BRANTLEY CAPITAL CORP
Form 10-K
March 30, 2004

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the Fiscal Year Ended December 31, 2003 **Commission File Number: 814-00127**

BRANTLEY CAPITAL CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**34-1838462**
(State or other Jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

3201 Enterprise Parkway, Suite 350, Cleveland, Ohio 44122

(Address of principal executive offices including zip code)

(216) 464-8400

(Registrant s telephone number including area code)

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

None

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

Common Stock, $.01 par value

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act Yes o No x

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2003 was $27,852,177, based on the last sale price of such stock as quoted by the NASDAQ National Market System on such date (officers, directors and 5% shareholders are considered affiliates for purposes of this calculation).

The number of shares of common stock outstanding as of March 30, 2004 was 3,810,535.

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PART I

Item 1. Business

We are a non-diversified investment company incorporated on August 1, 1996 under the General Corporation Law of the State of Maryland that has elected to be regulated as a business development company under the Investment Company Act of 1940. Our investment objective is to achieve long-term capital appreciation in the value of our investments and to provide current income primarily from interest, dividends and fees paid by our portfolio companies.

We have provided equity and long-term debt financing to small and medium-sized companies in a variety of industries throughout the United States. Our portfolio currently consists primarily of private equity securities and, to a lesser extent, mezzanine investments primarily in the form of subordinated debt with warrants. As of December 31, 2003, our portfolio was composed of the following investments:

	Cost	Fair Value	Percent
Private Equity Securities(1)	$19,075,503	$55,011,012	91%
Private Mezzanine Securities(2)	$ 6,106,651	$ 5,379,392	9%
Total	$25,182,154	$60,390,404	100%

(1) Our private equity securities typically consist of preferred stock.

(2) All of our other current investments, including demand notes, subordinated notes and promissory notes are considered mezzanine investments, although such investments are often accompanied by warrants to purchase common stock. These mezzanine investments are sometimes referred to as equity-linked securities.

Historically, we have focused our investing activities on private equity securities intended to provide long-term capital appreciation. Currently we have a total of $25.2 million invested in 11 private companies. At December 31, 2003, these investments had a stated fair value of $60.4 million, a 140% increase over our original cost. Our investing activity has resulted in inception to date dividends of $2.09 per share and an increase in our net asset value per share to $17.34 as of December 31, 2003. The ending net asset value per share and our cumulative dividends paid per share representing a 94% appreciation since we began operations.

We periodically evaluate potential acquisitions, financing transactions, initial public offerings, strategic alliances, and sale opportunities involving our private portfolio companies. These transactions and activities are generally not disclosed to our stockholders and the investing public until such time as the transactions are publicly announced or completed, as the case may be. Any such pending transaction could have an impact on the value of an investment, which is also generally not adjusted until the transaction is publicly announced or completed.

The following table presents the fair value at December 31, 2003 of each investment that represented more than 5% of our total assets as of such date:

	Fair Value	Percent of Total Assets
Flight Options International, Inc.	$32,500,000	42%
Fitness Quest, Inc.	$11,186,539	15%
Integrated Physician Solutions, Inc.	$ 3,864,348	5%

For a discussion of such investments, see Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Condition, Liquidity and Capital Resources.

On March 19, 2003, the Company entered into a Memorandum of Understanding with Phillip Goldstein, a director of the Company, pursuant to which Mr. Goldstein agreed to dismiss the lawsuit he filed against the Company in September 2002, subject to compliance with the Investment Company Act of 1940. The Court approved the proposed settlement on February 26, 2004.

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On June 4, 2003, the Company filed an application for exemptive relief from certain provisions of the 1940 Act in order to effect the provisions of the Memorandum of Understanding. On June 18, 2003, the Company received comments on its application from the staff of the Division of Investment Management of the Securities and Exchange Commission. On August 14, 2003 the Company responded to those comments. With such response, the Company proposed a new Memorandum of Understanding that was submitted to the staff of the Division of Investment Management. On November 12, 2003, the Company received comments regarding its August 14, 2003 response. The Company responded to such comments on December 18, 2003. On February 11, 2004, the staff of the Division of Investment Management requested a response from the Board of Directors, which the Board provided on February 15, 2004. The Company continues to discuss this matter with the staff of the Division of Investment Management.

The Memorandum of Understanding is subject to approval by the stockholders, and the receipt of exemptive relief from the SEC. There can be no assurance that this exemptive relief will be granted.

Pursuant to the proposed Memorandum of Understanding the Company would agree, among other things:

- to cause there to be four (4) directors who are not interested persons as defined under the 1940 Act and cause the board to be exactly seven (7) directors in total;
- if Mr. Goldstein or Gerald Hellerman is no longer a director of the Company then whichever of Mr. Goldstein or Mr. Hellerman remains on the board shall have the right to select a nominee;
- to not convert the Company from being an advised fund to an internally managed fund unless a majority of the independent directors agree;
- to allow any independent director to request independent counsel, subject to the approval of the board, which cannot be unreasonably withheld; and
- to refrain from making defamatory remarks about any party to the agreement.

In addition, the proposed Memorandum of Understanding provides that at the next Annual Meeting of Stockholders:

- the Company would ask shareholders to approve a plan of orderly disposition of the assets of the Company or a sale of the assets with the goal of prompt cash distribution to shareholders;
- the Company would ask shareholders to approve a new investment advisory agreement pursuant to which, prospectively:
  - the advisor s fees would be reduced from 2.85% to 2.5% of our net asset value;
  - all stock options would be forfeited and cancelled; and
  - the advisor would be entitled to receive a fee equal to 20% of the aggregate distributions made by the Company in excess of $10.00 per share; however, none of the amount would be paid until aggregate distributions totaled $12.50 per share.

