterly distributions may from time to time be paid out of our capital rather than from earnings

for the quarter as a result of our deliberate planning or by accounting reclassifications.

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

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

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

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

We maintain an "opt out" dividend reinvestment plan for our common stockholders. As a result, if we declare a dividend, then stockholders' cash dividends will be automatically reinvested in additional shares of our common stock, unless they specifically "opt out" of the dividend reinvestment plan so as to receive cash dividends. See "Dividend Reinvestment Plan." To the extent prudent and practicable, we intend to declare and pay dividends on a quarterly basis.

With respect to the dividends paid to stockholders, income from origination, structuring, closing, commitment and other upfront fees associated with investments in portfolio companies were treated as taxable income and accordingly, distributed to stockholders. During the fiscal year ended June 30, 2009, we declared total dividends of approximately \$56.1 million.

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

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

Declaration Date	Ex-Date	Record Date	Pay Date	Rate	Amount (in thousands)
6/23/2009	7/6/2009	7/8/2009	7/20/2009	\$0.40625	\$ 19,548
3/24/2009	3/27/2009	3/31/2009	4/20/2009	0.40500	12,671
12/19/2008	12/29/2008	12/31/2008	1/19/2009	0.40375	11,966
9/16/2008	9/26/2008	9/30/2008	10/16/2008	0.40250	11,882

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6/19/2008	6/26/2008	6/30/2008	7/16/2008	0.40125	11,845
3/6/2008	3/27/2008	3/31/2008	4/16/2008	0.40000	10,468
12/8/2007	12/26/2007	12/28/2007	1/7/2008	0.39500	9,370
9/6/2007	9/17/2007	9/19/2007	9/28/2007	0.39250	7,830
6/14/2007	6/20/2007	6/22/2007	6/29/2007	0.39000	7,753
3/14/2007	3/21/2007	3/23/2007	3/30/2007	0.38750	7,667
12/15/2006	12/27/2006	12/29/2006	1/5/2007	0.38500	7,264
7/31/2006	9/20/2006	9/22/2006	9/29/2006	0.38000	4,858
6/14/2006	6/21/2006	6/23/2006	6/30/2006	0.34000	2,401
3/15/2006	3/22/2006	3/24/2006	3/31/2006	0.30000	2,117
12/12/2005	12/20/2005	12/22/2005	12/29/2005	0.28000	1,975
9/15/2005	9/20/2005	9/22/2005	9/29/2005	0.20000	1,411
4/21/2005	6/8/2005	6/10/2005	6/30/2005	0.15000	1,058
2/9/2005	3/9/2005	3/11/2005	3/31/2005	0.12500	882
11/11/2004	12/8/2004	12/10/2004	12/30/2004	0.10000	706
				Since Inception	\$133,672

### Dividend Reinvestment

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

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

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

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

During the year ended June 30, 2009, we distributed 613,361 shares of common stock in accordance with this dividend reinvestment plan. 480,205 shares were distributed from new issues, and 133,156 shares were distributed from common stock re-acquired from the open market.

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

Record Date	Shares Issued	Aggregate Offering Price (in thousands)	% of Dividend
March 31, 2009	214,456	\$1,827	14.4%
December 31, 2008	148,200	1,774	14.8%
September 30, 2008	117,549	1,506	12.7%
March 31, 2008	99,241	1,510	14.4%

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September 19, 2007	72,073	1,243	15.9%
June 22, 2007	69,834	1,190	15.3%
March 23, 2007	93,843	1,595	20.8%
December 29, 2006	108,047	1,850	25.5%
September 22, 2006	80,818	1,273	26.2%
June 23, 2006	7,932	130	5.4%
March 24, 2006	6,841	111	5.2%

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

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

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### Stock Performance Graph

This graph compares the return on our common stock with that of the Standard & Poor's 500 Stock Index and the NASDAQ Financial 100 Index, for the period July 27, 2004 (our inception) through June 30, 2009. The graph assumes that, on July 27, 2004, a person invested \$100 in each of our common stock, the S&P 500 Index, and the NASDAQ Financial 100 Index. The graph measures total shareholder return, which takes into account both changes in stock price and dividends. It assumes that dividends paid are invested in like securities.

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

### Sales of unregistered securities

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

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### Item 6. Selected Financial Data.

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

	For the Year/Period Ended June 30,			
	2009	2008	2007	2006
(in thousands except data relating to shares, per share and number of portfolio companies)				
<b>Performance Data:</b>				
Interest income	\$ 62,926	\$ 59,033	\$ 30,084	\$ 13,268
Dividend income	22,793	12,033	6,153	3,601
Other income	14,762	8,336	4,444	□
Total investment income	100,481	79,402	40,681	16,869
Interest and credit facility expenses	(6,161)	(6,318)	(1,903)	(642)
Investment advisory expense	(26,705)	(20,199)	(11,226)	(3,868)
Other expenses	(8,452)	(7,772)	(4,421)	(3,801)
Total expenses	(41,318)	(34,289)	(17,550)	(8,311)
Net investment income	59,163	45,113	23,131	8,558
Realized and unrealized (losses) gains	(24,059)	(17,522)	(6,403)	4,338
Net increase in net assets from operations	\$ 35,104	\$ 27,591	\$ 16,728	\$ 12,896
<b>Per Share Data:</b>				
Net increase in net assets from operations (1)	\$ 1.11	\$ 1.17	\$ 1.06	\$ 1.83
Distributions declared per share	\$ (1.62)	\$ (1.59)	\$ (1.54)	\$ (1.12)
Average weighted shares outstanding for the period	31,559,905	23,626,642	15,724,095	7,056,846
<b>Assets and Liabilities Data:</b>				
Investments	\$ 547,168	\$ 497,530	\$ 328,222	\$ 133,969
Other assets	119,857	44,248	48,280	4,511
Total assets	667,025	541,778	376,502	138,480
Amount drawn on credit facility	124,800	91,167	□	28,500
Amount owed to related parties	6,713	6,641	4,838	745
Other liabilities	2,916	14,347	71,616	965
Total liabilities	134,429	112,155	76,454	30,210
Net assets	\$ 532,596	\$ 429,623	\$ 300,048	\$ 108,270
<b>Investment Activity Data:</b>				
No. of portfolio companies at period end	30	29 (2)	24 (2)	15
Acquisitions	\$ 98,305	\$ 311,947	\$ 167,255	\$ 83,625
Sales, repayments, and other disposals	\$ 27,007	\$ 127,212	\$ 38,407	\$ 9,954
Weighted-Average Yield at end of period (3)	13.7%	15.5%	17.1%	17.0%

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

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

(3) Includes dividends from certain equity investments

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

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

**Overview**

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

The aggregate value of our portfolio investments was \$547,168 and \$497,530 as of June 30, 2009 and June 30, 2008, respectively. During the fiscal year ended June 30, 2009, our net cost of investments increased by \$34,619, or 7.0%, as we invested in three new and several follow-on investments while we sold three investments and we received repayment on four other investments.

Compared to the end of last fiscal year (ended June 30, 2008), net assets increased by \$102,973 or 24.0% during the year ended June 30, 2009, from \$429,623 to \$532,596. This increase resulted from the issuance of new shares of our common stock (less offering costs) in the amount of \$99,281, dividend reinvestments of \$5,107, and another \$35,104 from operations. These increases, in turn, were offset by \$36,519 in dividend distributions to our stockholders. The \$35,104 increase in net assets resulting from operations is net of the following: net investment income of \$59,163, realized loss on investments of \$39,078, and a net increase in net assets due to changes in net unrealized appreciation of investments of \$15,019. On June 30, 2009, we determined that the impairment of the Change Clean Energy Holdings, Inc. (["CCEHI"]) investment (formerly known as Worchester Energy Partners, Inc. (["WEPI"])) was other than temporarily impaired and recognized a realized loss for the amount by which the amortized cost exceeded the current fair value. This loss was partially offset by realized gains from sales of the Arctic Acquisition Corp. (["Arctic"]) warrants and Deep Down, Inc. (["Deep Down"]) common stock. The net unrealized appreciation was driven by significant write-ups of our investments in American Gilsonite Company (["AGC"]), Gas Solutions Holdings, Inc. (["GSHI"] or ["Gas Solutions"]), NRG Manufacturing, Inc. (["NRG"]), R-V Industries, Inc. (["R-V"]), Shearer's Foods, Inc. (["Shearer's"]) and Stryker Energy, LLC (["Stryker"]) due to improvements in operations, and by the disposition of previously written-down investment in CCEHI mentioned above, which, in turn, were offset by significant write-downs our investments in Ajax Rolled Ring & Machine (["Ajax"]), Appalachian Energy Holdings LLC (["AEH"]), Conquest Cherokee, LLC (["Conquest"]), Deb Shops, Inc. (["Deb Shops"]), Iron Horse Coiled Tubing, Inc. (["Iron Horse"]) and Yatesville Coal Holdings, Inc. (["Yatesville"]) due to deterioration in operations combined with general increases in lending rates.

We seek to be a long-term investor with our investment companies. To date we have invested primarily in industries related to the industrial/energy economy. However, we continue to widen our strategy focus in other sectors of the economy to diversify our portfolio holdings.

## Market Conditions

In 2008 and early 2009, the financial services industry has been negatively affected by turmoil in the global capital markets. What began in 2007 as a deterioration of credit quality in subprime residential mortgages has spread rapidly to other credit markets. Market liquidity and credit quality conditions are significantly weaker today than two years ago.

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We believe that Prospect Capital is well positioned to navigate through these adverse market conditions. As a business development company, we are limited to a maximum 1 to 1 debt to equity ratio, and as of June 30, 2009, our debt to equity ratio was 0.23 to 1. As of June 30, 2009, we have borrowed \$124,800 against our credit facility with Rabobank Nederland, which outstanding balance was reduced to zero subsequent to June 30, 2009. As we make additional investments that are eligible to be pledged under the credit facility, we will generate additional availability. The revolving period for the extended credit facility continues until June 25, 2010, with an expected maturity on June 25, 2011.

We also continue to generate liquidity through stock offerings and the realization of portfolio investments. On March 19, 2009, April 27, 2009, May 26, 2009, and July 7, 2009, we completed public stock offerings for 1,500,000 shares, 3,680,000 shares, 7,762,500 shares, and 5,175,000 shares, of our common stock at \$8.20 per share, \$7.75 per share, \$8.25 per share, \$9.00 per share, raising \$12,300, \$28,520, \$64,040, and \$46,580 of gross proceeds, respectively. On August 20, 2009, we issued 3,449,686 shares at \$8.50 per share in a private stock offering generating \$29,322 of gross proceeds from the offering. Concurrent with the sale of these shares,

we entered into a registration rights agreement in which we granted the purchasers certain registration rights with respect to the shares. Under the terms and conditions of the registration rights agreement, we will use our reasonable best efforts to file with the SEC within sixty (60) days a post-effective amendment to the registration statement on Form N-2 and will also use our reasonable best efforts to cause such post-effective amendment to be declared effective by the SEC within one hundred twenty (120) days. Under the registration rights agreement, we may be obligated to make liquidated damages payments to holders upon certain events.

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

#### **Fourth Quarter Highlights**

On April 27, 2009, we closed a public offering of 3,680,000 shares of our common stock (including the exercise of over-allotment options of our underwriters). The net proceeds to us were approximately \$26,956 after deducting estimated offering expenses.

On May 26, 2009, we closed a public offering of 7,762,500 shares of our common stock (including the exercise of over-allotment options of our underwriters). The net proceeds to us were approximately \$60,539 after deducting estimated offering expenses.

On June 23, 2009, we declared our fourth fiscal quarter (for the fiscal year ending June 30, 2009) dividend of \$0.40625 per share. The ex-dividend and record dates were July 6, 2009 and July 8, 2009, respectively. This dividend marked the Company's 19<sup>th</sup> consecutive quarterly increase.

#### **Recent Developments**

On July 6, 2009, and July 8, 2009, we paid down \$50,500 and \$74,300 of our revolving credit facility, respectively, reducing our outstanding borrowing to zero.

On July 7, 2009, we closed a public offering of 5,175,000 shares of our common stock (including the exercise of over-allotment options of our underwriters). The net proceeds to us were approximately \$44,046 after deducting estimated offering expenses.

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On July 20, 2009, we issued 297,294 shares of our common stock in connection with the dividend reinvestment plan.

On August 3, 2009, we announced that we had entered into a definitive agreement to acquire Patriot Capital Funding, Inc. (NASDAQ: PCAP) (Patriot) for approximately \$197,000 comprised of our common stock and cash to repay all Patriot debt, anticipated to be \$110,500 when the acquisition closes. Our common shares will be exchanged at a ratio of approximately 0.3992 for each Patriot share, or 8,616,467 shares of our common stock for 21,584,251 Patriot shares, with such exchange ratio decreased for any tax distributions Patriot may declare before closing. In return, we will acquire assets with an amortized cost of approximately \$311,000 for approximately \$196,000, based on an estimate of our common stock price of \$10 per share and the anticipated debt outstanding at the closing, for which the value of either may change prior to the closing. We, in conjunction with an independent valuation agent, have determined that the fair value of the assets is approximate to the anticipated purchase price and does not anticipate recording any material gain on the consummation of the transaction.

On August 20, 2009, we issued 3,449,686 shares at \$8.50 per share in a private stock offering. The net proceeds to us were approximately \$29,205 after deducting legal and advisory fees. Concurrent with the sale of these shares, we entered into a registration rights agreement in which we granted the purchasers certain registration rights with respect to the Shares. Under the terms and conditions of the registration rights



agreement, we will use our reasonable best efforts to file with the SEC within sixty (60) days a post-effective amendment to the registration statement on Form N-2 and will also use our reasonable best efforts to cause such post-effective amendment to be declared effective by the SEC within one hundred twenty (120) days. Under the registration rights agreement, the Corporation may be obligated to make liquidated damages payments to holders upon certain events.

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

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

#### *Critical Accounting Policies and Estimates*

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

#### *Basis of Consolidation*

Under the 1940 Act rules, the regulations pursuant to Article 6 of Regulation S-X, and the American Institute of Certified Public Accountants' Audit and Accounting Guide for Investment Companies, we are precluded from consolidating any entity other than another investment company or an operating company which provides substantially all of its services and benefits to us. Our June 30, 2009, and June 30, 2008 financial statements include our accounts and the accounts of Prospect Capital Funding, LLC, our only wholly-owned, closely-managed subsidiary that is also an investment company. All intercompany balances and transactions have been eliminated in consolidation.

#### *Investment Classification*

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

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

#### *Investment Valuation*

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

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

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

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

In September, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. We adopted this statement on a prospective basis beginning in the quarter ended September 30, 2008. Adoption of this statement did not have a material effect on our financial position or results.

FAS 157 classifies the inputs used to measure these fair values into the following hierarchy:

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

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

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

In all cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to each investment.

The changes to generally accepted accounting principles from the application of FAS 157 relate to the definition of fair value, framework for measuring fair value, and the expanded disclosures about fair value measurements. FAS 157 applies to fair value measurements already required or permitted by other standards.

In accordance with FAS 157, the fair value of our investments is defined as the price that we would receive upon selling an investment in an orderly transaction to an independent buyer in the principal or most advantageous market in which that investment is transacted.

In April 2009, FASB issued Staff Position No. 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" (FSP FAS 157-4). FSP FAS 157-4 provides further clarification for the application of FAS 157 in

markets that are not active and provides additional guidance for determining when the volume of trading level of activity for an asset or liability has significantly decreased and for identifying circumstances that indicate a transaction is not orderly. FSP FAS 157-4 is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of FSP FAS 157-4 for the year ended June 30, 2009, did not have any effect on our net asset value, financial position or results of operations as there was no change to the fair value measurement principles set forth in FAS 157.

### *Revenue Recognition*

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

Interest income, adjusted for amortization of premium and accretion of discount, is recorded on an accrual basis. Origination, closing and/or commitment fees associated with investments in portfolio companies are accreted into interest income over the respective terms of the applicable loans. Upon the prepayment of a loan or debt security, any prepayment penalties and unamortized loan origination, closing and commitment fees are recorded as interest income.

Loans are placed on non-accrual status when principal or interest payments are past due 90 days or more or when there is reasonable doubt that principal or interest will be collected. Unpaid accrued interest is generally reversed when a loan is placed on non-accrual status. Interest payments received on non-accrual loans may be recognized as income or applied to principal depending upon management's judgment. Non-accrual loans are restored to accrual status when past due principal and interest is paid and in management's judgment, are likely to remain current. As of June 30, 2009, approximately 7.3% of our net assets are in non-accrual status.

Dividend income is recorded on the ex-dividend date.

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

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### *Federal and State Income Taxes*

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

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

We adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 provides guidance for how uncertain tax positions should be recognized, measured, presented, and disclosed in the financial statements. FIN 48 requires the evaluation of tax positions taken or expected to be taken in the course of preparing the Company's tax returns to determine whether the tax positions are "more-likely-than-not" of being sustained by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. Adoption of FIN 48 was applied to all open tax years as of July 1, 2007. The adoption of FIN 48 did not have an effect on our net asset value, financial condition or results of operations as there was no liability for unrecognized tax benefits and no change to our

beginning net asset value. As of June 30, 2009 and for the year then ended, we did not have a liability for any unrecognized tax benefits. Management's determinations regarding FIN 48 may be subject to review and adjustment at a later date based upon factors including, but not limited to, an on-going analysis of tax laws, regulations and interpretations thereof.