The proposed Memorandum of Understanding also includes provisions that would require the parties to take all steps necessary to accomplish the goals of the Memorandum, including voting their shares in favor of the proposals. Under the proposed memorandum, the Company would also be required to reimburse Mr. Goldstein for certain expenses (not to exceed $275,000) incurred in connection with the proxy solicitation and litigation related to the Annual Meeting of Stockholders on September 17, 2002. Mr. Goldstein would also agree not to engage in, lead or fund a proxy contest while the agreement is in effect. The term of the new proposed Memorandum of Understanding would run until December 31, 2006.

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Investments in Private Companies

We have provided equity and long-term debt financing to private companies. We have sought to invest in established companies that generally:

- have annual revenues of $25 million or greater;
- operate in stable industries;
- have demonstrated favorable financial performance for at least five years; and
- have an experienced management team.

We generally have not targeted companies in industries where businesses tend to be particularly vulnerable to changes in economic cycles, are capital intensive, or are highly leveraged. Our private financing has been generally used to fund internal growth, buyouts, acquisitions and recapitalizations.

Our investment adviser has sourced and originated our investment opportunities, thereby avoiding auctions, which we believe affords us better investment terms, enhances our investment returns, and heightens the probability of successfully completing a greater percentage of our targeted transactions.

We have an extensive network of potential investment sources. We estimate that we have historically funded approximately 1% of all the private investment opportunities that our investment adviser reviews on our behalf. When assessing a prospective investment, we generally look for a company that has achieved, or has the potential to achieve, market leadership, critical mass, and sustainable cash flow.

We function as a partner in the growth of our private portfolio companies, rather than merely as a financial participant. We provide managerial assistance to our private companies through board representation and otherwise. Our representatives generally have one or two board seats on each of our private companies. We expect that our representatives will play a role in setting corporate strategies and advising our private portfolio companies regarding important decisions affecting their businesses, including:

- analyzing potential acquisitions;
- recruiting key managers;
- securing equity and debt financing; and
- evaluating strategic opportunities.

We historically have sought to enable our stockholders to participate in investments not typically available to the public due to the private nature of a substantial majority of our portfolio companies, the size of the financial commitment often required in order to participate in such investments, and/or the experience, skill and time commitment required to identify and take advantage of these investment opportunities.

Private Equity Investments

With respect to our private equity investments, we have principally focused on companies that demonstrate strong internal growth dynamics that we consider to be good candidates to achieve growth through selective acquisitions. We have also favored equity investments in private companies that we believe can achieve the necessary size, profitability, management depth and sophistication to become public companies or candidates for acquisition.

Our private equity investments have typically ranged in size from $1 million to $5 million. We generally structure our private equity investments as participating preferred stock with an 8% to 10% dividend yield that accumulates and is paid upon a liquidity event. We generally expect our private equity investments to achieve liquidity within three to five years from their respective origination dates, although there can be no assurance that such a time frame will be met, and situations may arise in which we hold securities for a significantly longer period of time.

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Mezzanine Investments

To date our equity-linked investments have been in the form of mezzanine debt with an equity kicker such as a warrant. Our existing mezzanine investments are generally subordinated notes, ranging in size from $1 million to $3 million with a fixed interest rate of approximately 12% and maturities of five to seven years. Currently, mezzanine investments represent 9% of our investment portfolio.

With respect to our mezzanine investments, we have focused on private companies that have demonstrated predictable and sustainable cash flows from operations, strong tangible assets, reasonable financial leverage relative to cash flows from operations, and reasonable prospects to retire at least 50% of their senior indebtedness within three years of our investment.

The opportunity to liquidate the equity ownership attributable to our mezzanine investments and to realize a gain may occur if the business completes a recapitalization of its equity, either through a sale to new owners, a public offering of its equity, or if we exercise our contractual right, referred to as a put right, to require the portfolio company to purchase the warrants or options held by us at a predetermined put price. The put price of the put right is determined at the time of the original investment and is structured to provide our target return.

Small-Capitalization Public Stock Investments

From our inception through September 2002, we invested a portion of our assets in small-capitalization public companies. With respect to our investments in small-capitalization public companies, our primary focus was on companies that our investment adviser believed had significant potential for growth in sales and earnings. We considered a small-capitalization company to be a company that has a market capitalization under $1.5 billion.

As the Company s assets became more fully invested, we made the decision to dedicate the remaining available capital to our private company investment activities. As a result, we liquidated our small-capitalization public stock portfolio in the third quarter of 2002.

Investment Sourcing

We have enjoyed significant deal sourcing benefits from relationships that the principals of our investment adviser have developed over the years. These individuals have, collectively, in excess of 60 years of private company investment experience including financings involving private equity securities and mezzanine investments, have invested in over 100 private companies and currently manage approximately $250 million in assets. As such, they have established an extensive network of investment referral relationships. Our investment adviser reviews approximately 800 investment opportunities annually for private investment funds that it manages.

We have also worked with numerous other intermediaries to source new investment opportunities, including, but not limited to:

- Private mezzanine and equity investors;
- Banks, law firms, and accountants;
- Investment bankers;
- Business brokers; and
- Industry organizations.

Selection of Investments and Underwriting Process

Most of our investments are in small to medium-sized companies with annual sales of under $500 million. The main criteria for the selection of our investments in portfolio companies has remained consistent since we began operations. We have sought to identify platform companies which we believe have significant opportunities in the markets they serve or have devised innovative products, services or ways of doing business that afford them a distinct competitive advantage. Such companies might achieve growth either internally or by acquisition.

In evaluating potential portfolio companies, we have paid particular attention to the following characteristics:

Management. We have sought investments in companies whose management team consists of talented individuals of high integrity with significant experience. We pay particular attention to the depth of the management team and the extent to which key managers have an ownership interest in the company.

Opportunity for Significant Influence. We have favored investments in companies in which we have had the opportunity to become a partner in the building of the business, rather than being merely a financial participant. In addition, we pursued companies in which our representatives play a role in setting corporate strategies and providing advice regarding important decisions affecting the business, including analyzing potential acquisitions, recruiting key managers, securing equity and debt financing and evaluating strategic opportunities.

Market Dynamics. We preferred investments in companies that address a large, unfulfilled market demand with long-term growth prospects that can reasonably expect to achieve and maintain a significant market share through proprietary products and services. We also favored investments in companies that deliver products and services with significant performance and cost advantages in industries and markets in which significant barriers to effective competition by others exist.

Ability to Achieve Liquidity. We considered the potential and likely means for achieving the liquidity that would ultimately enable us to realize the value of our equity investments. Possible ways of achieving liquidity include an initial public offering of the company, a sale of the company or a purchase by the company or its managers of our equity interest. With respect to our mezzanine investments, we also may achieve liquidity through an exercise of the put right that we receive in connection with such investments.

Ability to Service Debt. With respect to our mezzanine investments, we sought companies that have demonstrated predictable and sustainable cash flows from operations, strong tangible assets, reasonable financial leverage relative to cash flows from operations, and reasonable prospects to retire at least 50% of their senior indebtedness within three years of our investment.

Our investment process includes the identification, due diligence, negotiation, documentation and closing of the investment. Our due diligence typically includes:

- review of historical and prospective financial information;
- on-site visits;
- interviews with management, employees, customers and vendors of the potential portfolio company;
- background checks; and
- research relating to the company s management, markets, products and services.

Upon the completion of due diligence and a decision to proceed with an investment in a company, our investment adviser creates an investment memorandum for presentation to our board of directors, which must approve the investment. Additional due diligence with respect to any investment by us may be conducted on our behalf by attorneys and independent accountants prior to the closing of the investment, as well as other outside advisers, as appropriate.

Portfolio Monitoring and Valuation

We have a written policy that governs the valuation of our assets, pursuant to which our board of directors values our assets each quarter.

We value our privately held investments based on a determination of their fair value made in good faith by our board of directors. Initially, the fair value of each such security is based upon its original cost. Cost is also the primary factor used to determine fair value on an ongoing basis until significant developments or other factors affecting the investment (such as results of subsequent financings, the availability of market quotations, the portfolio company s operations and changes in general market conditions) provide a basis for value other than

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cost. Portfolio investments listed on a securities exchange or traded on the Nasdaq Stock Market are valued at the closing price listed on the relevant exchange or quotation system at the date of valuation. Securities traded in the over-the-counter market are valued based on the average of the closing bid and asked prices on the date of valuation.

Public securities with legal, contractual or other restrictions on transfer may be discounted due to such restrictions. The lack of liquidity of these securities may adversely affect our ability to dispose of them in a timely manner and at a fair price when we deem it necessary or advantageous to do so.

We continuously evaluate opportunities to maximize the value of our investments. In that regard, we periodically evaluate potential acquisitions, financing transactions, initial public offerings, strategic alliances, and sale opportunities involving our private portfolio companies. These transactions and activities are generally not disclosed to our stockholders and the investing public until such time as the transactions are publicly announced or completed, as the case may be. Any such pending transaction could have an impact on the value of an investment, which is also generally not adjusted until the transaction is publicly announced or completed.

Investment Adviser

Brantley Capital Management, L.L.C. has served as our investment adviser since our inception pursuant to an Investment Advisory Agreement. The principals of our investment adviser collectively have in excess of 60 years of private company investment experience, have invested in over 100 private companies and currently manage approximately $250 million in assets, including our assets.

In addition to managing our investments, principals of our investment adviser currently manage the following other funds:

Fund Name	Adviser Since	Committed Capital (in millions)	Status
Brantley Venture Partners I (BVP I)	1987	$ 12.5	Completed
Brantley Venture Partners II (BVP II)	1990	30.0	Completed
Brantley Venture Partners III (BVP III)	1993	57.5	Closed to new investments
Brantley Partners IV (BP IV)	1998	123.8	Approximately 70% invested or committed

The principals of our adviser may form other funds that may make similar investments to the Company s investments.

The principals of our investment adviser select our investments and those of other private investment funds they manage separately, considering in each case only the investment objectives, investment position, available capital and other pertinent factors applicable to that particular investment fund.

Since our inception, our investment adviser has been responsible, on a day-to-day basis, for the selection and supervision of our investments and for the oversight of our financial records and financial reporting requirements. Our investment adviser has experience with both equity and mezzanine investments, including the mezzanine investments in our current portfolio.

Under the terms of our Investment Advisory Agreement, we currently pay our investment adviser an annual management fee of 2.85% of our net assets, determined at the end of each calendar quarter, and payable quarterly in arrears throughout the term of the Investment Advisory Agreement. In connection with the Memorandum of Understanding which is subject to stockholder approval and the receipt of exemptive relief from the SEC, our board has approved and we intend to enter into a new investment advisory agreement that, among other things, reduces the fee we pay on our net assets from 2.85% to 2.5%. The new investment advisory agreement also requires us to pay our advisor a fee equal to 20% of the distributions we make to stockholders in excess of $10.00 per share, provided that no payment shall be made until we have distributed at least $12.50 per share to our stockholders. We intend to seek stockholder approval of the new investment advisory agreement at our 2004 Annual Meeting of Stockholders. The terms of the new agreement will not become effective until stockholder approval has been obtained.

Our investment adviser is responsible for the salaries and expenses of its own personnel, office space costs and local telephone and administrative support costs. For the fiscal years ended December 31, 2003, 2002 and 2001, fees earned by our investment advisor were $1,952,808, $1,901,941, and $1,631,885 respectively. The Investment Advisory Agreement is renewed annually and is terminable with 60 days notice by either party.

Co-Investments and Follow-On Investments

We have co-invested with other private investment funds managed by our investment adviser, on terms and conditions that are the same in all material respects for all parties. At the present time, these funds include Brantley Venture Partners II, L.P., Brantley Venture Partners III, L.P. and Brantley Partners IV, L.P. On November 18, 1997, we received an exemptive order from the Securities and Exchange Commission that, subject to certain terms and conditions, relieves us from certain provisions of the Investment Company Act of 1940 and generally permits us to co-invest with investment funds managed by our investment adviser.