#### *Dividends and Distributions*

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

#### *Financing Costs*

We record origination expenses related to its credit facility as deferred financing costs. These expenses are deferred and amortized as part of interest expense using the straight-line method, which approximates the effective interest method, over the stated life of the facility.

We record registration expenses related to shelf filings as prepaid assets. These expenses consist principally of SEC registration, legal and accounting fees incurred through June 30, 2009 that are related to the shelf filings that will be charged to capital upon the receipt of the capital or charged to expense if not completed.

#### *Guarantees and Indemnification Agreements*

We follow FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45). FIN 45 elaborates on the disclosure requirements of a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires a guarantor to recognize, at the inception of a guarantee, for those guarantees that are covered by FIN 45, the fair value of the obligation undertaken in issuing certain guarantees. FIN 45 did not have a material effect on the financial statements.

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#### *Valuation of Other Financial Assets and Financial Liabilities*

In February 2007, FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - including an amendment of FASB Statement No. 115" (FAS 159). FAS 159 permits an entity to elect fair value as the initial and subsequent measurement attribute for many of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. We have adopted this statement on July 1, 2008 and have elected not to value some assets and liabilities at fair value as would be permitted by FAS 159.

#### *Recent Accounting Pronouncements*

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (R), "Business Combinations" (FAS 141(R)). FAS 141(R) establishes accounting principles and disclosure requirements for all transactions in which a company obtains control over another business. The standard is effective for fiscal years beginning after December 15, 2008. Our management does not believe that the adoption of FAS 141(R) will have a material impact on our financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, "Disclosures about Derivative Instruments and Hedging Activities" an amendment of FASB Statement No. 133 (FAS 161). FAS 161 is intended to improve financial reporting for derivative instruments by requiring enhanced disclosure that enables investors to understand how and why the entity uses derivatives, how derivatives are accounted for, and how derivatives affect an entity's results of operations, financial position, and cash flows. FAS 161 becomes effective for fiscal years beginning after November 15, 2008; therefore, is applicable for our fiscal year beginning

July 1, 2009. Our management does not believe that the adoption of FAS 161 will have a material impact on our financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No.162, "The Hierarchy of Generally Accepted Accounting Principles" (FAS 162). FAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP. This statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. Our management does not believe that the adoption of FAS 162 will have a material impact on our financial statements.

In May 2009, the FASB issued Statement of Financial Accounting Standards No. 165, "Subsequent Events" (FAS 165). FAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The standard, which includes a new required disclosure of the date through which an entity has evaluated subsequent events, is effective for interim or annual periods ending after June 15, 2009. We evaluated all events or transactions that occurred after June 30, 2009 up through September 11, 2009, the date we issued the accompanying financial statements. During this period, we did not have any material recognizable subsequent events other than those disclosed in our financial statements.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 168, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles" a replacement of FASB Statement No. 162 (FAS 168). FAS 168 provides for the FASB Accounting Standards Codification (the Codification) to become the single official source of authoritative, nongovernmental GAAP. The Codification did not change GAAP but reorganizes the literature. FAS 168 is effective for interim and annual periods ending after September 15, 2009. Our management does not believe that the adoption of FAS 168 will have a material impact on our financial statements.

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### *Per Share Information*

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

### **Investment Holdings**

As of June 30, 2009, we continue to pursue our investment strategy. Despite our name change to "Prospect Capital Corporation" and the termination of our policy to invest at least 80% of our net assets in energy companies in May 2007, we currently have a concentration of investments in companies in the energy and energy related industries. Some of the companies in which we invest have relatively short or no operating histories. These companies are and will be subject to all of the business risk and uncertainties associated with any new business enterprise, including the risk that these companies may not reach their investment objective or the value of our investment in them may decline substantially or fall to zero.

Our portfolio had an annualized current yield of 13.7% and 15.5% across all our long-term debt and certain equity investments as of June 30, 2009 and June 30, 2008, respectively. This yield includes interest from all of our long-term investments as well as dividends from GSHI and NRG for the year ended June 30, 2009 and Ajax, GSHI and NRG for the year ended June 30, 2008. The 1.8% decrease is primarily due to loans which have been classified as non-accrual status during the fiscal year ended June 30, 2009. For the year ended June 30, 2009, total foregone interest related to loans on non-accrual status was \$18,746. Monetization of other equity positions that we hold is not included in this yield calculation. In each of our portfolio companies, we hold equity positions, ranging from minority interests to majority stakes, which we expect over time to contribute to our investment returns. Some of these equity positions include features such as contractual minimum internal rates of returns, preferred distributions, flip structures and other features expected to generate additional investment returns, as well as contractual protections and preferences over junior equity, in addition to the yield and security offered by our cash flow and collateral debt protections.

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As of June 30, 2009, we own controlling interests in Ajax, C&J, CCEHI, GSHI, Integrated Contract Services, Inc. (ICS), Iron Horse, NRG, R-V, and Yatesville. We also own an affiliated interest in AEH and BNN Holdings Corp. d/b/a Biotronic NeuroNetwork (Biotronic).

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

Level of Control	June 30, 2009		June 30, 2008	
	Fair Value	Percent of Portfolio	Fair Value	Percent of Portfolio
Control	\$ 206,332	31.9%	\$ 205,827	38.8%
Affiliate	32,254	5.0%	6,043	1.2%
Non-control/Non-affiliate	308,582	47.8%	285,660	53.8%
Money Market Funds	98,735	15.3%	33,000	6.2%
Total Portfolio	\$ 645,903	100.0%	\$ 530,530	100.0%

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The following is our investment portfolio presented by type of investment at June 30, 2009 and June 30, 2008, respectively:

Type of Investment	June 30, 2009		June 30, 2008	
	Fair Value	Percent of Portfolio	Fair Value	Percent of Portfolio
Money Market Funds	\$ 98,735	15.3%	\$ 33,000	6.2%
Senior Secured Debt	220,993	34.2%	199,946	37.7%
Subordinated Secured Debt	194,547	30.1%	219,623	41.4%
Subordinated Unsecured Debt	16,331	2.5%	□	0.0%
Preferred Stock	4,139	0.7%	7,707	1.4%
Common Stock	89,278	13.8%	58,312	11.0%
Membership Interests	7,270	1.1%	3,000	0.6%
Overriding Royalty Interests	3,483	0.5%	□	0.0%
Net Profits Interests	2,561	0.4%	□	0.0%
Warrants	8,566	1.4%	8,942	1.7%
Total Portfolio	\$ 645,903	100.0%	\$ 530,530	100.0%

The following is our investment portfolio presented by geographic location of the investment at June 30, 2009 and June 30, 2008, respectively:

Geographic Exposure	June 30, 2009		June 30, 2008	
	Fair Value	Percent of Portfolio	Fair Value	Percent of Portfolio
Western US	\$ 48,091	7.4%	\$ 30,322	5.7%
Southeast US	101,710	15.7%	128,512	24.2%
Southwest US	253,615	39.3%	211,177	39.9%
Midwest US	84,097	13.0%	47,869	9.0%
Northeast US	47,049	7.3%	68,468	12.9%
Canada	12,606	2.0%	11,182	2.1%
Money Market Funds	98,735	15.3%	33,000	6.2%
Total Portfolio	\$ 645,903	100.0%	\$ 530,530	100.0%

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The following is our investment portfolio presented by industry sector of the investment at June 30, 2009 and June 30, 2008, respectively:

Industry Sector	June 30, 2009		June 30, 2008	
	Fair Value	Percent of Portfolio	Fair Value	Percent of Portfolio
Biomass Power	\$ 2,530	0.4%	\$ 15,580	2.9%
Construction Services	2,408	0.4%	6,043	1.1%
Contracting	5,000	0.8%	5,000	0.9%
Financial Services	23,073	3.6%	23,699	4.5%
Food Products	29,416	4.6%	19,351	3.7%
Gas Gathering and Processing	85,187	13.2%	61,542	11.6%
Healthcare	60,293	9.3%	13,752	2.6%
Manufacturing	110,929	17.2%	109,542	20.7%
Metal Services	7,133	1.1%	6,829	1.3%
Mining and Coal Production	13,097	2.0%	25,726	4.9%
Oil and Gas Production	104,806	16.2%	112,850	21.3%
Oilfield Fabrication	34,931	5.4%	24,854	4.7%
Pharmaceuticals	11,452	1.8%	11,523	2.2%
Production Services	12,606	1.9%	14,038	2.6%
Retail	6,272	1.0%	13,428	2.5%
Shipping Vessels	7,381	1.1%	6,804	1.3%
Specialty Minerals	18,924	2.9%	15,632	2.9%
Technical Services	11,730	1.8%	11,337	2.1%
Money Market Funds	98,735	15.3%	33,000	6.2%
Total Portfolio	\$ 645,903	100.0%	\$ 530,530	100.0%

### Investment Activity

At June 30, 2009, approximately 102.7% of our net assets or about \$547,168 was invested in 30 long-term portfolio investments and 18.5% of our net assets invested in money market funds. Liabilities in excess of other assets offset the excess of these amounts over 100%.

### Long-Term Portfolio Investment Activity

During the year ended June 30, 2009, we completed three new investments and several follow-on investments in existing portfolio companies, totaling approximately \$96,263. The more significant of these investments are described briefly in the following:

On August 1, 2008, we provided \$7,400 in debt financing to Houston, Texas-based Castro Cheese Company Inc. (□Castro□), a leading manufacturer of Hispanic cheeses and creams. The investment was in the form of a junior secured note with a net profits interest.

On August 4, 2008, we provided \$15,000 in debt financing to support the take-private acquisition of the TriZetto Group (□TriZetto□), a leading health care information technology company. The investment was in the form of a subordinated unsecured note with a net profits interest.

On August 21, 2008, we provided a \$26,000 senior secured debt financing and co-invested \$2,300 in equity alongside Great Point Partners, LLC in its growth recapitalization of Biotronic, the largest independent national provider of intra-operative neurophysiological monitoring services. The investment was in the form of a senior secured note with preferred shares.

During the fiscal year ended June 30, 2009, we made four follow-on secured debt investments totaling \$7,500 in Iron Horse in support of the build out of additional equipment. All fundings of Iron Horse were in the form of a

bridge loan.

On December 10, 2008, we made a follow-on investment of \$5,000 in GSHI for the repayment of third-party bank senior credit facility. The investment was in the form of a senior secured note. On June 30, 2009, we made a follow-on investment of \$5,000 in GSHI in the form of a junior secured note.

During the fiscal year ended June 30, 2009, we provided additional fundings of \$5,250 and \$9,284 to CCEI and Yatesville, respectively, to fund ongoing operations.

For the year ended June 30, 2009, we closed-out four positions which are briefly described below.

On July 3, 2008, we exercised our warrant for 4,960,585 shares of common stock in Deep Down. As permitted by the terms of the warrant, we elected to make this exercise on a cashless basis entitling us to 2,618,129 common shares. On August 1, 2008, we sold all the shares acquired, receiving \$1,649 of net proceeds.

On August 27, 2008, R-V repaid the \$7,526 debt outstanding to us. We continue to hold common stock and warrants in this investment.

On January 21, 2009, Diamondback Operating, L.P. repaid the \$9,200 debt outstanding to us. We continue to hold a net profits interest in this investment.

On May 7, 2009, we received \$75 as settlement of our net profits interest in Charlevoix.

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

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

Quarter-End	Acquisitions (1)	Dispositions (2)
June 30, 2009	\$ 7,929	\$ 3,148
March 31, 2009	6,356	10,782
December 31, 2008	13,564	2,128
September 30, 2008	70,456	10,949
June 30, 2008	118,913	61,148
March 31, 2008	31,794	28,891
December 31, 2007	120,846	19,223
September 30, 2007	40,394	17,949
June 30, 2007	130,345	9,857
March 31, 2007	19,701	7,731
December 31, 2006	62,679	17,796
September 30, 2006	24,677	2,781
June 30, 2006	42,783	5,752
March 31, 2006	15,732	901
December 31, 2005	□	3,523
September 30, 2005	25,342	□
June 30, 2005	17,544	□
March 31, 2005	7,332	□
December 31, 2004	23,771	32,083



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September 30, 2004	30,371	□
Since inception	\$ 810,529	\$ 234,642

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

(2) Includes scheduled principal payments, prepayments and repayments

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

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

Level of Control	June 30, 2009		June 30, 2008	
	Fair Value	Percent of Portfolio	Fair Value	Percent of Portfolio
Control	\$ 206,332	31.9%	\$ 205,827	38.8%
Affiliate	32,254	5.0%	6,043	1.2%
Non-control/Non-affiliate	308,582	47.8%	285,660	53.8%
Money Market Funds	98,735	15.3%	33,000	6.2%
Total Portfolio	\$ 645,903	100.0%	\$ 530,530	100.0%

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### Investment Valuation

In determining the fair value of our portfolio investments at June 30, 2009, the Audit Committee considered valuations from the independent valuation firm and from management having an aggregate range of \$527,122 to \$572,503, excluding money market investments.

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

The Board of Directors looked at several factors in determining where within the range to value the asset including: recent operating and financial trends for the asset, independent ratings obtained from third parties and comparable multiples for recent sales of companies within the industry. The composite of all these analysis, applied to each investment, was a total valuation of \$547,168, excluding money market investments.

Our investments are generally lower middle market companies, outside of the financial sector, with less than \$30,000 of annual EBITDA. We believe our market has experienced less volatility than others because we believe there are more buy and hold investors who own these less liquid investments. In addition, the middle market relies on less leverage than the large capitalization marketplace, which we believe will result in less financial distress.

During the fiscal year ended June 30, 2009, several general economic factors have occurred which have affected the valuation of our investment portfolio.

Generally, interest rates offered on loans similar to those that we have originated have changed since our investments were consummated. While we do not believe that there has been any diminution of credit quality, general changes in current interest rates would affect the price for which we could sell these assets and we have adjusted our fair value of these assets to reflect such changes. We have adjusted the value of fourteen debt investments based upon such general changes in market interest rates including: AGC, Biotronic, C&J, Castro, Freedom Marine Services LLC, H&M Oil & Gas, LLC, IEC/ARS, Maverick Healthcare, LLC, Peerless, Resco Products, Inc. (Resco), Shearer's, Stryker, TriZetto and Unitek.

Seven debt investments were made to companies that are not performing in line with budget expectations as of June 30, 2009. These investments (Ajax, AEH, Conquest, Deb Shops, ICS, Iron Horse, and Wind River Resources Corp. and Wind River II Corp. (Wind River)) are well collateralized and we expect full recovery. For these assets, we have increased the market interest rates to take into account the increased credit risk and general changes in current interest rates for similar assets to determine their fair value.

Control investments offer increased risk and reward over straight debt investments. Operating results and changes in market multiples can result in dramatic changes in values from quarter to quarter. Significant downturns in operations can further result in our looking to recoveries on sales of assets rather than the enterprise value of the investment. Several control assets in our portfolio are under enhanced scrutiny by our senior management and our Board of Directors and are discussed below.

#### *Gas Solutions Holdings, Inc.*

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

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During the past year, we have been in discussions with multiple interested purchasers for Gas Solutions. While we wish to unlock the value in Gas Solutions, we do not wish to enter into any agreement at any time that does not recognize the long term value we see in Gas Solutions. As a well hedged midstream asset, which will generate predictable and consistent cash flows to us, Gas Solutions is a valuable asset that we wish to sell at a value-maximizing price, or not at all. We continue discussions with interested parties, but have a patient approach toward the process. In addition, a sale of the assets, rather than the stock of GSHI, might result in a significant tax liability at the GSHI level which will need to be paid prior to any distribution to us.

In late March 2008, Royal Bank of Canada provided a \$38,000 term loan to Gas Solutions II Ltd, a wholly owned subsidiary of GSHI, the proceeds of which were used to refinance all of Citibank's approximately \$8,000 of outstanding senior secured debt and provide liquidity to GSHI. In December 2008, we lent an additional \$5,000 to GSHI, which enabled the company to repay the loan to the Royal Bank of Canada. Upon repayment, our existing loan position moved to a first lien position in GSHI, improving our borrowing base requirements with our lender. In June 2009, we lent an additional \$5,000 to GSHI in the form of junior secured debt to enable GSHI to dividend additional retained earnings and profits.

In early May 2008, Gas Solutions II Ltd purchased a series of propane puts at \$0.10 out of the money and at prices of \$1.53 per gallon and \$1.394 per gallon covering the periods May 1, 2008, through April 30, 2009, and May 1, 2009, through April 30, 2010, respectively. These hedges were executed at close to the highest market propane prices ever achieved on an historical basis; such hedges preserve the upside of Gas Solutions II Ltd to benefit from potential future increases in commodity prices. GSHI generated approximately \$26,172 of EBITDA for the fiscal year ending December 31, 2008, an increase of 67% from 2007 results. Despite the decline in oil and natural gas over the last year, GSHI generated approximately \$15,900 of EBITDA for the twelve months ending April 30, 2009.

In determining the value of GSHI, we have utilized several valuation techniques to determine the value of the investment. These techniques offer a wide range of values. Our Board of Directors has determined the value to be \$85,187 for our debt and equity positions at June 30, 2009 based upon a combination of a discounted cash flow analysis, a public comparables analysis and review of recent indications of interest. At June, 2009, GSHI is valued

\$50,184 above its amortized cost at June 30, 2009, compared to the \$36,321 unrealized gain recorded at June 30, 2008.

*Integrated Contract Services, Inc.*

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

In January 2009, we foreclosed on the real and personal property of ICS. Through this foreclosure process, we gained 100% ownership of THS and certain ESA assets. Based upon an analysis of the liquidation value of the ESA assets and the enterprise value of THS, our Board of Directors reaffirmed the fair value of our investment in ICS at \$5,000 at June 30, 2009, a reduction of \$11,652 from its amortized cost, compared to the \$11,464 unrealized loss recorded at June 30, 2008.

*Yatesville Coal Holdings, Inc.*

All of our coal holdings have been consolidated under common management in Yatesville. Yatesville began to show improvement after the consolidation of the coal holdings, but the company exhausted its permitted reserves in December 2008 and has not had any meaningful revenue stream since. Yatesville's management continues to pursue additional mine permits and received its first new permit in May 2009 for approximately 650,000 tons. Yatesville has elected not to begin production from its new permit and is investigating alternative revenue streams. These actions have been complicated and impacted by an environment where coal prices are depressed from historical norms. We continue to evaluate strategies for Yatesville such as selling unneeded equipment and reserves. During the year ended June 30, 2009, we provided additional funding of \$9,284 to Yatesville to fund ongoing operations and received back \$815 on our loan. Our Board of Directors, upon recommendation from senior management, has set the value of the Yatesville investment at \$13,097 at June 30, 2009, a reduction of \$35,793 from its amortized cost, compared to the \$14,694 unrealized loss recorded at June 30, 2008.

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

Change Clean Energy, Inc. ("CCEI") is under enhanced review by our senior management team due to poor operating results. In March 2009 CCEI ceased operations temporarily as it was not economically feasible to make a profit based on the cost of materials and the price being paid for electricity. During that quarter, we determined that it was appropriate to institute foreclosure proceedings against the co-borrowers of our debt to take full control of the assets. In anticipation of such proceedings CCEHI was established and on March 11, 2009, the foreclosure was completed and the assets were assigned to a wholly owned subsidiary of CCEHI. During the year ended June 30, 2009, we provided additional funding of \$5,250 to CCEI and \$694 to CCEHI to fund ongoing operations. CCEI currently has no material operations. We have determined that the current impairment at both CCEI and CCEHI is other than temporary and have recognized a realized loss of \$41,134 for the year ended June 30, 2009, which is the amount by which the amortized cost exceeded the fair value at June 30, 2009 of \$2,530, as set by our Board of Directors. We had recorded an unrealized loss of \$22,141 at June 30, 2008.

**Capitalization**

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

equity capital is currently comprised entirely of common equity.

On June 25, 2009, we completed a first closing on an expanded \$250,000 syndicated revolving credit facility (the "Facility"). The new Facility, for which lenders have closed on \$175,000 to date, includes an accordion feature which allows the Facility to accept up to an aggregate total of \$250,000 of commitments for which we continue to solicit additional commitments from other lenders for the additional \$75,000. The revolving period of the Facility extends through June 2010, with an additional one year amortization period after the completion of the revolving period.

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As of June 30, 2009 and 2008, we had \$124,800 and \$91,167 of borrowings outstanding under our credit facility, respectively. Interest on borrowings under the credit facility was one-month Libor plus 250 basis points prior to June 25, 2009, increasing to one-month Libor plus 400 basis points, subject to a minimum Libor floor of 200 basis points after that date. The maintenance of this facility requires us to pay a fee for the amount not drawn upon. Prior to June 25, 2009, this fee was assessed at the rate of 37.5 basis points per annum of the amount of that unused portion, after that date this rate increased to 100 basis points per annum. The following table shows the facility amounts and outstanding borrowings at June 30, 2009 and June 30, 2008:

	June 30, 2009		June 30, 2008	
	Facility Amount	Amount Outstanding	Facility Amount	Amount Outstanding
Revolving Credit Facility	\$175,000	\$124,800	\$200,000	\$91,167

	Payments Due By Period		
	Less Than 1 Year	1-3 Years	More Than 3 Years
Revolving Credit Facility	\$0	\$124,800	\$0

During the year ended June 30, 2009, we completed three stock offerings and raised \$100,304 of additional equity by issuing 12,942,500 shares of our common stock below net asset value diluting shareholder value by \$2.06 per share. The following table shows the calculation of net asset value per share as of June 30, 2009 and June 30, 2008:

	As of June 30, 2009	As of June 30, 2008
Net Assets	\$ 532,596	\$ 429,623
Shares of common stock outstanding	42,943,084	29,520,379
Net asset value per share	\$ 12.40(1)	\$ 14.55

(1) Our most recently estimated NAV per share is \$11.36 on an as adjusted basis solely to give effect to our payment of the July dividend recorded on ex-dividend date of July 6, 2009 and issuance of common shares on July 20, 2009 in connection with our dividend reinvestment plan, and issuances on July 7, 2009 and August 20, 2009 in underwritten common and unregistered direct common stock offerings, respectively, versus \$12.40 determined by us as of June 30, 2009. NAV as of September 11, 2009 may be higher or lower than \$11.36 based on potential changes in valuations. Our Board of Directors has not yet determined the fair value of portfolio investments subsequent to June 30, 2009. Our Board of Directors determines the fair value of our portfolio investments on a quarterly basis in connection with the preparation of quarterly financial statements and based on input from an independent valuation firm, our Investment Advisor and the audit committee of our Board of Directors.

At June 30, 2009, we had 42,943,084 shares of our common stock outstanding.

## Results of Operations

Net increase in net assets resulting from operations for the years ended June 30, 2009, 2008 and 2007 was \$35,104, \$27,591 and \$16,728, respectively, representing \$1.11, \$1.17 and \$1.06 per weighted average share, respectively. During the year ended June 30, 2009, we experienced net unrealized and realized losses of \$24,059 or approximately \$0.76 per weighted average share primarily from the write-downs of our investments in CCEI

and Yatesville. During the year ended June 30, 2008, we experienced net unrealized and realized losses of \$17,522 or approximately \$0.74 per weighted average share primarily from the sales of our investments in Advantage Oilfield Group and Central Illinois Energy at a loss. During the year ended June 30, 2007, we experienced net unrealized and realized losses of \$6,403 or approximately \$0.41 per weighted average share primarily from the write-downs of our investments in Advantage Oilfield Group.

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

## Investment Income

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

Investment income, which consists of interest income, including accretion of loan origination fees and prepayment penalty fees, dividend income and other income, including settlement of net profits interests, overriding royalty interests and structuring fees, was \$100,481, \$79,402, and \$40,681 for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. Drivers of these increases include increased assets generating increased interest and dividend income along with increased income from royalty and settlement of net profits interests. The following table describes the various components of investment income and the related levels of debt investments:

	Year Ended June 30, 2009	Year Ended June 30, 2008	Year Ended June 30, 2007
Interest income	\$ 62,926	\$ 59,033	\$ 30,084
Dividend income	22,793	12,033	6,153
Other income	14,762	8,336	4,444
Total investment income	\$ 100,481	\$ 79,402	\$ 40,681
Average debt principal of investments	\$ 525,144	\$ 397,913	\$ 172,605
Weighted-average interest rate earned	12.0%	14.8%	17.4%

Total investment income has increased from \$40,681 for the year ended June 30, 2007 to \$79,402 for the year ended June 30, 2008 to \$100,481 for the year ended June 30, 2009. Investment income has been increasing as we continue to deploy the additional capital, raised in both debt and equity offerings, in revenue-producing assets.

Average interest income producing assets have increased from \$172,605 for the year ended June 30, 2007 to \$397,913 for the year ended June 30, 2008 to \$525,144 for the year ended June 30, 2009. While we have been able to increase the gross amount of interest income, average yields on interest bearing assets have decreased from 17.4% for the year ended June 30, 2007 to 14.8% for the year ended June 30, 2008 to 12.0% for the year ended June 30, 2009. These decreases are the result of our increasing our asset mix in financings with private equity sponsors. We believe that such financings offer less risk, and consequently lower yields, due, in part, to lesser risk to our capital resulting from larger equity at risk underneath our capital. Holding these types of investments has allowed us to more effectively utilize our credit facility to finance such assets at an average rate of 3.8% for the year ended June 30, 2009. Additionally, during the year ended June 30, 2009, interest of \$18,746

was foregone on non-accrual debt investments compared to \$3,449 and \$1,270 of foregone interest for the year ended June 30, 2008 and June 30, 2007, respectively. Without these adjustments, the weighted average interest rates earned on debt investments would have been 15.6%, 15.7% and 18.2% for the years ended June 30, 2009, 2008 and 2007, respectively.

Investment income is also generated from dividends and other income. Dividend income has grown significantly from \$6,153 for the year ended June 30, 2007 to \$12,033 for the year ended June 30, 2008 to \$22,793 for the year ended June 30, 2009. We have received dividends from our investments in GSHI, R-V, Ajax, C&J and NRG. The increase in dividend income is mostly attributable to dividends received from our investment in GSHI, which were \$9,450 and \$20,500 during the years ended June 30, 2008 and June 30, 2009, respectively.

Other income has come primarily from structuring fees, overriding royalty interests, and settlement of net profits interests. Income from other sources has grown significantly from \$4,444 for the year ended June 30, 2007 to \$8,336 for the year ended June 30, 2008 to \$14,762 for the year ended June 30, 2009. During the year ended June 30, 2008 we received royalty income and settlement of net profits interest of \$2,984 in the aggregate related to Ken-Tex Energy Corp, and \$4,751 of structuring fees related to Ajax, H&M and various other portfolio investments. During the year ended June 30, 2009, structuring fees of \$1,274 were received primarily related to Biotronic and GSHI, a decrease of \$3,477 from the year ended June 30, 2008. The increase in other income for the year ended June 30, 2009 is largely due to the settlement of our net profit interests in IEC/ARS for \$12,576.

### Operating Expenses

Our primary operating expenses consist of investment advisory fees (base and incentive fees), credit facility costs, legal and professional fees and other operating and overhead-related expenses. These expenses include our allocable portion of overhead under the Administration Agreement with Prospect Administration under which Prospect Administration provides administrative services and facilities for us. Our investment advisory fees compensate our Investment Adviser for its work in identifying, evaluating, negotiating, closing and monitoring our investments. We bear all other costs and expenses of our operations and transactions in accordance with our Administration Agreement with Prospect Administration. Operating expenses were \$41,318, \$34,289 and \$17,550 for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively.

The base investment advisory expenses were \$11,915, \$8,921 and \$5,445 for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. These increases are directly related to our growth in total assets. \$14,790, \$11,278 and \$5,781 in income incentive fees were earned for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. The increases in the income incentive fees are driven by our stronger performance with respect to net investment income as evidenced by net operating income ratios of 13.14%, 12.66% and 9.71% for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. No capital gains incentive fee has yet been incurred pursuant to the Investment Advisory Agreement.

During the years ended June 30, 2009, June 30, 2008 and June 30, 2007, we incurred \$6,161, \$6,318 and \$1,903, respectively, of expenses related to our credit facilities. These expenses are related directly to the leveraging capacity put into place for each of those years and the levels of indebtedness actually undertaken in those years. The table below describes the various credit facility expenses and the related indicators of leveraging capacity and indebtedness.

	Year Ended June 30, 2009	Year Ended June 30, 2008	Year Ended June 30, 2007
Interest expense	\$ 5,075	\$ 5,104	\$ 357
Amortization of deferred financing costs	759	726	1,264
Commitment and other fees	327	488	282
Total	\$ 6,161	\$ 6,318	\$ 1,903
Weighted average debt outstanding	\$ 132,013	\$ 90,032	\$ 4,282
Weighted average interest rate	3.84%	5.67%	8.37%

Facility amount at beginning of year	\$ 200,000	\$ 200,000	\$ 30,000
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The decrease in our interest rate incurred is primarily due to a decrease in average LIBOR of approximately 1.44% for the year ended June 30, 2009 in comparison to 4.08% and 5.33% for the years ended June 30, 2008 and 2007, respectively. This decrease is partially offset by an increase of 125 basis points in our current borrowing rate effective November 14, 2008.

As our asset base has grown and we have added complexity to our capital raising activities, due, in part, to our securitization credit facility initiated in June 2007, we have commensurately increased the size of our administrative and financial staff, accounting for a significant increase in the overhead allocation from Prospect Administration. Over the last year, Prospect Administration has added several additional staff members, including a senior finance professional, a treasurer, a corporate counsel and other finance professionals. As our portfolio continues to grow, we expect to continue to increase the size of our administrative and financial staff on a basis that provides increasing returns to scale. However, initial investments in administrative and financial staff may not provide returns to scale immediately, perhaps not until the portfolio increases to a greater size. Other allocated expenses from Prospect Administration have, as expected, increased alongside with the increase in staffing and asset base.

Legal costs decreased significantly from \$2,503 for the year ended June 30, 2008 to \$947 for the year ended June 30, 2009 as there were reduced costs for litigation.

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

Our net investment income was \$59,163, \$45,113 and \$23,131 for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. Net investment income represents the difference between investment income and operating expenses and is directly impacted by the items described above.

Net realized (losses) gains were (\$39,078), (\$16,222) and \$1,949 for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. On June 30, 2009, we determined that the impairment of the CCEHI investment was other than temporarily impaired and recognized a realized loss for the amount by which the amortized cost exceeded the current fair value. This loss was partially offset by realized gains from sales of the Arctic warrants and Deep Down common stock. The net realized loss of \$16,222 sustained in the year ended June 30, 2008 was due mainly to the sale of Charlevoix and Advantage Oilfield Group Ltd. (["AOG"]) while the \$1,949 realized gain registered for the year ended June 30, 2007 is attributable to the sale of Evolution Petroleum Corporation.

Increase (decrease) in net assets from changes in unrealized appreciation/depreciation was \$15,019, (\$1,300) and (\$8,352) for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. For the year ended June 30, 2009, the net unrealized appreciation was driven by significant write-ups of our investments in AGC, GSHI, NRG, R-V, Shearer's and Stryker, and by the disposition of previously written-down investment in CCEI mentioned above, which, in turn, were offset by significant write-downs our investments in Ajax, AEH, Conquest, Deb Shops, Iron Horse and Yatesville as well as the elimination of the unrealized appreciation resulting from the sale of Deep Down mentioned above. For the year ended June 30, 2008, \$1,300 of the decrease in net assets from the net change in unrealized appreciation/depreciation was driven by significant write-downs in our investments in ICS, WECO, and Yatesville partially offset by the write-up for our investment in GSHI and by the disposition of previously written-down investments in AOG and ESA. For the year ended June 30, 2007, \$8,352 of the decrease in net assets from such changes is attributable to significant write-downs of our investments in AOG, ESA, Unity Virginia Holdings LLC and Whymore Coal Company Inc. which, in turn, were slightly offset by a significant write-up in the value for GSHI.

#### **Financial Condition, Liquidity and Capital Resources**

Our cash flows used in operating activities totaled (\$74,000), (\$204,025) and (\$143,890) for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. Financing activities provided cash flows of \$83,387, \$204,580 and \$143,890 for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. Dividends paid and declared were \$43,257, \$24,915 and \$21,634 for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively.

Our primary uses of funds have been to add to our investments in our portfolio companies, to add new companies to our investment portfolio, and to make cash distributions to holders of our common stock.

We have funded and may continue to fund a portion of our cash needs through borrowings from banks, issuances of senior securities or secondary offerings. We may also securitize a portion of our investments in mezzanine or senior secured loans or other assets. Our objective is to put in place such borrowings in order to enable us to expand our portfolio. At June 30, 2009, we had a \$175,000 revolving credit facility on which \$124,800 was outstanding.

On September 6, 2007, our Registration Statement on Form N-2 was declared effective by the SEC. At June 30, 2009, under the Registration Statement, we had remaining availability to issue up to approximately \$248,700 of our equity securities over the next 14 months. In July 2009 and August 2009, we issued an additional \$46,580 and \$29,322, respectively, in common stock, reducing the remaining availability to approximately \$172,800.

We also continue to generate liquidity through stock offerings and the realization of portfolio investments. On March 19, 2009, April 27, 2009, May 26, 2009, and July 7, 2009, we completed public stock offerings for 1,500,000 shares, 3,680,000 shares, 7,762,500 shares, and 5,175,000 shares, of our common stock at \$8.20 per share, \$7.75 per share, \$8.25 per share, \$9.00 per share, raising \$12,300, \$28,520, \$64,041, and \$46,580 of gross proceeds, respectively. On August 20, 2009, we issued 3,449,686 shares at \$8.50 per share in a private stock offering generating \$29,322 of gross proceeds from the offering. Concurrent with the sale of these shares, we entered into a registration rights agreement in which we granted the purchasers certain registration rights with respect to the shares. Under the terms and conditions of the registration rights agreement, we will use our reasonable best efforts to file with the SEC within sixty (60) days a post-effective amendment to the registration statement on Form N-2 and will also use our reasonable best efforts to cause such post-effective amendment to be declared effective by the SEC within one hundred twenty (120) days. Under the registration rights agreement, we may be obligated to make liquidated damages payments to holders upon certain events.

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## **Off-Balance Sheet Arrangements**

At June 30, 2009, we did not have any off-balance sheet liabilities or other contractual obligations that are reasonably likely to have a current or future material effect on our financial condition, other than those which originate from 1) the investment advisory and management agreement and the administration agreement and 2) the portfolio companies.

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

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

We may hedge against interest rate fluctuations by using standard hedging instruments such as futures, options and forward contracts subject to the requirements of the 1940 Act. While hedging activities may insulate us against adverse changes in interest rates, they may also limit our ability to participate in the benefits of higher interest rates with respect to our portfolio of investments. During the twelve months ended June 30, 2009, we did not engage in hedging activities.