Temporary Investments

We invest our cash in cash equivalents, government securities and high quality debt securities maturing in 90 days or less from the time of investment.

The Investment Advisory Agreement

Pursuant to the Investment Advisory Agreement, Brantley Capital Management, L.L.C., Lakepoint, 3201 Enterprise Parkway, Suite 350, Cleveland, Ohio 44122, serves as our investment adviser. Subject to the overall supervision of our board of directors, our investment adviser administers our business affairs and furnishes us with office facilities and clerical, bookkeeping and record keeping services at such facilities.

Pursuant to the terms of the Investment Advisory Agreement, our investment adviser is responsible for, among other things:

- Determining what securities we will purchase, retain or sell;
- Identifying and evaluating the structure of the investments we make;
- Arranging debt financing for us;
- Providing portfolio management and servicing of securities in our portfolio; and
- Administering our day-to-day affairs.

Our investment adviser is also responsible for oversight of the administrator responsible for the financial records which we are required to maintain and assists in the preparation of financial information for reports to our stockholders and reports filed with the Securities and Exchange Commission. In addition, our investment adviser assists us in determining and publishing our net asset value, oversees both 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.

In return for its services, we currently pay our investment adviser an annual management fee of 2.85% of our average net assets, determined at the end of each calendar quarter, and payable quarterly in arrears, throughout the term of the Investment Advisory Agreement.

The Investment Advisory Agreement is not exclusive, and the adviser is free to furnish similar services to others so long as its services to us are not impaired.

Our investment adviser is responsible for the salaries and expenses of its own personnel and for certain additional expenses, including but not limited to:

- all costs associated with identifying and selecting prospective investments;
- the cost of office space and necessary office equipment for us; and

the cost of adequate corporate, administrative and clerical personnel for us.

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We are responsible for all other expenses, including those relating to calculating and publishing our net asset value, all other expenses incurred by either our investment adviser or us in connection with administering the ordinary course of our business, and direct costs such as printing, mailing, long distance telephone, staff, independent accountants and outside legal costs.

The Investment Advisory Agreement was approved by our board of directors on October 29, 1996, and is renewable each year on November 26, provided that its continuance is approved annually by our board of directors or by the affirmative vote of the holders of a majority of the outstanding shares of our common stock, including, in either case, approval by our directors who are not interested persons. Our board of directors recently approved the renewal of the Investment Advisory Agreement and it is therefore subject to renewal on November 26, 2004. The Investment Advisory Agreement may be terminated by either party without penalty upon at least 60 days notice to the other. See Risk Factors We Depend Upon Our Investment Adviser for Our Future Success.

In connection with the Memorandum of Understanding which is subject to stockholder approval and the receipt of exemptive relief from the SEC, our board of directors has approved and we intend to enter into a new investment advisory agreement that, among other things, reduces the fee we pay on our net assets from 2.85% to 2.5%. The new investment advisory agreement also requires us to pay our advisor a fee equal to 20% of the distributions we make to stockholders in excess of $10.00 per share, provided that no payment shall be made until we have distributed at least $12.50 per share to our stockholders. We intend to seek stockholder approval of the new investment advisory agreement at our 2004 Annual Meeting of Stockholders. Our investment advisor will operate under the currently executed investment advisory agreement pending the approval of the new investment advisory agreement by our stockholders.

Administrator, Custodian, Transfer and Dividend Paying Agent and Registrar

State Street Bank and Trust Company serves as our administrator and, subject to appropriate review and approval by our board of directors or our officers:

- oversees the determination and publication of our net asset value;
- oversees the maintenance by our custodian of certain of our books and records;
- prepares income tax returns for review by our independent accountants;
- reviews and arranges for payment of our expenses;
- prepares financial information to be submitted to our stockholders and arranges for the printing and dissemination of reports and communications to our stockholders;
- prepares periodic financial information required to be filed with the Securities and Exchange Commission;
- prepares certain reports relating to our business and affairs, and upon request, makes recommendations to the board of directors concerning the performance of the independent accountants or the performance and fees of the custodian and transfer agent;
- oversees calculations of fees paid to our investment adviser, custodian and transfer agent;
- provides periodic testing of portfolios to assist our investment adviser in complying with the Internal Revenue Code, the requirements of the Investment Company Act of 1940; and
- provides such other services as necessary to administer the ordinary course of our business.

For its services, we pay the administrator an annual fee based on our average net assets of (i) 0.08% of the first $100 million of average net assets; (ii) 0.06% of the next $100 million of average net assets; and (iii) 0.04% of average net assets in excess of $200 million, subject to a minimum annual fee of $75,000. Based on our net assets of $66,090,665 at December 31, 2003, the annual fee we would pay to the administrator in 2004 would be $75,000. An additional annual fee of $10,000 will be applied if we engage in leverage transactions other than temporary borrowings. We also reimburse the administrator for its out-of-pocket expenses.

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Our administration agreement with State Street Bank and Trust Company also provides for certain limitations on the liability of State Street and indemnification of State Street by us under certain circumstances. State Street cannot be held liable for damages under the agreement unless such damages were caused by gross negligence or willful misconduct, and such damages are limited to State Street s total annual compensation under the administration agreement. In addition, we agree to indemnify State Street against any claims made under the administration agreement that are not the result of the gross negligence or willful misconduct of State Street, its officers or employees.

State Street Bank and Trust Company, 225 Franklin Street, Boston, MA, 02110 is our transfer and dividend paying agent and registrar as well as our custodian.

Determination of Net Asset Value

We have a written policy that governs the valuation of our assets, pursuant to which our board of directors values our assets each quarter. We value our privately held investments based on a determination of their fair value made in good faith by our board of directors. Initially, the fair value of each such security is based upon its original cost. Cost is also the primary factor used to determine fair value on an ongoing basis until significant developments or other factors affecting the investment (such as results of subsequent financings, the availability of market quotations, the portfolio company s operations and changes in general market conditions) provide a basis for value other than cost.