**Item 8. Financial Statements and Supplementary Data.****TABLE OF CONTENTS**

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**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders  
Prospect Capital Corporation  
New York, New York

We have audited the accompanying consolidated statements of assets and liabilities of Prospect Capital Corporation, including the schedule of investments, as of June 30, 2009 and 2008, and the related consolidated statements of operations, changes in net assets, and cash flows for each of the three years in the period ended June 30, 2009, and the financial highlights for each of the periods presented. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

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

In our opinion, the consolidated financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Prospect Capital Corporation at June 30, 2009 and 2008, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2009, and the financial highlights for each of the periods presented in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Prospect Capital Corporation's internal control over financial reporting as of June 30, 2009, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated September 11, 2009 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP

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BDO Seidman, LLP  
New York, New York

September 11, 2009

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

	June 30, 2009	June 30, 2008
<b>Assets (Note 10)</b>		
Investments at fair value (net cost of \$531,424 and \$496,805, respectively, Note 3)		
Control investments (net cost of \$187,105 and \$203,661, respectively)	\$ 206,332	\$ 205,827
Affiliate investments (net cost of \$33,544 and \$5,609, respectively)	32,254	6,043
Non-control/Non-affiliate investments (net cost of \$310,775 and \$287,535, respectively)	308,582	285,660
Total investments at fair value	547,168	497,530
Investments in money market funds	98,735	33,000
Cash	9,942	555
Receivables for:		
Interest, net	3,562	4,094
Dividends	28	4,248
Loan principal	□	71
Other	571	567
Prepaid expenses	68	273
Deferred financing costs	6,951	1,440
<b>Total Assets</b>	<b>667,025</b>	<b>541,778</b>
<b>Liabilities</b>		
Credit facility payable (Note 10)	124,800	91,167
Dividends payable	□	11,845
Due to Prospect Administration (Note 7)	842	695
Due to Prospect Capital Management (Note 7)	5,871	5,946
Accrued expenses	2,381	1,104
Other liabilities	535	1,398
<b>Total Liabilities</b>	<b>134,429</b>	<b>112,155</b>
<b>Net Assets</b>	<b>\$ 532,596</b>	<b>\$ 429,623</b>
<b>Components of Net Assets</b>		
Common stock, par value \$0.001 per share (100,000,000 and 100,000,000 common shares authorized, respectively; 42,943,084 and 29,520,379 issued and outstanding, respectively) (Note 5)	\$ 43	\$ 30
Paid-in capital in excess of par	545,707	441,332
Undistributed net investment income	24,152	1,508
Accumulated realized losses on investments	(53,050)	(13,972)
Unrealized appreciation on investments	15,744	725
<b>Net Assets</b>	<b>\$ 532,596</b>	<b>\$ 429,623</b>
<b>Net Asset Value Per Share</b>	<b>\$ 12.40</b>	<b>\$ 14.55</b>

See notes to consolidated financial statements.

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

Year Ended

	June 30, 2009	June 30, 2008	June 30, 2007
<b>Investment Income</b>			
Interest income:			
Control investments (Net of foreign withholding tax of \$166, \$230, and \$178, respectively)	\$ 19,281	\$ 21,709	\$ 13,500
Affiliate investments (Net of foreign withholding tax of \$□, \$70, and \$237, respectively)	3,039	1,858	3,489
Non-control/Non-affiliate investments	40,606	35,466	13,095
Total interest income	62,926	59,033	30,084
Dividend income			
Control investments	22,468	11,327	3,400
Money market funds	325	706	2,753
Total dividend income	22,793	12,033	6,153
Other income: (Note 4)			
Control/affiliate investments	1,249	1,123	230
Non-control/Non-affiliate investments	13,513	7,213	4,214
Total other income	14,762	8,336	4,444
<b>Total Investment Income</b>	<b>100,481</b>	<b>79,402</b>	<b>40,681</b>
<b>Operating Expenses</b>			
Investment advisory fees:			
Base management fee (Note 7)	11,915	8,921	5,445
Income incentive fee (Note 7)	14,790	11,278	5,781
Total investment advisory fees	26,705	20,199	11,226
Interest and credit facility expenses	6,161	6,318	1,903
Sub-administration fees (including former Chief Financial Officer and Chief Compliance Officer)	846	859	567
Legal fees	947	2,503	1,365
Valuation services	705	577	395
Audit, compliance and tax related fees	1,015	470	599
Allocation of overhead from Prospect Administration (Note 7)	2,856	2,139	532
Insurance expense	246	256	291
Directors' fees	269	253	230
Other general and administrative expenses	1,035	715	442
Excise taxes	533	□	□
<b>Total Operating Expenses</b>	<b>41,318</b>	<b>34,289</b>	<b>17,550</b>
<b>Net Investment Income</b>	<b>59,163</b>	<b>45,113</b>	<b>23,131</b>
Net realized (loss) gain on investments	(39,078)	(16,222)	1,949
Net change in unrealized appreciation (depreciation) on investments	15,019	(1,300)	(8,352)
<b>Net Increase in Net Assets Resulting from Operations</b>	<b>\$ 35,104</b>	<b>\$ 27,591</b>	<b>\$ 16,728</b>
Net increase in net assets resulting from operations			
per share: (Note 6 and Note 8)	\$ 1.11	\$ 1.17	\$ 1.06
Weighted average shares of common stock outstanding:	31,559,905	23,626,642	15,724,095

See notes to consolidated financial statements.

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

	June 30, 2009	Year Ended June 30, 2008	June 30, 2007
<b>Increase in Net Assets from Operations:</b>			
Net investment income	\$ 59,163	\$ 45,113	\$ 23,131
Net realized (loss) gain on investments	(39,078)	(16,222)	1,949
Net change in unrealized appreciation (depreciation) on investments	15,019	(1,300)	(8,352)

<b>Net Increase in Net Assets Resulting from Operations</b>	35,104	27,591	16,728
<b>Dividends to Shareholders</b>	(36,519)	(39,513)	(27,542)
<b>Capital Share Transactions:</b>			
Net proceeds from capital shares sold	100,304	140,249	197,558
Less: Offering costs of public share offerings	(1,023)	(1,505)	(874)
Reinvestment of dividends	5,107	2,753	5,908
<b>Net Increase in Net Assets Resulting from Capital Share Transactions</b>	104,388	141,497	202,592
<b>Total Increase in Net Assets:</b>	102,973	129,575	191,778
Net assets at beginning of year	429,623	300,048	108,270
<b>Net Assets at End of Year</b>	\$ 532,596	\$ 429,623	\$ 300,048

**Capital Share Activity:**

Shares sold	12,942,500	9,400,000	12,526,650
Shares issued through reinvestment of dividends	480,205	171,314	352,542
Net increase in capital share activity	13,422,705	9,571,314	12,879,192
Shares outstanding at beginning of year	29,520,379	19,949,065	7,069,873
<b>Shares Outstanding at End of Year</b>	42,943,084	29,520,379	19,949,065

See notes to consolidated financial statements.

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

	June 30, 2009	Year Ended June 30, 2008	June 30, 2007
<b>Cash Flows from Operating Activities:</b>			
Net increase in net assets resulting from operations	\$ 35,104	\$ 27,591	\$ 16,728
Net realized loss (gain) on investments	39,078	16,239	(1,947)
Net change in unrealized (appreciation) depreciation on investments	(15,019)	1,300	8,352
Accretion of original issue discount on investments	(2,399)	(2,095)	(1,808)
Amortization of deferred financing costs	759	727	1,264
Change in operating assets and liabilities:			
Payments for purchases of investments	(98,305)	(311,947)	(167,255)
Proceeds from sale of investments and collection of investment principal	27,007	127,212	38,407
Purchases of cash equivalents	(39,999)	(274,949)	(259,887)
Sales of cash equivalents	39,999	274,932	259,885
Net (increase) decrease investments in money market funds	(65,735)	8,760	(40,152)
Decrease (increase) in interest receivable, net	532	(1,955)	(500)
Decrease (increase) in dividends receivable	4,220	(3,985)	(250)
Decrease (increase) in loan principal receivable	71	(71)	385
Decrease in receivable for securities sold	□	□	369
Decrease in receivable for structuring fees	□	1,625	□
Decrease in due from Prospect Administration	□	□	28
Decrease in due from Prospect Capital Management	□	□	5
Increase in other receivables	(4)	(296)	(1,896)
Decrease (increase) in prepaid expenses	205	198	(394)
(Decrease) increase in payables for securities purchased	□	(70,000)	32
Increase in due to Prospect Administration	147	365	330
(Decrease) increase in due to Prospect Capital Management	(75)	1,438	3,763
Increase (decrease) in accrued expenses	1,277	(208)	469
(Decrease) increase in other liabilities	(863)	1,094	182

<b>Net Cash Used In Operating Activities:</b>	(74,000)	(204,025)	(143,890)
<b>Cash Flows from Financing Activities:</b>			
Borrowings under credit facility	100,157	238,492	□
Payments under credit facility	(66,524)	(147,325)	(28,500)
Financing costs paid and deferred	(6,270)	(416)	(2,660)
Net proceeds from issuance of common stock	100,304	140,249	197,558
Offering costs from issuance of common stock	(1,023)	(1,505)	(874)
Dividends paid	(43,257)	(24,915)	(21,634)
<b>Net Cash Provided By Financing Activities:</b>	<b>83,387</b>	<b>204,580</b>	<b>143,890</b>
<b>Total Increase in Cash</b>	<b>9,387</b>	<b>555</b>	<b>□</b>
Cash balance at beginning of year	555	□	□
<b>Cash Balance at End of Year</b>	<b>\$ 9,942</b>	<b>\$ 555</b>	<b>\$ □</b>
<b>Cash Paid For Interest</b>	<b>\$ 5,014</b>	<b>\$ 4,942</b>	<b>\$ 639</b>
<b>Non-Cash Financing Activity:</b>			
Amount of shares issued in connection with dividend reinvestment plan	\$ 5,107	\$ 2,753	\$ 5,908

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

			June 30, 2009		
	Locale/Industry	Par Value / Shares / Ownership %	Cost	Fair Value (2)	% of Net Assets
<b>Portfolio Investments (1)</b>					
<b>Control Investments (25.00% or greater of voting control)</b>					
<u>Ajax Rolled Ring &amp; Machine</u>					
	South Carolina/ Manufacturing				
Unrestricted common shares (7 total unrestricted common shares issued and outstanding and 681.85 restricted common shares issued and outstanding)		6	\$ □	\$ □	0.0%
Series A convertible preferred shares (7,192.6 total preferred shares issued and outstanding)		6,142.6	6,057	□	0.0%
Subordinated secured note □ Tranche B, 11.50% plus 6.00% PIK, 4/01/2013 (3), (4)		\$ 11,675	11,675	10,151	1.9%
Senior secured note □ Tranche A, 10.50%, 4/01/2013 (3), (5)		\$ 21,487	21,487	21,487	4.0%
<b>Total</b>			<b>39,219</b>	<b>31,638</b>	<b>5.9%</b>
<u>C&amp;J Cladding LLC</u>					
	Texas/Metal Services				
Warrant, common units, expiring 3/30/2014 (1,000 total company units outstanding)		400	580	3,825	0.7%
Senior secured note, 14.00%, 3/30/2012 (3), (6)		\$ 3,150	2,722	3,308	0.6%
<b>Total</b>			<b>3,302</b>	<b>7,133</b>	<b>1.3%</b>
<u>Change Clean Energy Holdings, Inc. (□CCEHI□) (7)</u>					
	Maine/Biomass Power				
CCEHI common shares (1,000 total common					

shares issued and outstanding)	1,000	2,530	2,530	0.5%
<u>Gas Solutions Holdings, Inc. (3), (8)</u>				
	Texas/Gas Gathering and Processing			
Common shares (100 total common shares outstanding)	100	5,003	55,187	10.4%
Junior secured note, 18.00%, 12/23/2018	\$ 5,000	5,000	5,000	0.9%
Senior secured note, 18.00%, 12/22/2018	\$ 25,000	25,000	25,000	4.7%
Total		35,003	85,187	16.0%

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS □ (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

		Par Value / Shares / Ownership %	Cost	Fair Value (2)
<b>Portfolio Investments (1)</b>				<b>June 30, 2009</b>
<b>Control Investments (continued)</b>				
<u>Integrated Contract Services, Inc. (9)</u>	North Carolina/ Contracting			
Common stock (100 total common shares outstanding)		49	\$ 679	\$ □
Series A preferred shares (10 total Series A preferred shares outstanding)		10	□	□
Junior secured note, stated rate 7.00% plus 7.00% PIK plus 6.00% default interest, in non-accrual status effective 10/09/2007, past due		\$ 14,003	14,003	3,030
Senior secured note, stated rate 7.00% plus 7.00% PIK plus 6.00% default interest, in non-accrual status effective 10/09/2007, past due		\$ 800	800	800
Senior demand note, 15.00%, 6/30/2009 (10)		\$ 1,170	1,170	1,170
Total			16,652	5,000
<u>Iron Horse Coiled Tubing, Inc.</u>	Alberta, Canada/ Production Services			
Common shares (2,231 total class A common shares outstanding)		1,781	268	□
Senior secured note, 15.00%, 12/31/2009		\$ 9,250	9,250	3,004
Bridge loan, 15.00% plus 3.00% PIK, 12/31/2009		\$ 9,826	9,826	9,602
Total			19,344	12,606
<u>NRG Manufacturing, Inc.</u>	Texas/ Manufacturing			
Common shares (1,000 total common shares issued and outstanding)		800	2,317	19,294
Senior secured note, 16.50%, 8/31/2011 (3), (11)		\$ 13,080	13,080	13,080
Total			15,397	32,374
<u>R-V Industries, Inc.</u>	Pennsylvania/ Manufacturing			
Common shares (750,000 total common shares issued and outstanding)		545,107	5,086	12,267
Warrants, common shares, expiring 6/30/2017				

(200,000 total common shares outstanding)		200,000	1,682	4,500
<b>Total</b>			<b>6,768</b>	<b>16,767</b>
<u>Yatesville Coal Holdings, Inc. (12)</u>	Kentucky/ Mining and Coal Production			
Common stock (1,000 total common shares outstanding)		1,000	427	□
Junior secured note, 15.72%, in non-accrual status effective 1/01/2009, matures 12/31/2010		\$ 38,463	38,463	3,097
Senior secured note, 15.72%, in non-accrual status effective 1/01/2009, matures 12/31/2010		\$ 10,000	10,000	10,000
<b>Total</b>			<b>48,890</b>	<b>13,097</b>
<b>Total Control Investments</b>			<b>187,105</b>	<b>206,332</b>

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS □ (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

			June 30, 2009	
	Locale/Industry	Par Value / Shares / Ownership %	Cost	Fair Value (2)
<b>Portfolio Investments (1)</b>				
<b>Affiliate Investments</b>				
<b>(5.00% to 24.99% of voting control)</b>				
<u>Appalachian Energy Holdings LLC (13)</u>	West Virginia/ Construction Services			
Warrants - Class A common units, expiring 2/13/2016 (86,843 total fully-diluted class A common units outstanding)		6,065	\$ 176	\$ □
Warrants - Class A common units, expiring 6/17/2018 (86,843 total fully-diluted class A common units outstanding)		6,025	172	□
Warrants □ Class A common units, expiring 11/30/2018 (86,843 total fully-diluted class A common units outstanding)		25,000	□	□
Series A preferred equity (1,075 total series A preferred equity units outstanding)		200	82	□
Series B preferred equity (794 total series B preferred equity units outstanding)		241	241	□
Series C preferred equity (500 total series C preferred equity units outstanding)		500	500	□
Senior Secured Debt Tranche B, 14.00% plus 3.00% PIK plus 3.00% default interest, non- accrual status effective 11/01/2008, past due		\$ 2,050	1,955	356
Senior Secured Debt Tranche A, 14.00% plus 3.00% PIK plus 3.00% default interest, non- accrual status effective 11/01/2008, matures 1/31/2011		\$ 1,997	1,891	2,052
<b>Total</b>			<b>5,017</b>	<b>2,408</b>
<u>Biotronic NeuroNetwork</u>	Michigan/			

	Healthcare		
Preferred shares (85,000 total preferred shares outstanding) (14)	9,925,455	2,300	2,839
Senior secured note, 11.50% plus 1.00% PIK, 2/21/2013 (3), (15)	\$ 26,227	26,227	27,007
Total		28,527	29,846
<b>Total Affiliate Investments</b>		33,544	32,254
<b>Non-control/Non-affiliate Investments (less than 5.00% of voting control)</b>			
<u>American Gilsonite Company</u>	Utah/Specialty Minerals		
Membership interest units in AGC\PEP, LLC (16)	99.9999%	1,031	3,851
Senior subordinated note, 12.00% plus 3.00% PIK, 3/14/2013 (3)	\$ 14,783	14,783	15,073
Total		15,814	18,924

See notes to consolidated financial statements.