In adjusting the value of any given portfolio company, our board of directors applies various methods under our valuation guidelines to determine value. They may use, when available, third-party transactions in a portfolio company s securities as the basis of valuation. This basis of valuation is referred to as the private market method and is used only with respect to completed transactions or firm offers made by sophisticated, independent investors. Our board of directors may also use appraisal procedures to determine fair value. Appraisal valuations are based upon such factors as the portfolio company s earnings and net worth, the market prices for similar securities of comparable companies and an assessment of the company s future financial prospects. In the case of unsuccessful operations, the appraisal may be based upon liquidation value. Appraisal valuations are necessarily subjective.

Portfolio investments for which market quotations are readily available and which are freely transferable are valued as follows:

- securities listed on a securities exchange or traded on the Nasdaq Stock Market are valued at the closing price listed on the relevant exchange or quotation system on the date of valuation; and

- securities traded in the over-the-counter market (known as pink sheets) are valued based on the average of the closing bid and asked prices on the date of valuation.

Securities for which market quotations are readily available but are restricted from free trading in the public securities markets, such as Rule 144 stock, are valued by discounting the closing price or the closing bid and asked prices, as the case may be, for the last trading day prior to the date of valuation to reflect the illiquidity caused by such restrictions, but taking into consideration the existence, or lack thereof, of any contractual right to have the securities registered and freed from such trading restrictions.

An investment that is exercisable for or convertible into a security for which market quotations are readily available or otherwise contains the right to acquire such a security is deemed to be an investment for which market quotations are readily available, but the value of any such security is reduced by any consideration to be paid by us in connection with the exercise or conversion of such security.

The value of restricted stock investments for which no public market exists cannot be precisely determined. Generally, such investments are valued on a going concern basis without giving effect to any disposition costs. Debt securities with maturities of 60 days or less remaining are valued under the amortized cost method. The amount to be amortized is the value on the 61st day if the security was obtained with more than 60 days remaining to maturity. Securities with maturities of more than 60 days remaining for which there is a market and which are freely transferable are valued at the most recent bid price or yield equivalent as obtained from dealers that make markets in such securities. Certificates of deposit which we purchase generally are valued at their face value, plus interest accrued to the date of valuation.

Our board of directors reviews our valuation policies from time to time to determine their appropriateness. Our board of directors may also hire independent firms to review the methodology of valuation or to conduct a valuation.

In order to determine the net asset value per share of our common stock:

- the value of our assets, including our portfolio securities, is determined by our board of directors;
- our liabilities, if any, are subtracted therefrom; and
- the difference is divided by the number of outstanding shares of our common stock.

The value of our investments may be very difficult to ascertain. Valuation of our investments by the board of directors is, by necessity, subjective and may not be indicative of the price at which such securities may ultimately be sold. The net asset value, as determined by our board of directors, may not be reflective of the price at which an investor could sell his, her or its shares of our common stock in the open market.

Regulation as a Business Development Company

We operate in a highly regulated environment. The following discussion generally summarizes certain regulations.

A business development company is defined and regulated by the Investment Company Act of 1940. It is a unique kind of investment company that primarily focuses on investing in or lending to small private companies and making managerial assistance available to them. A business development company may use capital provided by public stockholders and from other sources to invest in long-term, private investments in growing businesses. A business development company provides stockholders the ability to retain the liquidity of a publicly traded stock, while sharing in the possible benefits, if any, of investing in privately owned growth companies.

As a business development company, we may not acquire any asset other than qualifying assets unless, at the time we make the acquisition, our qualifying assets represent at least 70% of the value of our total assets. This is referred to as the 70% test. The principal categories of qualifying assets relevant to our business are:

- Securities purchased in transactions not involving any public offering, the issuer of which is an eligible portfolio company. An eligible portfolio company is defined to include any issuer that:
  - is organized and has its principal place of business in the United States;
  - is not an investment company other than a small business investment company wholly owned by a business development company; and
  - does not have any class of publicly traded securities with respect to which a broker may extend margin credit;
- Securities received in exchange for or distributed with respect to securities described above or pursuant to the exercise of options, warrants, or rights relating to such securities; and
- Cash, cash equivalents, government securities, or high quality debt securities, within the meaning of the Investment Company Act of 1940, maturing in one year or less from the time of investment.

In addition, a business development company must be organized in the United States for the purpose of making investments in the types of securities described above. To include certain securities described above as qualifying assets for the purpose of the 70% test, a business development company must make available to the issuer of those securities significant managerial assistance such as providing significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company.

We may invest up to 30% of our assets in portfolio investments that are not qualifying assets.

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As a business development company, we are entitled to issue senior securities in the form of stock or senior securities representing indebtedness, including debt securities and preferred stock, as long as each class of senior security has an asset coverage of at least 200% immediately after each such issuance.

We are also prohibited by the Investment Company Act of 1940 from knowingly participating in a joint transaction, including co-investments in a portfolio company with an affiliated person, including any of our directors, our investment adviser or any entity controlled or advised by any of them. We have been granted an exemptive order from the Securities and Exchange Commission relieving us, subject to certain terms and conditions, from certain of the provisions of the Investment Company Act of 1940, and generally permitting us to engage in co-investments with certain private investment funds managed by our investment adviser.

We have adopted a code of ethics that establishes procedures for personal investments and restricts certain transactions. You may read and copy the code of ethics at the Securities and Exchange Commission s Public Reference Room in Washington, DC. You may obtain information on the operation of the Public Reference Room by calling the Commission at 1-202-942-8090. In addition, the code of ethics is available on the EDGAR Database on the Commission s Internet site at http://www.sec.gov. You may obtain copies of the code of ethics, after paying a duplicating fee, by electronic request at the following Email address: publicinfo@sec.gov, or by writing the Commission s Public Reference Section Washington, DC 20549-0102.

Our Internet address is www.brantleycapital.com. We make available free of charge on our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Information contained on our website is not incorporated by reference into this annual report on Form 10-K, and you should not consider information contained on our website to be part of this annual report on Form 10-K.

Under the Investment Company Act of 1940, we are prohibited, as a business development company, from selling our common stock at a price below the current net asset value per share for such stock unless, among other conditions, the policy and practice of making such sales is approved by holders of a majority of our outstanding voting securities, as well as the holders of a majority of our outstanding voting securities who are not our affiliates. In addition, a majority of our directors who are not interested persons of our company must first determine that any such sale would be in the best interest of our company and our stockholders, and in consultation with the underwriter, that the offering price would be not less than a price that closely approximates the market price less any distributing discount or commission.

We may not change the nature of our business so as to cease to be, or withdraw our election as, a business development company unless authorized by vote of a majority of the outstanding voting securities, as defined in the Investment Company Act of 1940. The Investment Company Act of 1940 defines a majority of the outstanding voting securities as (1) 67% or more of the voting securities present at such meeting if the holders of more than 50% of the outstanding voting securities are present or represented by proxy, or (2) 50% of the outstanding voting securities, whichever of the two is the lesser.

Tax Status

The following discussion is a general summary of the material United States federal income tax considerations applicable to us and to an investment in our common stock. This summary does not purport to be a complete description of the income tax considerations applicable to such an investment. The discussion is based upon the Internal Revenue Code, Treasury Regulations, and administrative and judicial interpretations, each as of the date of this report and all of which are subject to change. You should consult your own tax advisor with respect to tax considerations that pertain to your purchase of our common stock.

This summary is intended to apply to investments in our common stock and assumes that investors hold our common stock as capital assets. This summary does not discuss all aspects of federal income taxation relevant to holders of our common stock in light of particular circumstances, or to certain types of holders subject to special treatment under federal income tax laws, including dealers in securities, pension plans and trusts and financial institutions. This summary does not discuss any aspects of U.S. estate and gift tax or foreign, state or local tax. It *does not discuss the special treatment under federal income tax laws that could result if we invested in tax-exempt securities or certain other investment assets.*

Except as specifically indicated herein, this summary is intended to apply to U.S. Stockholders (as defined below) and does not purport to discuss all U.S. federal income tax consequences to persons who are not U.S. Stockholders (Non-U.S. Stockholders) from an investment in our common stock. A U.S. Stockholder is a stockholder who is (i) a citizen or resident of the United States, (ii) a corporation, partnership or other entity created in or organized under the laws of the United States or any political subdivision thereof, (iii) an estate, the income of which is subject to United States federal income taxation regardless of its source, or (iv) a trust subject to the supervision of a court within the United States and the control of a United States person. Non-U.S. Stockholders should consult their own tax advisors to discuss the consequences of an investment in our common stock.

Taxation as a Regulated Investment Company

We intend to continue to be treated for tax purposes as a regulated investment company under Subchapter M of the Internal Revenue Code (the Code). If we (i) qualify as a regulated investment company and (ii) distribute to our stockholders in a timely manner at least 90% of our investment company taxable income, as defined below (the 90% Distribution Requirement) each year, we will not be subject to federal income tax on the portion of our investment company taxable income and net capital gain (i.e., net long-term capital gain in excess of net short-term capital loss) that we distribute (or treat as deemed distributed) to stockholders. Investment Company Taxable Income under the Code generally means all taxable income excluding any net capital gains and with certain other adjustment period. In addition, if we distribute in a timely manner the sum of (i) 98% of our ordinary income for each calendar year, (ii) 98% of our capital gain net income for the one-year period ending October 31 in that calendar year, and (iii) any income not distributed in prior years, we will not be subject to the 4% nondeductible federal excise tax on certain undistributed income of regulated investment companies (the Excise Tax Avoidance Requirements). We generally will endeavor to distribute (or treat as deemed distributed) to our stockholders all of our investment company taxable income and our net capital gain, if any, for each taxable year so that we will not incur federal income or excise taxes on our earnings. We will be subject to federal income tax at our regular corporate rate for any amounts of investment company taxable income or net capital gain not distributed (or deemed distributed) to our stockholders.

In order to qualify as a regulated investment company for federal income tax purposes, we must, among other things: (a) continue to qualify as a business development company under the Investment Company Act of 1940; (b) derive in each taxable year at least 90% of our gross income from dividends, interest, payments with respect to securities loans, gains from the sale of stock or other securities, or other income derived with respect to our business of investing in such stock or securities (the 90% Income Test); and (c) diversify our holdings so that at the end of each quarter of the taxable year (i) at least 50% of the value of our assets consists of cash, cash equivalents, U.S. government securities, securities of other regulated investment companies, and other securities if such other securities of any one issuer do not represent more than 5% of our assets or more than 10% of the outstanding voting securities of the issuer (the 50% of the Value Requirement), and (ii) no more than 25% of the value of our assets is invested in the securities (other than U.S. government securities or securities of other regulated investment companies) of any one issuer or of two or more issuers that are controlled (as determined under applicable rules of the Internal Revenue Code) by us and are engaged in the same or similar or related trades or businesses (the 25% of the Value Limitation and together, the 50% of the Value Requirement and the 25% of the Value Limitation shall be referred to as the Diversification Test.)

Because we invest in only a limited number of portfolio companies, we currently do not satisfy the 25% of the Value Limitation (and therefore the Diversification Test). In addition, we anticipate that we may not satisfy the Diversification Test on the last day of one or more future quarters. The Internal Revenue Code, however, modifies the above Diversification Test in the case of certain investment companies furnishing capital to development corporations (the Modified Diversification Test). In order for the Modified Diversification Test to be applicable to us, the Securities and Exchange Commission must determine and certify to the Internal Revenue Service no more than 60 days prior to the close of each relevant taxable year that we are principally engaged in the furnishing of capital to other corporations that are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available. For purposes of this determination, a corporation will be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available for at least 10 years after our first acquisition of any security in such corporation if, as of the date of such first acquisition, the issuer corporation was principally so engaged. In addition, we will be considered on any date to be furnishing capital to a corporation whose securities we hold if we have acquired securities in such corporation within the preceding 10 years. We intend to request such certification, if necessary. Periodic recertification may be necessary.