**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

Portfolio Investments (1) Non-control/Non-affiliate Investments (continued)	Locale/Industry	Par Value / Shares / Ownership %	June 30, 2009		
			Cost	Fair Value (2)	% of Net Assets
<u>Castro Cheese Company, Inc. (3)</u>	Texas/Food Products				
Junior secured note, 11.00% plus 2.00% PIK, 2/28/2013		\$ 7,538	\$ 7,413	\$ 7,637	1.4%
<u>Conquest Cherokee, LLC (17)</u>	Tennessee/Oil and Gas Production				
Overriding Royalty Interests		□	□	565	0.1%
Senior secured note, 13.00%, in non-accrual status effective 4/01/2009 plus 4.00% default interest, past due (18)		\$ 10,200	10,191	6,855	1.3%
Total			10,191	7,420	1.4%
<u>Deb Shops, Inc. (19)</u>	Pennsylvania/ Retail				
Second lien debt, 8.67%, 10/23/2014		\$ 15,000	14,623	6,272	1.2%
<u>Diamondback Operating, LP</u>	Oklahoma/Oil and Gas Production				
Net profits interest, 15.00% payable on equity distributions (20)		□	□	458	0.1%
<u>Freedom Marine Services LLC (3), (21)</u>	Louisiana/ Shipping Vessels				
Net profits interest, 22.50% payable on equity					



distributions				229	0.0%
Subordinated secured note, 12.00% plus 4.00% PIK, 12/31/2011 (22)		\$ 7,234	7,160	7,152	1.4%
Total			7,160	7,381	1.4%
<u>H&amp;M Oil &amp; Gas, LLC (3), (21)</u>	Texas/Oil and Gas Production				
Net profits interest, 8.00% payable on equity distributions				1,682	0.3%
Senior secured note, 13.00%, 6/30/2010 (23)		\$ 49,688	49,688	49,697	9.3%
Total			49,688	51,379	9.6%
<u>IEC Systems LP ("IEC") / Advanced Rig Services LLC ("ARS") (3), (24)</u>	Texas/Oilfield Fabrication				
IEC senior secured note, 12.00% plus 3.00% PIK, 11/20/2012		\$ 21,411	21,411	21,839	4.1%
ARS senior secured note, 12.00% plus 3.00% PIK, 11/20/2012		\$ 12,836	12,836	13,092	2.5%
Total			34,247	34,931	6.6%

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

Portfolio Investments (1) Non-control/Non-affiliate Investments (continued)	Locale/Industry	Par Value / Shares / Ownership %	June 30, 2009		
			Cost	Fair Value (2)	% N Ass
<u>Maverick Healthcare, LLC</u>	Arizona/ Healthcare				
Common units (79,000,000 total class A common units outstanding)		1,250,000	\$	\$	0.
Preferred units (79,000,000 total preferred units outstanding)		1,250,000	1,252	1,300	0.
Second lien debt, 12.00% plus 1.50% PIK, 4/30/2014 (3)		\$ 12,691	12,691	12,816	2.
Total			13,943	14,116	2.
<u>Miller Petroleum, Inc. (25)</u>	Tennessee/Oil and Gas Production				
Warrants, common shares, expiring 5/04/2010 to 6/30/2014 (15,811,856 total common shares outstanding)		1,935,523	150	241	0.
<u>Peerless Manufacturing Co. (3)</u>	Texas/ Manufacturing				
Subordinated secured note, 11.50% plus 3.50% PIK, 4/29/2013		\$ 20,000	20,000	20,400	3.
<u>Qualitest Pharmaceuticals, Inc. (3), (26)</u>	Alabama/ Pharmaceuticals				
Second lien debt, 8.10%, 4/30/2015		\$ 12,000	11,949	11,452	2.
<u>Regional Management Corp. (3)</u>	South Carolina/				

	Financial Services				
Second lien debt, 12.00% plus 2.00% PIK, 6/29/2012		\$ 25,424	25,424	23,073	4.1
<u>Resco Products, Inc. (3), (27)</u>	Pennsylvania/ Manufacturing				
Second lien debt, 8.67%, 6/22/2014		\$ 9,750	9,594	9,750	1.0
<u>Shearer's Foods, Inc.</u>	Ohio/Food Products				
Membership interest units in Mistral Chip Holdings, LLC (45,300 total membership units outstanding) (28)		2,000	2,000	3,419	0.0
Second lien debt, 14.00%, 10/31/2013 (3)		\$ 18,000	18,000	18,360	3.0
Total			20,000	21,779	4.1
<u>Stryker Energy, LLC (29)</u>	Ohio/Oil and Gas Production				
Overriding Royalty Interests		□	□	2,918	0.0
Subordinated secured revolving credit facility, 12.00%, 12/01/2011 (3), (30)		\$ 29,500	29,154	29,554	5.0
Total			29,154	32,472	6.1

See notes to consolidated financial statements.

**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS □ (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

	Locale/Industry	Par Value / Shares / Ownership %	Cost	June 30, 2009 Fair Value (2)
<b>Portfolio Investments (1)</b>				
<b>Non-control/Non-affiliate Investments (continued)</b>				
<u>TriZetto Group (3)</u>	California/ Healthcare			
Subordinated unsecured note, 12.00% plus 1.50% PIK, 10/01/2016		\$ 15,205	\$ 15,065	\$ 16,331
<u>Unitek (3), (31)</u>	Pennsylvania/ Technical Services			
Second lien debt, 13.08%, 12/31/2013		\$ 11,500	11,360	11,730
<u>Wind River Resources Corp. and Wind River II Corp. (21)</u>	Utah/Oil and Gas Production			
Net profits interest, 5.00% payable on equity distributions		□	□	192
Senior secured note, stated rate 13.00% plus 3.00% default interest, in non-accrual status effective 12/01/2008, matures 7/31/2010 (32)		\$ 15,000	15,000	12,644
Total			15,000	12,836
<b>Total Non-control/Non-affiliate Investments</b>			310,775	308,582
<b>Total Portfolio Investments</b>			531,424	547,168
<b>Money Market Funds</b>				
Fidelity Institutional Money Market Funds - Government Portfolio (Class I)		94,752,972	94,753	94,753

Fidelity Institutional Money Market Funds - Government Portfolio (Class I) (3)	3,982,278	3,982	3,982
<b>Total Money Market Funds</b>		98,735	98,735
<b>Total Investments</b>		\$ 630,159	\$ 645,903

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS □ (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

			June 30, 2008		
	Locale/Industry	Par Value / Shares / Ownership %	Cost	Fair Value (2)	% Ne Ass
<b>Portfolio Investments (1)</b>					
<b>Control Investments (25.00% or greater of voting control)</b>					
<u>Ajax Rolled Ring &amp; Machine</u>	South Carolina/ Manufacturing				
Unrestricted common shares (7 total unrestricted common shares issued and outstanding and 803.18 restricted common shares issued and outstanding)		6	\$ □	\$ □	0.0
Series A convertible preferred shares (7,222.6 total preferred shares issued and outstanding)		6,142.6	6,293	6,293	1.5
Subordinated secured note □ Tranche B, 11.50% plus 6.00% PIK, 4/01/2013 (3), (4)		\$ 11,500	11,500	11,500	2.6
Senior secured note □ Tranche A, 10.50%, 4/01/2013 (3), (5)		\$ 21,890	21,890	21,890	5.3
<b>Total</b>			39,683	39,683	9.2
<u>C&amp;I Cladding LLC (3)</u>	Texas/Metal Services				
Warrant, common units, expiring 3/30/2014 (600 total company units outstanding)		400	580	2,222	0.5
Senior secured note, 14.00%, 3/30/2012 (6)		\$ 4,800	4,085	4,607	1.3
<b>Total</b>			4,665	6,829	1.6
<u>Gas Solutions Holdings, Inc. (8)</u>	Texas/Gas Gathering and Processing				
Common shares (100 total common shares outstanding)		100	5,221	41,542	9.7
Subordinated secured note, 18.00%, 12/22/2009 (3)		\$ 20,000	20,000	20,000	4.7
<b>Total</b>			25,221	61,542	14.4
<u>Integrated Contract Services, Inc. (9)</u>	North Carolina/ Contracting				
Common stock (100 total common shares outstanding)		49	491	□	0.0
Series A preferred shares (10 total Series A preferred shares outstanding)		10	□	□	0.0
Junior secured note, 14.00%, 9/30/2010		\$ 14,003	14,003	3,030	0.7
Senior secured note, 14.00%, 9/30/2010		\$ 800	800	800	0.2

Senior demand note, 15.00%, 6/30/2009 (10)	\$ 1,170	1,170	1,170	0.3
Total		16,464	5,000	1.2

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS □ (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

		Par Value / Shares / Ownership %	Cost	June 30, 2008 Fair Value (2)	% of Net Assets
<b>Portfolio Investments (1)</b>					
<b>Control Investments (continued)</b>					
<u>Iron Horse Coiled Tubing, Inc.</u>	Alberta, Canada/ Production Services				
Common shares (1,093 total common shares outstanding)		643	\$ 268	\$ 49	0.0%
Warrants for common shares (33)		1,138	□	□	0.0%
Senior secured note, 15.00%, 4/19/2009		\$ 9,250	9,094	9,073	2.1%
Bridge loan, 15.00% plus 3.00% PIK, 12/11/2008			2,103	2,060	0.5%
Total			11,465	11,182	2.6%
<u>NRG Manufacturing, Inc.</u>	Texas/ Manufacturing				
Common shares (1,000 total common shares issued and outstanding)		800	2,317	8,656	2.0%
Senior secured note, 16.50%, 8/31/2011 (3), (11)		\$ 13,080	13,080	13,080	3.0%
Total			15,397	21,736	5.0%
<u>R-V Industries, Inc.</u>	Pennsylvania/ Manufacturing				
Common shares (800,000 total common shares outstanding)		545,107	5,031	8,064	1.9%
Warrants, common shares, expiring 6/30/2017		200,000	1,682	2,959	0.7%
Senior secured note, 15.00%, 6/30/2017 (3)		\$ 7,526	5,912	7,526	1.8%
Total			12,625	18,549	4.4%
<u>Worcester Energy Partners, Inc. (7)</u>	Maine/ Biomass Power				
Equity ownership		□	457	1	0.0%
Senior secured note, 12.50%, 12/31/2012		\$ 37,388	37,264	15,579	3.6%
Total			37,721	15,580	3.6%
<u>Yatesville Coal Holdings, Inc. (12)</u>	Kentucky/ Mining and Coal Production				
Common stock (1,000 total common shares outstanding)		1,000	284	□	0.0%
Junior secured note, 12.50%, 12/31/2010		\$ 30,136	30,136	15,726	3.7%
Senior secured note, 12.50%, 12/31/2010		\$ 10,000	10,000	10,000	2.3%
Total			40,420	25,726	6.0%
<b>Total Control Investments</b>			203,661	205,827	48.0%

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED SCHEDULES OF INVESTMENTS (CONTINUED)**  
**June 30, 2009 and June 30, 2008**  
**(in thousands, except share data)**

			June 30, 2008		
	Locale/Industry	Par Value / Shares / Ownership %	Cost	Fair Value (2)	%
<b>Portfolio Investments (1)</b>					
<b>Affiliate Investments</b>					
<b>(5.00% to 24.99% of voting control)</b>					
<u>Appalachian Energy Holdings LLC (3), (13)</u>					
	West Virginia/ Construction Services				
Warrants - Class A common units, expiring 2/13/2016 (49,753 total class A common units outstanding)		12,090	\$ 348	\$ 794	0
Series A preferred equity (16,125 total series A preferred equity units outstanding)		3,000	72	162	0
Series B preferred equity (794 total series B preferred equity units outstanding)		241	241	□	0
Senior Secured Debt Tranche A, 14.00% plus 3.00% PIK, 1/31/2011		\$ 3,003	3,003	3,003	0
Senior Secured Debt Tranche B, 14.00% plus 3.00% PIK, 05/01/2009		\$ 1,945	1,945	2,084	0
Total			5,609	6,043	1
<b>Total Affiliate Investments</b>			5,609	6,043	1
<b>Non-control/Non-affiliate Investments</b>					
<b>(less than 5.00% of voting control)</b>					
<u>American Gilsonite Company</u>					
	Utah/Specialty Minerals				
Membership interest units in AGC/PEP, LLC (16)		99.9999%	1,000	1,000	0
Senior subordinated note, 12.00% plus 3.00%, 3/14/2013 (3)		\$ 14,632	14,632	14,632	3
Total			15,632	15,632	3
<u>Conquest Cherokee, LLC (3), (17), (18)</u>					
	Tennessee/Oil and Gas Production				
Senior secured note, 13.00%, 5/05/2009		\$ 10,200	10,125	9,923	2
<u>Deb Shops, Inc. (3), (19)</u>					
	Pennsylvania/ Retail				
Second lien debt, 10.69%, 10/23/2014		\$ 15,000	14,577	13,428	3
<u>Deep Down, Inc. (3)</u>					
	Texas/Production Services				
Warrant, common shares, expiring 8/06/2012 (174,732,501 total common shares outstanding)		4,960,585	□	2,856	0

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS □ (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

Portfolio Investments (1)	Locale/Industry	Par Value / Shares / Ownership %	June 30, 2008		
			Cost	Fair Value (2)	% of Net Assets
<b>Non-control/Non-affiliate Investments (continued)</b>					
<u>Diamondback Operating, LP (3), (21)</u>	Oklahoma/Oil and Gas Production				
Senior secured note, 12.00% plus 2.00% PIK, 8/28/2011		\$ 9,200	\$ 9,200	\$ 9,108	2.1
<u>Freedom Marine Services LLC (3), (21), (22)</u>	Louisiana/ Shipping Vessels				
Subordinated secured note, 12.00% plus 4.00% PIK, 12/31/2011		\$ 6,948	6,850	6,805	1.6
<u>H&amp;M Oil &amp; Gas, LLC (3), (21), (23)</u>	Texas/Oil and Gas Production				
Senior secured note, 13.00%, 6/30/2010		\$ 50,500	50,500	50,500	11.8
<u>IEC Systems LP ("IEC") / Advanced Rig Services LLC ("ARS") (3), (24)</u>	Texas/Oilfield Fabrication				
IEC senior secured note, 12.00% plus 3.00% PIK, 11/20/2012		\$ 19,028	19,028	19,028	4.4
ARS senior secured note, 12.00% plus 3.00% PIK, 11/20/2012		\$ 5,825	5,825	5,825	1.4
Total			24,853	24,853	5.8
<u>Maverick Healthcare, LLC (3)</u>	Arizona/ Healthcare				
Common units (78,100,000 total common units outstanding)		1,250,000	1,252	1,252	0.3
Preferred units (78,100,000 total preferred units outstanding)		1,250,000	□	□	0.0
Senior secured note, 12.00% plus 1.50% PIK, 10/13/2014		\$ 12,500	12,500	12,500	2.4
Total			13,752	13,752	3.2
<u>Miller Petroleum, Inc.</u>	Tennessee/Oil and Gas Production				
Warrants, common shares, expiring 5/04/2010 to 3/31/2013 (14,566,856 total common shares outstanding)		1,571,191	150	111	0.0
<u>Peerless Manufacturing Co. (3)</u>	Texas/ Manufacturing				
Subordinated secured note, 11.50% plus 3.50% PIK, 4/30/2013		\$ 20,000	20,000	20,000	4.7

See notes to consolidated financial statements.

**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS □ (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

Portfolio Investments (1)	Locale/Industry	Par Value / Shares / Ownership %	June 30, 2008	
			Cost	Fair Value (2)
<b>Non-control/Non-affiliate Investments (continued)</b>				
<u>Qualitest Pharmaceuticals, Inc. (3), (26)</u>	Alabama/ Pharmaceuticals			
Second lien debt, 12.45%, 4/30/2015		\$ 12,000	\$ 11,944	\$ 11,523
<u>Regional Management Corp. (3)</u>	South Carolina/ Financial Services			
Subordinated secured note, 12.00% plus 2.00% PIK, 6/29/2012		\$ 25,000	25,000	23,699
<u>Resco Products, Inc. (3), (27)</u>	Pennsylvania/ Manufacturing			
Second lien debt, 11.06%, 6/24/2014		\$ 9,750	9,574	9,574
<u>Shearer's Foods, Inc.</u>	Ohio/Food Products			
Mistral Chip Holdings, LLC membership unit (45,300 total membership units outstanding) (28)		2,000	2,000	2,000
Second lien debt, 14.00%, 10/31/2013 (3)		\$ 18,000	18,000	17,351
Total			20,000	19,351
<u>Stryker Energy, LLC (3), (29), (30)</u>	Ohio/Oil and Gas Production			
Subordinated revolving credit facility, 12.00%, 11/30/2011		\$ 29,500	29,041	28,518
<u>Unitek (3), (31)</u>	Pennsylvania/ Technical Services			
Second lien debt, 12.75%, 12/27/2012		\$ 11,500	11,337	11,337
<u>Wind River Resources Corp. and Wind River II Corp. (3), (21), (32)</u>	Utah/Oil and Gas Production			
Senior secured note, 13.00%, 7/31/2009		\$ 15,000	15,000	14,690
<b>Total Non-control/Non-affiliate Investments</b>			287,535	285,660
<b>Total Portfolio Investments</b>			496,805	497,530
<b>Money Market Funds</b>				
Fidelity Institutional Money Market Funds - Government Portfolio (Class I)		25,954,531	25,954	25,954
First American Funds, Inc. - Prime Obligations Fund (Class A) (3)		7,045,610	7,046	7,046
<b>Total Money Market Funds</b>			33,000	33,000
<b>Total Investments</b>			\$ 529,805	\$ 530,530

See notes to consolidated financial statements.

**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

**Endnote Explanations for the Consolidated Schedules of Investments as of June 30, 2009 and June 30, 2008**

(1) The securities in which Prospect Capital Corporation (□we□, □us□ or □our□) has invested were acquired in transactions that were exempt from registration under the Securities Act of 1933, as amended, or the □Securities Act.□ These securities may be resold only in transactions that are exempt from registration under the Securities Act.

(2) Fair value is determined by or under the direction of our Board of Directors (see Note 2).