If the Modified Diversification Test is applicable to us, then for purposes of determining whether we satisfy the 50% of the Value Requirement discussed above, we will be able to include the value of the securities of any issuer (whether or not we hold more than 10% of the outstanding voting securities of such issuer) provided that at the time of the latest acquisition of any securities of such issuer our basis in all securities of such issuer held by us did not exceed 5% of the value of our total assets as of such date. The Modified Diversification Test will not apply to any security of an issuer if we have continuously held securities in such issuer (or any predecessor company) for more than 10 years. In addition, the Modified Diversification Test will not apply to us for a quarter if, as of the close of such quarter, more than 25% of our total assets are represented by securities of issuers for which we hold more than 10% of the outstanding voting securities of such issuers and with respect to which we have continuously held securities in such issuers (or any predecessor companies) for more than 10 years, unless the value of our total assets represented by such securities is reduced to 25% or less within 30 days after the close of such quarter. Even if the Modified Diversification Test is applicable to us, we must still satisfy the 25% of the Value Limitation discussed above. The Internal Revenue Code also contains two other exceptions to the Diversification Test that may allow us to continue to qualify as a regulated investment company even if we fail to satisfy the Diversification Test (or the Modified Diversification Test) as of the close of any quarter. In this respect, the Code provides that a company that satisfied the Diversification Test as of the close of any quarter shall not lose its status as a regulated investment company during a subsequent quarter due to a discrepancy between the value of its various investments and the requirements of the Diversification Test unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. Thus, if we have satisfied the Diversification Test for at least one quarter, we will not lose our status as a regulated investment company as a result of failing to satisfy the Diversification Test provided such failure is due to a fluctuation in the value of our assets or a distribution made by us and is not attributable in whole or in part to the acquisition of any securities (the Fluctuation in Value Exception). In addition, if a discrepancy is due in whole or in part to the acquisition of securities, the Internal Revenue Code provides that a company will not lose its status as a regulated investment company if such discrepancy is eliminated within 30 days after the close of such quarter. Thus, we will generally have 30 days after the close of any quarter to dispose of assets in order to satisfy the Diversification Test. We currently satisfy the Fluctuation in Value Exception. Accordingly, although we do not satisfy the Diversification Test, we are still adequately diversified under the Subchapter M requirements for regulated investment companies.

If we fail to satisfy the Diversification Test for any future quarter, the Modified Diversification Test and the exceptions to the Diversification Test discussed above, we will fail to qualify as a regulated investment company and all of our income will be subject to federal income tax at the regular corporate tax rate as discussed below. As a result, we will make every effort to satisfy the Diversification Test, the Modified Diversification Test, or the exceptions to the Diversification Test. In order to satisfy these tests, however, we may be prevented from making acquisitions (including acquisitions through the exercise of options, warrants, conversion rights, or other purchase rights) of new or additional securities, even though we believe such acquisitions to be advantageous or beneficial from an investment standpoint. Alternatively, it may be necessary for us to dispose of certain currently held securities in order to satisfy these tests even though such dispositions may not be advantageous or beneficial from an investment standpoint. Because our portfolio will consist primarily of illiquid investments, we may not be able to dispose of our assets in a timely manner or on an economically advantageous basis in order to satisfy the Diversification Test, the Modified Diversification Test or the exceptions to the Diversification Test.

If we acquire or are deemed to have acquired debt obligations that were issued originally at a discount or that otherwise are treated under applicable tax rules as having original issue discount, we must include in income

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each year a portion of the original issue discount that accrues over the life of the obligation regardless of whether cash representing such income is received by us in the same taxable year. Any amount accrued as original issue discount will be included in our investment company taxable income for the year of accrual and may have to be distributed to our stockholders in order to satisfy the 90% Distribution Requirement or the Excise Tax Avoidance Requirements even though we have not received any cash representing such income.

Although we do not presently expect to do so, we are authorized to borrow funds and to sell assets in order to satisfy distribution requirements. However, under the Investment Company Act of 1940, we are not permitted to make distributions to our stockholders while our debt obligations and other senior securities are outstanding unless certain asset coverage tests are met. Moreover, our ability to dispose of assets to meet our distribution requirements may be limited by (i) the illiquid nature of our portfolio and/or (ii) other requirements relating to our status as a regulated investment company, including the Diversification Test. If we dispose of assets in order to meet the 90% Distribution Requirement or the Excise Tax Avoidance Requirements, we may make such dispositions at times that, from an investment standpoint, are not advantageous.

If we fail to satisfy the 90% Distribution Requirement or otherwise fail to qualify as a regulated investment company in any taxable year, we will be subject to tax in that year on all of our taxable income, regardless of whether we make any distributions to our stockholders. In that case, all of our distributions to our stockholders will be characterized as ordinary income (to the extent of our current and accumulated earnings and profits). In contrast, as is explained below, if we qualify as a regulated investment company, a portion of our distributions or deemed distributions may be characterized as long-term capital gain in the hands of our stockholders.

The remainder of this summary assumes that we qualify as a regulated investment company and satisfy the 90% Distribution Requirement.

Taxation of Stockholders

Our distributions generally are taxable to our stockholders as ordinary income or capital gains. Distributions of our investment company taxable income will be taxable as ordinary income to our stockholders to the extent of our current or accumulated earnings and profits, whether paid in cash or reinvested in additional common stock. Distributions of our net capital gains properly designated by us as capital gain dividends will be taxable to a stockholder as long-term capital gains regardless of such stockholder s holding period for his or her common stock and regardless of whether paid in cash or reinvested in additional common stock. Distributions in excess of our earnings and profits first will reduce a stockholder s adjusted tax basis in such stockholder s common stock and, after the adjusted basis is reduced to zero, will constitute capital gains to such stockholder. Any distribution automatically reinvested in additional shares of our common stock through our opt out dividend reinvestment plan will be taxable to a stockholder to the same extent, and with the same character, as if such stockholder received the distribution in cash. Any additional shares of our common stock acquired by a stockholder pursuant to such an automatic reinvestment of a distribution will have an adjusted basis equal to the amount of the reinvested distribution and will have a holding period that will commence on the date such shares are acquired by, or allocated for the benefit of, such stockholder. A portion of our distributions may be subject to alternative minimum tax. You should consult your own tax advisor to determine how an investment in our stock would affect your alternative minimum tax liability.

At our option, we may elect to retain some or all of our net capital gains for a tax year, but designate the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount for the benefit of our stockholders, our stockholders will be required to report their share of the deemed distribution on their tax returns as if it had been distributed to them, and our stockholders will report a credit for the tax paid thereon by us. The amount of the deemed distribution net of such tax will be added to a stockholder s cost basis for his or her common stock. Since we expect to pay tax on any retained net capital gains at our regular corporate capital gain tax rate, and since that rate is in excess of the maximum rate currently payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid and for which they will receive a credit will exceed the amount of tax that such stockholders would be required to pay on the retained net capital gains. Such excess generally will be available to offset other tax liability to the stockholders. A stockholder that is not subject to U.S. federal income tax should be able to file a

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return on the appropriate form or a claim for refund that allows such stockholder to recover the taxes paid on his or her behalf. In the event we choose this deemed distribution option, we must provide written notice to our stockholders prior to the expiration of 60 days after the close of the relevant tax year.

Any dividend we declare in October, November, or December of any calendar year, payable to our stockholders of record on a specified date in such a month and which we actually pay during January of the following year, will be treated as if it had been received by our stockholders on December 31 of the year in which we declared the dividend.

If we acquire qualified small business stock, hold such stock for more than five years, and dispose of such stock at a gain, a non-corporate stockholder who held his, her, or its common stock at the time that we purchased the qualified small business stock and at all times thereafter until the disposition of such qualified small business stock may be entitled to exclude from such stockholder s taxable income up to 50% of such stockholder s share of such gain. For this purpose, qualified small business stock generally means stock that was acquired directly from the issuing corporation, where such issuing corporation is taxable under Subchapter C of the Internal Revenue Code, is actively engaged in a trade or business, and has no more than $50,000,000 of gross assets at any time prior to issuance and immediately thereafter. A portion of any amount excluded from your taxable income pursuant to the rules discussed in this paragraph will be treated as a preference item for purposes of computing your alternative minimum tax liability.

You should consider the tax implications of buying our common stock just prior to a distribution. Even if the price of our common stock includes the amount of the forthcoming distribution, you may be taxed upon receipt of the distribution and will not be entitled to offset the distribution against your tax basis in our common stock. You may recognize taxable gain or loss if you sell or exchange our common stock. The amount of the gain or loss will be measured by the difference between your adjusted tax basis in such stock and the amount of the proceeds you receive in exchange for such stock. Any gain or loss arising from (or, in the case of distributions in excess of earnings and profits, treated as arising from) the sale or exchange of our common stock generally will be a capital gain or loss. This capital gain or loss normally will be treated as a long-term capital gain or loss if you have held such stock for more than one year; otherwise, it will be classified as short-term capital gain or loss. However, any capital loss arising from the sale or exchange of our common stock held for six months or less generally will be treated as a long-term capital loss to the extent of the amount of capital gain dividends received, or treated as deemed distributed, with respect to such stock and, for this purpose, the special rules of Section 852(b)(4)(C) of the Internal Revenue Code generally apply in determining the holding period of such stock. In addition, all or a portion of any loss realized upon a taxable disposition of our common stock may be disallowed if other shares of our common stock are purchased, under our dividend reinvestment and cash purchase plan or otherwise, within 30 days before or after the disposition.

In general, non-corporate stockholders currently are subject to a maximum federal income tax rate on their net long-term capital gain (the excess of net long-term capital gain over net short-term capital loss) for a taxable year (including a long-term capital gain derived from an investment in the common stock of the company) that is lower than the maximum rate for other income. Corporate taxpayers currently are subject to federal income tax on net capital gains at a maximum rate equal to the maximum rate applied to ordinary income. Tax rates imposed by states and local jurisdictions on capital gain and ordinary income may differ. Non-corporate stockholders with net capital losses for a year (i.e., capital losses in excess of capital gains) generally may deduct up to $3,000 of such losses against their ordinary income each year; any net capital losses of a non-corporate stockholder in excess of $3,000 generally may be carried forward and used in subsequent years as provided in Section 1212(b) of the Internal Revenue Code. Corporate stockholders generally may not deduct any net capital losses for a year, but may carryback such losses for three years or carry forward such losses for five years.

We will send to each of our stockholders, as promptly as possible after the end of each calendar year, a notice detailing, on a per share and per distribution basis, the amounts includible in such stockholder s taxable income for such year as ordinary income and as long-term capital gain. In addition, the federal tax status of each year s distributions generally will be reported to the Internal Revenue Service. Distributions may also be subject to additional state, local, and foreign taxes depending on a stockholder s particular situation. Our ordinary income dividends to corporate stockholders may, if certain conditions are met, qualify for the dividends received

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deduction to the extent that we have received qualifying dividend income during the taxable year; capital gain dividends distributed by us are not eligible for the dividends received deduction. However, the alternative minimum tax applicable to corporations may reduce the benefit of the dividends received deduction.

A Non-U.S. Stockholder may be subject to withholding of U.S. federal tax at a 30% rate (or lower applicable treaty rate) on our distributions (including certain redemptions of our common stock). Accordingly, investment in our common stock is likely to be appropriate for a Non-U.S. Stockholder only if such person can utilize a foreign tax credit or corresponding tax benefit in respect of such withholding tax. Non-U.S. Stockholders should consult their own tax advisors w