(3) Security, or portion thereof, is held as collateral for the credit facility with Rabobank Nederland (see Note 11). The market values of these investments at June 30, 2009 and June 30, 2008 were \$434,069 and \$376,463, respectively; they represent 67.2% and 71.0% of total investments at fair value, respectively.

(4) Interest rate is the greater of 11.5% or 3-month LIBOR plus 8.5%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(5) Interest rate is the greater of 10.5% or 3-month LIBOR plus 7.5%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(6) Interest rate is the greater of 14.0% or 12-Month LIBOR plus 7.5%; rate reflected is as of the reporting date □ June 30, 2009 or June 30, 2008, as applicable.

(7) There are several entities involved in the Biomass investment. We own 100 shares of common stock in Worcester Energy Holdings, Inc. (□WEHI□), representing 100% of the issued and outstanding common stock. WEHI, in turn, owns 51 membership certificates in Biochips LLC (□Biochips□), which represents a 51% ownership stake.

We own 282 shares of common stock in Worcester Energy Co., Inc. (□WECO□), which represents 51% of the issued and outstanding common stock. We own directly 1,665 shares of common stock in Change Clean Energy Inc. (□CCEI□), f/k/a Worcester Energy Partners, Inc., which represents 51% of the issued and outstanding common stock and the remaining 49% is owned by WECO. CCEI owns 100 shares of common stock in Precision Logging and Landclearing, Inc. (□Precision□), which represents 100% of the issued and outstanding common stock.

During the quarter ended March 31, 2009, we created two new entities in anticipation of the foreclosure proceedings against the co-borrowers (WECO, CCEI and Biochips) Change Clean Energy Holdings, Inc. (□CCEHI□) and DownEast Power Company, LLC (□DEPC□). We own 1,000 shares of CCEHI, representing 100% of the issued and outstanding stock, which in turn, owns a 100% of the membership interests in DEPC.

On March 11, 2009, we foreclosed on the assets formerly held by CCEI and Biochips with a successful credit bid of \$6,000 to acquire the assets. The assets were subsequently assigned to DEPC.

WECO, CCEI and Biochips are joint borrowers on the term note issued to Prospect Capital. Effective July 1, 2008, this loan was placed on non-accrual status.

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

(8) Gas Solutions Holdings, Inc. is a wholly-owned investment of us. See notes to consolidated financial statements.



**Endnote Explanations for the Consolidated Schedules of Investments as of June 30, 2009 and June 30, 2008 (continued)**

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

(10) Loan is with THS an affiliate of ICS.

(11) Interest rate is the greater of 16.5% or 12-Month LIBOR plus 11.0%; rate reflected is as of the reporting date □ June 30, 2009 or June 30, 2008, as applicable.

(12) On June 30, 2008, we consolidated our holdings in four coal companies into Yatesville Coal Holdings, Inc. (□Yatesville□), and consolidated the operations under one management team. In the transaction, the debt that we held of C&A

Construction, Inc. (□C&A□), Genesis Coal Corp. (□Genesis□), North Fork Collieries LLC (□North Fork□) and Unity Virginia Holdings LLC (□Unity□) were exchanged for newly issued debt from Yatesville, and our ownership interests in C&A, E&L Construction, Inc. (□E&L□), Whymore Coal Company Inc. (□Whymore□), Genesis and North Fork were exchanged for 100% of the equity of Yatesville. This reorganization allows for a better utilization of the assets in the consolidated group.

At June 30, 2009 and at June 30, 2008, Yatesville owned 100% of the membership interest of North Fork. In addition, Yatesville held a \$8,062 and \$5,721, respectively, note receivable from North Fork as of those two respective dates.

At June 30, 2009 and at June 30, 2008, Yatesville owned 87% and 75%, respectively, of the common stock of Genesis and held a note receivable of \$20,802 and \$17,692, respectively, as of those two respective dates.

Yatesville held a note receivable of \$4,261 and \$3,902, respectively, from Unity at June 30, 2009 and at June 30, 2008.

There are several entities involved in Yatesville's investment in Whymore at June 30, 2009 and at June 30, 2008. As of those two respective dates, Yatesville owned 10,000 shares of common stock or 100% of the equity and held a \$14,973 and \$12,822, respectively, senior secured debt receivable from C&A, which owns the equipment. Yatesville owned 10,000 shares of common stock or 100% of the equity of E&L, which leases the equipment from C&A, employs the workers, is listed as the operator with the Commonwealth of Kentucky, mines the coal, receives revenues and pays all operating expenses. Yatesville owns 4,900 shares of common stock or 49% of the equity of Whymore, which applies for and holds permits on behalf of E&L. Yatesville also owned 4,285 Series A convertible preferred shares in each of C&A, E&L and Whymore. Additionally, Yatesville retains an option to purchase the remaining 51% of Whymore. Whymore and E&L are guarantors under the C&A credit agreement with Yatesville.

(13) There are several entities involved in the Appalachian Energy Holdings LLC (□AEH□) investment. We own warrants, the exercise of which will permit us to purchase 15,215 units of Class A common units of AEH at a nominal cost and in near-immediate fashion. We own 200 units of Series A preferred equity, 241 units of Series B preferred equity, and 62.5 units of Series C preferred equity of AEH. The senior secured notes are with C&S Operating LLC and East Cumberland L.L.C., both operating companies owned by AEH.

(14) On a fully diluted basis represents, 11.677% of voting common shares.

(15) Interest rate is the greater of 11.5% or 6-month LIBOR plus 7.0%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(16) We own 99.9999% of AGC/PEP, LLC. AGC/PEP, LLC owns 2,038 out of a total of 65,232 shares of American Gilsonite Holding Company which owns 100% of American Gilsonite Company.

(17) In addition to the stated returns, we also hold overriding royalty interests on which we receive payment based upon operations of the borrower and net profits interest of 10.00% on equity distributions which will be realized upon sale of the borrower or a sale of the interests.  
See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
CONSOLIDATED SCHEDULES OF INVESTMENTS □ (CONTINUED)  
June 30, 2009 and June 30, 2008  
(in thousands, except share data)**

**Endnote Explanations for the Consolidated Schedules of Investments as of June 30, 2009 and June 30, 2008 (continued)**

(18) Interest rate is the greater of 13.0% or 12-Month LIBOR plus 7.5% not to exceed 14.50%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(19) Interest rate is 3-Month LIBOR plus 8.0%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(20) In January 2009, our loan was repaid in full and we retained a 15.0% net profits interest payable on equity distributions.

(21) In addition to the stated returns, we also hold net profits interest which will be realized upon sale of the borrower or a sale of the interests.

(22) Interest rate is the greater of 12.0% or 3-Month LIBOR plus 6.11%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(23) Interest rate is the greater of 13.0% or 12-Month LIBOR plus 7.5%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(24) Interest rate is the greater of 12.0% or 12-month LIBOR plus 6.0%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(25) Total common shares outstanding of 15,811,856 as of March 11, 2009 from Miller Petroleum, Inc.'s Quarterly Report on Form 10-Q filed on March 16, 2009.

(26) Interest rate is 3-Month LIBOR plus 7.5%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(27) Interest rate is 3-Month LIBOR plus 8.0%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(28) Mistral Chip Holdings, LLC owns 45,300 shares out of 50,500 total shares outstanding of Chip Holdings, Inc., the parent company of Shearer's Foods, Inc.

(29) In addition to the stated returns, we also hold overriding royalty interests on which we receive payment based upon operations of the borrower.

(30) Interest rate is the greater of 12.0% or 12-Month LIBOR plus 7.0%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(31) As of June 30, 2009 and June 30, 2008, interest rate is the greater of 13.08% and 12.75%, respectively, or 3-Month LIBOR plus 7.25%; rate reflected is as of the reporting date □ June 30, 2009 or June 30, 2008, as applicable.

(32) Interest rate is the greater of 13.0% or 12-month LIBOR plus 7.5% not to exceed 14.0%; rate reflected is as of the reporting date - June 30, 2009 or June 30, 2008, as applicable.

(33) The number of these warrants which are exercisable is contingent upon the length of time that passes before the bridge loan is repaid, 224 shares on August 11, 2008, 340 additional shares on October 11, 2008 and 574 additional shares on December 11, 2008.

See notes to consolidated financial statements.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(in thousands, except share and per share data)**

**Note 1. Organization**

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

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

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

**Note 2. Significant Accounting Policies**

The following are significant accounting policies consistently applied by us:

*Basis of Presentation*

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

*Use of Estimates*

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

*Basis of Consolidation*

Under the 1940 Act rules, the regulations pursuant to Article 6 of Regulation S-X and the American Institute of Certified Public Accountants' Audit and Accounting Guide for Investment Companies, we are precluded from consolidating any entity other than another investment company or an operating company which provides

substantially all of its services and benefits to us. Our financial statements include our accounts and the accounts of Prospect Capital Funding, LLC, our only wholly-owned, closely-managed subsidiary that is also an investment company. All intercompany balances and transactions have been eliminated in consolidation.

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*Investment Classification*

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

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

*Investment Valuation*

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

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

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

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

Investments are valued utilizing a market approach, an income approach, or both approaches, as appropriate. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). The income approach uses valuation

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

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. We have adopted this statement on a prospective basis beginning in the quarter ended September 30, 2008. Adoption of this statement did not have a material impact on our financial statements for the year ended June 30, 2009.

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**PROSPECT CAPITAL CORPORATION AND SUBSIDIARY  
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FAS 157 classifies the inputs used to measure these fair values into the following hierarchy:

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

In all cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to each investment. The changes to GAAP from the application of FAS 157 relate to the definition of fair value, framework for measuring fair value, and the expanded disclosures about fair value measurements. FAS 157 applies to fair value measurements already required or permitted by other standards. In accordance with FAS 157, the fair value of our investments is defined as the price that we would receive upon selling an investment in an orderly transaction to an independent buyer in the principal or most advantageous market in which that investment is transacted.

In April 2009, FASB issued Staff Position No. 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (FSP FAS 157-4). FSP FAS 157-4 provides further clarification for the application of FAS 157 in markets that are not active and provides additional guidance for determining when the volume of trading level of activity for an asset or liability has significantly decreased and for identifying circumstances that indicate a transaction is not orderly. FSP FAS 157-4 is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of FSP FAS 157-4 for the year ended June 30, 2009, did not have any effect on our net asset value, financial position or results of operations as there was no change to the fair value measurement principles set forth in FAS 157.

*Valuation of Other Financial Assets and Financial Liabilities*

In February 2007, FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - including an amendment of FASB Statement No. 115" ("FAS 159"). FAS 159 permits an entity to elect fair value as the initial and subsequent measurement attribute for many of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. We have adopted this statement on July 1, 2008 and have elected not to value some assets and liabilities at fair value as would be permitted by FAS 159.

#### *Revenue Recognition*

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

Interest income, adjusted for amortization of premium and accretion of discount, is recorded on an accrual basis. Origination, closing and/or commitment fees associated with investments in portfolio companies are accreted into interest income over the respective terms of the applicable loans. Upon the prepayment of a loan or debt security, any prepayment penalties and unamortized loan origination, closing and commitment fees are recorded as interest income.

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

Dividend income is recorded on the ex-dividend date.

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

#### *Federal and State Income Taxes*

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

If we do not distribute (or are not deemed to have distributed) at least 98% of our annual taxable income in the calendar year earned, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such taxable income for the year. To the extent that we determine that our estimated current year annual taxable income will be in excess of estimated current year dividend distributions from such taxable income, we accrue excise taxes, if any, on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income. During the quarter ended December 31, 2008, we elected to retain a portion of our annual taxable income and paid \$533 for the excise tax with the filing of the return in March 2009.

We adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 provides guidance for how uncertain tax positions should be recognized, measured, presented, and disclosed in the financial statements. FIN 48 requires the evaluation of tax positions taken or expected to be taken in the course of preparing our tax returns to determine whether the tax positions are "more-likely-than-not" of being sustained by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. Adoption of FIN 48 was applied to all open tax years as of July 1, 2007. The adoption of FIN 48 did not have an effect on our net asset value, financial condition or results of operations as there was no liability for unrecognized tax benefits and no change to our beginning net asset value. As of June 30, 2009 and for the twelve months then ended, we did not have a liability for any unrecognized tax benefits. Management's determinations regarding FIN 48 may be subject to review and adjustment at a later date based upon factors including, but not limited to, an on-going analysis of tax laws, regulations and interpretations thereof.

#### *Dividends and Distributions*

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

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#### *Financing Costs*

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

We record registration expenses related to shelf filings as prepaid assets. These expenses consist principally of Securities and Exchange Commission (SEC) registration, legal and accounting fees incurred through June 30, 2009 that are related to the shelf filings that will be charged to capital upon the receipt of the capital or charged to expense if not completed.

#### *Guarantees and Indemnification Agreements*

We follow FASB Interpretation Number 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45). FIN 45 elaborates on the disclosure requirements of a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires a guarantor to recognize, at the inception of a guarantee, for those guarantees that are covered by FIN 45, the fair value of the obligation undertaken in issuing certain guarantees. FIN 45 did not have a material effect on the financial statements. Refer to Note 3, Note 7 and Note 10 for further discussion of guarantees and indemnification agreements.

#### *Per Share Information*

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

#### *Reclassifications*

Certain reclassifications have been made in the presentation of prior consolidated financial statements to conform to the presentation as of and for the twelve months ended June 30, 2009.

*Recent Accounting Pronouncements*

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (R), "Business Combinations" (FAS 141(R)). FAS 141(R) establishes accounting principles and disclosure requirements for all transactions in which a company obtains control over another business. The standard is effective for fiscal years beginning after December 15, 2008. Our management does not believe that the adoption of FAS 141(R) will have a material impact on our financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, "Disclosures about Derivative Instruments and Hedging Activities" an amendment of FASB Statement No. 133 (FAS 161). FAS 161 is intended to improve financial reporting for derivative instruments by requiring enhanced disclosure that enables investors to understand how and why the entity uses derivatives, how derivatives are accounted for, and how derivatives affect an entity's results of operations, financial position, and cash flows. FAS 161 becomes effective for fiscal years beginning after November 15, 2008; therefore, is applicable for our fiscal year beginning July 1, 2009. Our management does not believe that the adoption of FAS 161 will have a material impact on our financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No.162, "The Hierarchy of Generally Accepted Accounting Principles" (FAS 162). FAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP. This statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. Our management does not believe that the adoption of FAS 162 will have a material impact on our financial statements.

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In May 2009, the FASB issued Statement of Financial Accounting Standards No. 165, "Subsequent Events" (FAS 165). FAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The standard, which includes a new required disclosure of the date through which an entity has evaluated subsequent events, is effective for interim or annual periods ending after June 15, 2009. We evaluated all events or transactions that occurred after June 30, 2009 up through September 11, 2009, the date we issued these financial statements. During this period, we did not have any material recognizable subsequent events other than those disclosed in Note 12.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 168, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles" a replacement of FASB Statement No. 162 (FAS 168). FAS 168 provides for the FASB Accounting Standards Codification (the Codification) to become the single official source of authoritative, nongovernmental GAAP. The Codification did not change GAAP but reorganizes the literature. FAS 168 is effective for interim and annual periods ending after September 15, 2009. Our management does not believe that the adoption of FAS 168 will have a material impact on our financial statements.

**Note 3. Portfolio Investments**

At June 30, 2009, we had invested in 30 long-term portfolio investments, which had an amortized cost of \$531,424 and a fair value of \$547,168 and at June 30, 2008, we had invested in 29 long-term portfolio investments (including a net profits interest in Charlevoix Energy Trading LLC), which had an amortized cost of \$496,805 and a fair value of \$497,530.

As of June 30, 2009, we own controlling interests in Ajax Rolled Ring & Machine (Ajax), C&J Cladding, LLC (C&J), Change Clean Energy Holdings, Inc. (CCEHI), Gas Solutions Holdings, Inc. (GSHI), Integrated



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Contract Services, Inc. (ICS), Iron Horse Coiled Tubing, Inc. (Iron Horse), NRG Manufacturing, Inc. (NRG), R-V Industries, Inc. (R-V), and Yatesville Coal Holdings, Inc. (Yatesville). We also own an affiliated interest in Appalachian Energy Holdings, LLC (AEH) and Biotronic NeuroNetwork (Biotronic).

The fair values of our portfolio investments as of June 30, 2009 disaggregated into the three levels of the FAS 157 valuation hierarchy are as follows:

	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Investments at fair value				
Control investments	\$ 0	\$ 0	\$206,332	\$206,332
Affiliate investments	0	0	32,254	32,254
Non-control/Non-affiliate investments	0	0	308,582	308,582
	0	0	547,168	547,168
Investments in money market funds	0	98,735		98,735
Total assets reported at fair value	\$ 0	\$98,735	\$547,168	\$645,903

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The aggregate values of Level 3 portfolio investments changed during the twelve months ended June 30, 2009 as follows:

Change in Portfolio Valuations using Significant Unobservable Inputs (Level 3)

Fair value at June 30, 2008	\$ 497,530
Total gains (losses) reported in the Consolidated Statement of Operations:	
Included in net investment income	
Interest income - accretion of original issue discount on investments	2,399
Included in realized (loss) gain on investments	(39,078)
Included in net change in unrealized appreciation (depreciation) on investments	15,019
Payments for purchases of investments, payment-in-kind interest, and net profits interests	98,305
Proceeds from sale of investments and collection of investment principal	(27,007)
Fair value at June 30, 2009	\$ 547,168
The amount of net unrealized gain included in the results of operations attributable to Level 3 assets still held at June 30, 2009 and reported within the caption <i>Net change in unrealized appreciation/depreciation</i> in the Consolidated Statement of Operations:	\$ 19,397

At June 30, 2009, we determined that one of our investments, Change Clean Energy Inc. (CCEI), was other than temporarily impaired and recorded a realized loss representing the amount by which the amortized cost exceeded the fair value. At June 30, 2009, five loan investments were on non-accrual status: AEH, Conquest Cherokee, LLC (Conquest), ICS, Wind River Resources Corp. and Wind River II Corp. (Wind River), and

Yatesville. At June 30, 2008, the loans extended to ICS were on non-accrual status. The loan principal of these loans amounted to \$92,513 and \$14,803 as of June 30, 2009, and June 30, 2008, respectively. The fair values of these investments represent approximately 7.3% and 0.9% of our net assets as of June 30, 2009 and June 30, 2008, respectively. For the years ended June 30, 2009, June 30, 2008 and June 30, 2007, the income foregone as a result of not accruing interest on non-accrual debt investments amounted to \$18,746, \$3,449 and \$1,270, respectively.

GSHI has indemnified us against any legal action arising from its investment in Gas Solutions, LP. We have incurred approximately \$2,093 from the inception of the investment in GSHI through June 30, 2009 for fees associated with a legal action, and GSHI has reimbursed us for the entire amount. The \$2,093 reimbursement is reflected as dividend income: control investments in the Consolidated Statements of Operations with \$179, \$118 and \$178 reflected for the year ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively, and the remainder reflected in prior periods. Additionally, certain other expenses incurred by us which are attributable to GSHI have been reimbursed by GSHI and are reflected as dividend income: control investments in the Consolidated Statements of Operations. For the years ended June 30, 2009, June 30, 2008 and June 30, 2007, such reimbursements totaled as \$4,422, \$4,589 and \$2,578, respectively.

The original cost basis of debt placements and equity securities acquired, including follow-on investments for existing portfolio companies, totaled \$98,305, \$311,947 and \$167,255 during the year ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. Debt repayments and sales of equity securities with a cost basis of approximately \$66,084, \$143,434 and \$36,458 were received during the year ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively.

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**Note 4. Other Investment Income**

Other investment income consists of structuring fees, overriding royalty interests, prepayment penalty on net profits interests, settlement of net profits interests, deal deposits, administrative agent fee, and other miscellaneous and sundry cash receipts. Income from such sources was \$14,762, \$8,336 and \$4,444 for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively.

Income Source	For The Year Ended		
	June 30, 2009	June 30, 2008	June 30, 2007
Structuring fees	\$ 1,274	\$4,751	\$ 2,574
Overriding royalty interests	550	1,819	196
Prepayment penalty on net profits interests	□	1,659	986
Settlement of net profits interests	12,651	□	□
Deal deposit	62	49	688
Administrative agent fee	55	48	□
Miscellaneous	170	10	□
Other Investment Income	\$ 14,762	\$8,336	\$ 4,444

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**Note 5. Equity Offerings and Related Expenses**

During the year ended June 30, 2009, we issued 12,942,500 shares of our common stock through public offerings, a registered direct offering, and through the exercise of over-allotment options on the part of the underwriters. Offering expenses were charged against paid-in capital in excess of par. All underwriting fees and offering expenses were borne by us. The proceeds raised, the related underwriting fees, the offering expenses, and the prices at which common stocks were issued since inception are detailed in the following table:

Issuances of Common Stock	Number of Shares Issued	Gross Proceeds Raised	Underwriting Fees	Offering Expenses	Offering Price
May 26, 2009 over-allotment	1,012,500	\$ 8,353	\$ 418	\$ □	\$ 8.250
May 26, 2009	6,750,000	55,687	2,784	300	8.250
April 27, 2009 over-allotment	480,000	\$ 3,720	\$ 177	\$ □	\$ 7.750
April 27, 2009	3,200,000	24,800	1,177	210	7.750
March 19, 2009	1,500,000	\$ 12,300	□	\$ 513	\$ 8.200
June 2, 2008	3,250,000	\$ 48,425	\$ 2,406	\$ 254	\$ 14.900
March 31, 2008	1,150,000	\$ 17,768	\$ 759	\$ 350	\$ 15.450
March 28, 2008	1,300,000	19,786	□	350	15.220
November 13, 2007 over-allotment	200,000	\$ 3,268	\$ 163	\$ □	\$ 16.340
October 17, 2007	3,500,000	57,190	2,860	551	16.340
January 11, 2007 over-allotment	810,000	\$ 14,026	\$ 688	\$ □	\$ 17.315(1)
December 13, 2006	6,000,000	106,200	5,100	279	17.700
August 28, 2006 over-allotment	745,650	\$ 11,408	\$ 566	\$ □	\$ 15.300
August 10, 2006	4,971,000	76,056	3,778	595	15.300
August 27, 2004 over-allotment	55,000	\$ 825	\$ 58	\$ 2	\$ 15.000
July 27, 2004	7,000,000	105,000	7,350	1,385	15.000

(1) We declared a dividend of \$0.385 per share between offering and over-allotment dates.

Our shareholders' equity accounts at June 30, 2009 and June 30, 2008 reflect cumulative shares issued as of those respective dates. Our common stock has been issued through public offerings, a registered direct offering, the exercise of over-allotment options on the part of the underwriters and our dividend reinvestment plan. When our common stock is issued, the related offering expenses have been charged against paid-in capital in excess of par. All underwriting fees and offering expenses were borne by us.

On October 9, 2008, our Board of Directors approved a share repurchase plan under which we may repurchase up to \$20,000 of our common stock at prices below our net asset value as reported in our financial statements published for the year ended June 30, 2008. We have not made any purchases of our common stock during the period from October 9, 2008 to June 30, 2009 pursuant to this plan.

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**Note 6. Net Increase in Net Assets per Common Share**

The following information sets forth the computation of net increase in net assets resulting from operations per common share for the years ended June 30, 2009, 2008 and 2007, respectively.

	For The Year Ended		
	June 30, 2009	June 30, 2008	June 30, 2007
Net increase in net assets resulting from operations	\$ 35,104	\$ 27,591	\$ 16,728

Weighted average common shares outstanding	31,559,905	23,626,642	15,724,095
Net increase in net assets resulting from operations per common share	\$ 1.11	\$ 1.17	\$ 1.06

## Note 7. Related Party Agreements and Transactions

### *Investment Advisory Agreement*

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

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

The Investment Adviser had previously voluntarily agreed to waive 0.5% of the base management fee if in the future the average amount of our gross assets for each of the two most recently completed calendar quarters at that time, appropriately adjusted for any share issuances, repurchases or other transactions during such quarters, exceeds \$750,000, for that portion of the average amount of our gross assets that exceeds \$750,000. The voluntary agreement by the Investment Adviser for such waiver for each fiscal quarter after December 31, 2007 has been terminated by the Investment Adviser.

The total base management fees earned by and paid to Prospect Capital Management for the years ended June 30, 2009, June 30, 2008 and June 30, 2007 were \$11,915, \$8,921 and \$5,445, respectively.

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

Previously, our Investment Adviser had voluntarily agreed that for each fiscal quarter from January 1, 2005 to March 31, 2007, the quarterly hurdle rate was to be equal to the greater of (a) 1.75% and (b) a percentage equal to the sum of 25.0% of the daily average of the "quoted treasury rate" for each month in the immediately preceding two quarters plus 0.50%. "Quoted treasury rate" means the yield to maturity (calculated on a semi-annual bond equivalent basis) at the time of computation for Five Year U.S. Treasury notes with a constant maturity (as compiled and published in the most recent Federal Reserve Statistical Release H). These calculations were to be appropriately prorated for any period of less than three months and adjusted for any share issuances or repurchases during the current quarter. The voluntary agreement by the Investment Adviser that the hurdle rate be fluctuating for each fiscal quarter after January 1, 2005 (as discussed above) was terminated by the Investment Adviser as of the June 30, 2007 quarter. The investment adviser had also voluntarily agreed that, in the event it is paid an incentive fee at a time when our common stock is trading at a price below \$15 per share for the immediately preceding 30 days (as adjusted for stock splits, recapitalizations and other transactions), it will cause the amount of such incentive fee payment to be held in an escrow account by an independent third party, subject to applicable regulations. The Investment Adviser had further agreed that this amount may not be drawn upon by the Investment Adviser or any affiliate or any other third party until such time as the price of our common stock achieves an average 30 day closing price of at least \$15 per share. The Investment Adviser also had voluntarily agreed to cause 30% of any incentive fee that it is paid and that is not otherwise held in escrow to be invested in shares of our common stock through an independent trustee. Any sales of such stock were to comply with any applicable six month holding period under Section 16(b) of the Securities Act and all other restrictions contained in any law or regulation, to the fullest extent applicable to any such sale. These two voluntary agreements by the Investment Adviser have been terminated by the Investment Adviser for all incentive fees after December 31, 2007.

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

- no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate;
- 100.00% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 125.00% of the quarterly hurdle rate in any calendar quarter (8.75% annualized assuming a 7.00% annualized hurdle rate); and
- 20.00% of the amount of our pre-incentive fee net investment income, if any, that exceeds 125.00% of the quarterly hurdle rate in any calendar quarter (8.75% annualized assuming a 7.00% annualized hurdle rate).

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

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

gains incentive fees paid since inception.

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Income incentive fees totaling \$14,790, \$11,278 and \$5,781 were earned for the years ended June 30, 2009, June 30, 2008 and June 30, 2007, respectively. No capital gains incentive fees were earned for years ended June 30, 2009, June 30, 2008 and June 30, 2007.

*Administration Agreement*

We have also entered into an Administration Agreement with Prospect Administration, LLC (["Prospect Administration"]) under which Prospect Administration, among other things, provides (or arranges for the provision of) administrative services and facilities for us. For providing these services, we reimburse Prospect Administration for our allocable portion of overhead incurred by Prospect Administration in performing its obligations under the Administration Agreement, including rent and our allocable portion of the costs of our chief compliance officer and chief financial officer and their respective staffs. For the years ended June 30, 2009, 2008 and 2007, the reimbursement was approximately \$2,856, \$2,139 and \$532, respectively. Under this agreement, Prospect Administration furnishes us with office facilities, equipment and clerical, bookkeeping and record keeping services at such facilities. Prospect Administration also performs, or oversees the performance of, our required administrative services, which include, among other things, being responsible for the financial records that we are required to maintain and preparing reports to our stockholders and reports filed with the SEC. In addition, Prospect Administration assists us in determining and publishing our net asset value, overseeing the preparation and filing of our tax returns and the printing and dissemination of reports to our stockholders, and generally oversees the payment of our expenses and the performance of administrative and professional services rendered to us by others. Under the Administration Agreement, Prospect Administration also provides on our behalf managerial assistance to those portfolio companies to which we are required to provide such assistance. The Administration Agreement may be terminated by either party without penalty upon 60 days' written notice to the other party. Prospect Administration is a wholly owned subsidiary of our Investment Adviser.

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

Prospect Administration, pursuant to the approval of our Board of Directors, has engaged Vastardis Fund Services LLC (["Vastardis"]) to serve as our sub-administrator to perform certain services required of Prospect Administration. Under the sub-administration agreement, Vastardis provides us with office facilities, equipment, clerical, bookkeeping and record keeping services at such facilities. Vastardis also conducts relations with custodians, depositories, transfer agents, dividend disbursing agents, other stockholder servicing agents, accountants, attorneys, underwriters, brokers and dealers, corporate fiduciaries, insurers, banks and such other persons in any such other capacity deemed to be necessary or desirable. Vastardis provides reports to the Administrator and the Directors of its performance of obligations and furnishes advice and recommendations with respect to such other aspects of our business and affairs as it shall determine to be desirable. Under the revised and renewed sub-administration agreement, Vastardis also provided the service of William E. Vastardis as our Chief Financial Officer (["CFO"]). We compensate Vastardis for providing us these services by the payment of an asset-based fee with a \$400 annual minimum, payable monthly. Our service agreement was amended on September 28, 2008 so that Mr. Vastardis no longer served as our CFO effective as of November 11, 2008. At that time, Brian H. Oswald, a managing director at Prospect Administration, assumed the role of CFO.

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Vastardis does not provide any advice or recommendation relating to the securities and other assets that we should purchase, retain or sell or any other investment advisory services to us. Vastardis is responsible for the financial and other records that either the Administrator on our behalf or we are required to maintain and prepares reports to stockholders, and reports and other materials filed with the SEC. In addition, Vastardis assists us in determining and publishing our net asset value, overseeing the preparation and filing of our tax returns, and the printing and dissemination of reports to our stockholders, and generally overseeing the payment of our expenses and the performance of administrative and professional services rendered to us by others.

Under the sub-administration agreement, Vastardis and its officers, partners, agents, employees, controlling persons, members, and any other person or entity affiliated with Vastardis, are not liable to the Administrator or us for any action taken or omitted to be taken by Vastardis in connection with the performance of any of its duties or obligations or otherwise as sub-administrator for the Administrator on our behalf. The agreement also provides that, absent willful misfeasance, bad faith or negligence in the performance of Vastardis' duties or by reason of the reckless disregard of Vastardis' duties and obligations, Vastardis and its officers, partners, agents, employees, controlling persons, members, and any other person or entity affiliated with Vastardis are entitled to indemnification from the Administrator and us. All damages, liabilities, costs and expenses (including reasonable attorneys' fees and amounts reasonably paid in settlement) incurred in or by reason of any pending, threatened or completed action, suit, investigation or other proceeding (including an action or suit by or in the right of the Administrator or us or our security holders) arising out of or otherwise based upon the performance of any of Vastardis' duties or obligations under the agreement or otherwise as sub-administrator for the Administrator on our behalf are subject to such indemnification.

On April 30, 2009 we gave a 60-day notice to Vastardis of termination of our agreement to provide sub-administration services effective June 30, 2009. We entered into a new consulting services agreement for the period from July 1, 2009 until the filing of our Form 10-K for the year ended June 30, 2009. We paid Vastardis a total of \$30 for services rendered in conjunction with preparation of Form 10-K under the new agreement. All administration services will be assumed by Prospect Administration effective with the filing of this report on Form 10-K.

*Managerial Assistance*

As a business development company, we offer, and must provide upon request, managerial assistance to certain of our portfolio companies. This assistance could involve, among other things, monitoring the operations of our portfolio companies, participating in board and management meetings, consulting with and advising officers of portfolio companies and providing other organizational and financial guidance. We billed \$846, \$1,027, and \$505 of managerial assistance fees for the years ended June 30, 2009, June 30, 2008, and June 30, 2007, respectively, of which \$60 and \$380 remains on the consolidated statement of assets and liabilities as of June 30, 2009, and June 30, 2008, respectively. These fees are paid to the Administrator so we simultaneously accrue a payable to the Administrator for the same amounts, which remain on the consolidated statements of assets and liabilities.

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**Note 8. Financial Highlights**

	Year Ended June 30, 2009	Year Ended June 30, 2008	Year Ended June 30, 2007	Year Ended June 30, 2006
<b>Per Share Data (1):</b>				

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Net asset value at beginning of period	\$ 14.55	\$ 15.04	\$ 15.31	\$
Costs related to the initial public offering	□	□	□	
Costs related to the secondary public offering	□	(0.07)	(0.06)	
Net investment income	1.87	1.91	1.47	
Realized (loss) gain	(1.24)	(0.69)	0.12	
Net unrealized appreciation (depreciation)	0.48	(0.05)	(0.52)	
Net (decrease) increase in net assets as a result of public offering	(2.11)	□	0.26	
Dividends declared and paid	(1.15)	(1.59)	(1.54)	
Net asset value at end of period	\$ 12.40	\$ 14.55	\$ 15.04	\$
Per share market value at end of period	\$ 9.20	\$ 13.18	\$ 17.47	\$
Total return based on market value (2)	(22.04%)	(15.90%)	12.65%	
Total return based on net asset value (2)	(4.81%)	7.84%	7.62%	
Shares outstanding at end of period	42,943,084	29,520,379	19,949,065	7,06
Average weighted shares outstanding for period	31,559,905	23,626,642	15,724,095	7,05
<b>Ratio / Supplemental Data:</b>				
Net assets at end of period (in thousands)	\$ 532,596	\$ 429,623	\$ 300,048	\$ 10
Annualized ratio of operating expenses to average net assets	9.03%	9.62%	7.36%	
Annualized ratio of net investment income to average net assets	13.14%	12.66%	9.71%	

(1) Financial highlights are based on weighted average shares.

(2) Total return based on market value is based on the change in market price per share between the opening and ending market prices per share in each period and assumes that dividends are reinvested in accordance with our dividend reinvestment plan. Total return based on net asset value is based upon the change in net asset value per share between the opening and ending net asset values per share in each period and assumes that dividends are reinvested in accordance with our dividend reinvestment plan.

## Note 9. Litigation

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

On December 6, 2004, Dallas Gas Partners, L.P. (DGP) served us with a complaint filed November 30, 2004 in the U.S. District for the Southern District of Texas, Galveston Division. DGP alleges that DGP was defrauded and that we breached our fiduciary duty to DGP and tortiously interfered with DGP's contract to purchase Gas Solutions, Ltd. (a subsidiary of our portfolio company, GSHI) in connection with our alleged agreement in September 2004 to loan DGP funds with which DGP intended to buy Gas Solutions, Ltd. for approximately \$26,000. The complaint sought relief not limited to \$100,000. On November 30, 2005, U.S. Magistrate Judge John R. Froeschner of the U.S. District Court for the Southern District of Texas, Galveston Division, issued a recommendation that the court grant our Motion for Summary Judgment dismissing all claims by DGP. On February 21, 2006, U.S. District Judge Samuel Kent of the U.S. District Court for the Southern District of Texas, Galveston Division issued an order granting our Motion for Summary Judgment dismissing all claims by DGP, against us. On May 16, 2007, the Court also granted us summary judgment on DGP's liability to us on our counterclaim for DGP's breach of a release and covenant not to sue. On January 4, 2008, the Court, Judge Melinda Harmon presiding, granted our motion to dismiss all DGP's claims asserted against certain of our officers and affiliates. On August 20, 2008, Judge Harmon entered a Final Judgment dismissing all of DGP's claims. DGP appealed to the U.S. Court of Appeals for the Fifth Circuit, which affirmed the Final Judgment on June 24, 2009. DGP has moved for rehearing. Our damage claims against DGP remain pending.



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In May 2006, based in part on unfavorable due diligence and the absence of investment committee approval, we declined to extend a loan for \$10,000 to a potential borrower (the "plaintiff"). Plaintiff was subsequently sued by its own attorney in a local Texas court for plaintiff's failure to pay fees owed to its attorney. In December 2006, plaintiff filed a cross-action against us and certain affiliates (the "defendants") in the same local Texas court, alleging, among other things, tortious interference with contract and fraud. We petitioned the United States District Court for the Southern District of New York (the "District Court") to compel arbitration and to enjoin the Texas action. In February 2007, our motions were granted. Plaintiff appealed that decision. On July 24, 2008, the Second Circuit Court of Appeals affirmed the judgment of the District Court. The arbitration commenced in July 2007 and concluded in late November 2007. Post-hearing briefings were completed in February 2008. On April 14, 2008, the arbitrator rendered an award in our favor, rejecting all of plaintiff's claims. On April 18, 2008, we filed a petition before the District Court to confirm the award. On October 8, 2008, the District Court granted the Company's petition to confirm the award, confirmed the awards and subsequently entered judgment thereon in favor of the Company in the amount of \$2,288. After filing a defective notice of appeal to the United States Court of Appeals for the Second Circuit on November 5, 2008, plaintiff's counsel resubmitted a new notice of appeal on January 9, 2009. The plaintiff subsequently requested that the Company agree to stipulate to the withdrawal of plaintiff's appeal to the Second Circuit. Such a stipulation was filed with the Second Circuit on or about April 14, 2009. Based on this stipulation, the Second Circuit issued a mandate terminating the appeal, which was transmitted to the District Court on April 23, 2009. Post-judgment discovery against plaintiff is continuing and we have filed a motion for sanctions against plaintiff's counsel which is scheduled for argument on October 5, 2009.

**Note 10. Revolving Credit Agreements**

On June 6, 2007, we closed on a \$200,000 three-year revolving credit facility (as amended on December 31, 2007) with Rabobank Nederland (the "Rabobank") as administrative agent and sole lead arranger (the "Rabobank Facility"). Until November 14, 2008, interest on the Rabobank Facility was charged at LIBOR plus 175 basis points; thereafter, under the terms of a commitment letter with Rabobank to arrange and structure a new rated credit facility, we agreed to an immediate increase in the current borrowing rate on the Rabobank Facility to LIBOR plus 250 basis points. Additionally, Rabobank charged a fee on the unused portion of the facility. This fee is assessed at the rate of 37.5 basis points per annum of the amount of that unused portion.

On June 25, 2009, we completed a first closing on an expanded \$250,000 revolving credit facility (the "Syndicated Facility"). The new Syndicated Facility, which had \$175,000 total commitments as of June 30, 2009, includes an accordion feature which allows the Syndicated Facility to accept up to an aggregate total of \$250,000 of commitments for which we continue to solicit additional commitments from other lenders for the additional \$75,000. The revolving period extends through June 24, 2010, with an additional one year amortization period thereafter whereby all principal, interest and fee payments received in conjunction with collateral pledged to the Syndicated Facility, less a monthly servicing fee payable to us, are required to be used to repay outstanding borrowings under the Syndicated Facility. Any remaining outstanding borrowings would be due and payable on the commitment termination date, which is currently June 24, 2011.

The Syndicated Facility contains restrictions pertaining to the geographic and industry concentrations of funded loans, maximum size of funded loans, interest rate payment frequency of funded loans, maturity dates of funded loans and minimum equity requirements. The Syndicated Facility also contains certain requirements relating to portfolio performance, including required minimum portfolio yield and limitations on delinquencies and charge-offs, violation of which could result in the early termination of the Syndicated Facility. The Syndicated Facility also requires the maintenance of a minimum liquidity requirement. At June 30, 2009, we were in compliance with the applicable covenants.

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Interest on borrowings under the credit facility is one-month LIBOR plus 400 basis points, subject to a minimum Libor floor of 200 basis points. Additionally, the banks charge a fee on the unused portion of the credit facility equal to 100 basis points. As of June 30, 2009, we had \$124,000 outstanding under our credit facility. As of June 30, 2009, \$946 was available to us for borrowing under our credit facility. As we make additional investments which are eligible to be pledged under the credit facility, we will generate additional availability to the extent such investments are eligible to be placed into the borrowing base. At June 30, 2009, the investments used as collateral for the Syndicated Facility had an aggregate market value of \$434,069, which represents 81.5% of net assets.

In connection with the origination and amendment of the Syndicated Facility, we incurred approximately \$6.3 million of fees which are being amortized over the term of the facility.

#### Note 11. Selected Quarterly Financial Data (Unaudited)

Quarter Ended	Investment Income		Net Investment Income		Net Realized and Unrealized Gains (Losses)		Net Increase (Decrease) in Net Assets from Operations	
	Total	Per Share (1)	Total	Per Share (1)	Total	Per Share (1)	Total	Per Share (1)
September 30, 2006	\$ 6,432	\$0.65	\$3,274	\$0.33	\$ 690	\$ 0.07	\$ 3,964	\$ 0.07
December 31, 2006	8,171	0.60	4,493	0.33	(1,553)	(0.11)	2,940	0.03
March 31, 2007	12,069	0.61	7,015	0.36	(2,039)	(0.10)	4,976	0.16
June 30, 2007	14,009	0.70	8,349	0.42	(3,501)	(0.18)	4,848	0.24
September 30, 2007	15,391	0.77	7,865	0.39	685	0.04	8,550	0.43
December 31, 2007	18,563	0.80	10,660	0.46	(14,346)	(0.62)	(3,686)	(0.17)
March 31, 2008	22,000	0.92	12,919	0.54	(14,178)	(0.59)	(1,259)	(0.06)
June 30, 2008	23,448	0.85	13,669	0.50	10,317	0.38	23,986	1.10
September 30, 2008 (2)	35,799	1.21	23,502	0.80	(9,504)	(0.33)	13,998	0.67
December 31, 2008	22,213	0.75	11,960	0.40	(5,436)	(0.18)	6,524	0.32
March 31, 2009	20,669	0.69	11,720	0.39	3,611	0.12	15,331	0.71
June 30, 2009	21,800	0.59	11,981	0.32	(12,730)	(0.34)	(749)	(0.03)

(1) Per share amounts are calculated using weighted average shares during period.

(2) Additional income for this quarter was driven by other investment income from the settlement of net profits interests on IEC Systems LP and Advanced Rig Services LLC. See Note 4.

#### Note 12. Subsequent Events

On July 6, 2009, and July 8, 2009, we paid down \$50,500 and \$74,300 of our revolving credit facility, respectively, reducing our outstanding borrowing to zero.

On July 7, 2009, we closed a public offering of 5,175,000 shares of our common stock (including the exercise of over-allotment options of our underwriters). The net proceeds to us were approximately \$44,046 after deducting estimated offering expenses.

On July 20, 2009, we purchased 297,294 shares of our common stock in connection with the dividend reinvestment plan.

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

On August 3, 2009, we announced that we had entered into a definitive agreement to acquire Patriot Capital Funding, Inc. (NASDAQ: PCAP) (Patriot) for approximately \$197,000 comprised of our common stock and cash to repay all Patriot debt, anticipated to be \$110,500 when the acquisition closes. Our common shares will be exchanged at a ratio of approximately 0.3992 for each Patriot share, or 8,616,467 shares of our common stock for 21,584,251 Patriot shares, with such exchange ratio decreased for any tax distributions Patriot may declare before closing. In return, we will acquire assets with an amortized cost of approximately \$311,000 for approximately \$196,000, based on an estimate of our common stock price of \$10 per share and the anticipated debt outstanding at the closing, the value of either may change prior to the closing. We, in conjunction with an independent valuation agent, have determined that the fair value of the assets is approximate to the anticipated purchase price and do not anticipate recording any material gain on the consummation of the transaction.

On August 20, 2009, we issued 3,449,686 shares at \$8.50 per share in a private stock offering. The net proceeds to us were approximately \$29,205 after deducting legal and advisory fees. Concurrent with the sale of these shares, we entered into a registration rights agreement in which we granted the purchasers certain registration rights with respect to the Shares. Under the terms and conditions of the registration rights agreement, we will use our reasonable best efforts to file with the SEC within sixty (60) days a post-effective amendment to the registration statement on Form N-2 and will also use our reasonable best efforts to cause such post-effective amendment to be declared effective by the SEC within one hundred twenty (120) days. Under the registration rights agreement, the Corporation may be obligated to make liquidated damages payments to holders upon certain events.

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

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

**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

As of June 30, 2009, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the 1934 Act). Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective and provided reasonable assurance that information required to be disclosed in our periodic SEC filings is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. However, in evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of such possible controls and procedures.

*Report of Management on Internal Control Over Financial Reporting*

Management is responsible for establishing and maintaining adequate internal control over financial reporting, and for performing an assessment of the effectiveness of internal control over financial reporting as of June 30, 2009. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that (i) pertain to assets of the Company; (ii) provide reasonable

assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Management performed an assessment of the effectiveness of the Company's internal control over financial reporting as of June 30, 2009 based upon criteria in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our assessment, management determined that the Company's internal control over financial reporting was effective as of June 30, 2009 based on the criteria on Internal Control — Integrated Framework issued by COSO. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2009 that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

Our management's assessment of the effectiveness of our internal control over financial reporting as of June 30, 2009 has been audited by BDO Seidman LLP, an independent registered public accounting firm, as stated in their report which appears herein.

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*Report of Independent Registered Public Accounting Firm*

Board of Directors and Shareholders  
Prospect Capital Corporation  
New York, New York

We have audited Prospect Capital Corporation's internal control over financial reporting as of June 30, 2009, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Prospect Capital Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A, Report of Management on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Prospect Capital Corporation maintained, in all material respects, effective internal control over financial reporting as of June 30, 2009, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of assets and liabilities of Prospect Capital Corporation as of June 30, 2009 and 2008, and the related consolidated statements of income, changes in net assets, and cash flows for each of the three years in the period ended June 30, 2009 and our report dated, September 11, 2009 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP  
New York, New York  
September 11, 2009

## **Item 9B. Other Information**

None.

## **PART III**

We will file a definitive Proxy Statement for our 2009 Annual Meeting of Stockholders, or the 2009 Proxy Statement, with the SEC, pursuant to Regulation 14A, not later than 120 days after the end of our fiscal year. Accordingly, certain information required by Part III has been omitted under General Instruction G(3) to Form 10-K. Only those sections of the 2009 Proxy Statement that specifically address the items set forth herein are incorporated by reference.

## **Item 10. Directors, Executive Officers and Corporate Governance.**

### *Section 16(a) Beneficial Ownership Reporting Compliance*

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's directors and executive officers, and persons who own more than 10% of the Company's common stock to file reports of ownership and changes in ownership with the Securities and Exchange Commission ("SEC"). To the Company's knowledge, during the fiscal year ended June 30, 2009, the Company's officers, directors and greater than 10% stockholders had complied with all Section 16(a) filing requirements, except that one Form 4 was filed one day late on behalf of John F. Barry III, Chief Executive Officer, for the purchase of shares of common stock due to an administrative error.

The information required by Item 10 is hereby incorporated by reference from our 2009 Proxy Statement.

### *Code of Ethics*

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

## **Item 11. Executive Compensation.**

The information required by Item 11 is hereby incorporated by reference from our 2009 Proxy Statement.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information required by Item 12 is hereby incorporated by reference from our 2009 Proxy Statement.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information required by Item 13 is hereby incorporated by reference from our 2009 Proxy Statement.

**Item 14. Principal Accounting Fees and Services.**

The information required by Item 14 is hereby incorporated by reference from our 2009 Proxy Statement.

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**PART IV**

**Item 15. Exhibits, Financial Statement Schedules**

The following exhibits are filed as part of this report or hereby incorporated by reference to exhibits previously filed with the SEC (according to the number assigned to them in Item 601 of Regulation S-K):

- 2.1 Agreement and Plan of Merger by and between Patriot Capital Funding, Inc. and Prospect Capital Corporation, dated as of August 3, 2009 (12).
- 3.1 Articles of Amendment and Restatement (1).
- 3.2 Amended and Restated Bylaws (9).
- 4.1 Form of Share Certificate (1).
- 10.1 Investment Advisory Agreement between Registrant and Prospect Capital Management LLC (1).
- 10.2 Custodian Agreement (2).
- 10.3 Administration Agreement between Registrant and Prospect Administration LLC (1).
- 10.4 Transfer Agency and Service Agreement (2).
- 10.5 Dividend Reinvestment Plan (1).
- 10.6 License Agreement between Registrant and Prospect Capital Management LLC (1).
- 10.7 Loan and Servicing Agreement dated June 6, 2007 among Prospect Capital Funding LLC, Prospect Capital Corporation, the lenders from time to time party thereto and Coöperative Centrale Raisseisen-Boerenleenbank B.A., [Rabobank Nederland,] New York Branch (6).

- 10.8 First Amendment to Loan and Servicing Agreement dated December 31, 2007 among Prospect Capital Funding LLC, Prospect Capital Corporation, and Coöperative Centrale Raisseisen-Boerenleenbank B.A., [Rabobank Nederland,] New York Branch (7).
- 10.9 Amended and Restated Loan and Servicing Agreement dated June 25, 2009 among Prospect Capital Funding LLC, Prospect Capital Corporation and Coöperative Centrale Raiffeisen-Boerenleenbank B.A., "Rabobank Nederland," New York Branch (11).
- 10.10 Stock Purchase Agreement, dated as of August 17, 2009, among Prospect Capital Corporation and the purchasers named therein (13).
- 10.11 Registration Rights Agreement, dated as of August 17, 2009, among Prospect Capital Corporation and the purchasers named therein (13).
- 11 Computation of Per Share Earnings (included in the notes to the financial statements contained in this report).
- 12 Computation of Ratios (included in the notes to the financial statements contained in this report).
- 14 Code of Conduct (10)
- 16 Letter regarding change in certifying accountant (4).
- 21 Subsidiaries of the Registrant: (included in the notes to the consolidated financial statements contained in this annual report). (8)
- 22.1 Proxy Statement (5).
- 31.1 \* Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.

31.2 \* Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.

32.1 \* Certification of Chief Executive Officer pursuant to Section 906 of The Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

32.2 \* Certification of Chief Financial Officer pursuant to Section 906 of The Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

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\* Filed herewith.

(1) Incorporated by reference to Pre-Effective Amendment No. 2 to the Registrant's Registration Statement on Form N-2 (File No. 333-114522), filed on July 6, 2004.

(2) Incorporated by reference to Pre-Effective Amendment No. 3 to the Registrant's Registration Statement on Form N-2 (File No. 333-114522), filed on July 23, 2004.

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- (3) Incorporated by reference from the Registrant's Form 10-K filed on September 28, 2006.
- (4) Incorporated by reference to the form 8-K/A (File No. 814-00659), filed on January 21, 2005.
- (5) Incorporated by reference from the Registrant's Proxy Statement filed on October 20, 2008.
- (6) Incorporated by reference from the Registrant's Registration Statement on Form N-2 (File No. 333-143819) filed on September 5, 2007.
- (7) Incorporated by reference from the Registrant's Quarterly Report on Form 10-Q filed on February 11, 2008.
- (8) Incorporated by reference from the Registrant's Form 10-K filed on September 28, 2007.
- (9) Incorporated by reference from the Registrant's Form 8-K filed on September 10, 2008.
- (10) Incorporated by reference from the Registrant's Quarterly Report on Form 10-Q filed on November 10, 2008.
- (11) Incorporated by reference to Exhibit 99.1 of the Registrant's Form 8-K filed on June 26, 2009.
- (12) Incorporated by reference to Exhibit 2.1 of the Registrant's Form 8-K filed on August 5, 2009
- (13) Incorporated by reference Exhibit 10.1 and 10.2 of the Registrant's Form 8-K filed on August 21, 2009.

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### SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized September 11, 2009.

### PROSPECT CAPITAL CORPORATION

#### By:

/s/ John F. Barry III  
John F. Barry III  
Chief Executive Officer and Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

SIGNATURE	TITLE	DATE
/s/ John F. Barry III John F. Barry, III	Chairman of the Board, Chief Executive Officer, Director	September 11, 2009
/s/ Brian H. Oswald Brian H. Oswald	Chief Financial Officer	September 11, 2009
/s/ M. Grier Eliasek M. Grier Eliasek	President, Chief Operations Officer, Director	September 11, 2009
/s/ Graham D.S. Anderson Graham D.S. Anderson	Director	September 11, 2009



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/s/ Andrew C. Cooper  
Andrew C. Cooper

Director

September 11, 2009

/s/ Eugene S. Stark  
Eugene S. Stark

Director

September 11, 2009

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