EQUUS TOTAL RETURN, INC.
Form 10-K
March 31, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (FEE REQUIRED)**

For the year ended December 31, 2007

or

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

For the transition period from _________ to _________

Commission File Number 0-19509

EQUUS TOTAL RETURN, INC.

(Exact name of registrant as specified in its charter)

Delaware	**76-0345915**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
2727 Allen Parkway, 13th Floor, Houston, Texas	**77019**
(Address of principal executive offices)	**(Zip Code)**

(713) 529-0900

Registrant s telephone number, including area code:

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

Title of each class	**Name of each exchange on which registered**
Common Stock	**New York Stock Exchange**

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

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

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

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 ¨

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

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

Approximate aggregate market value of common stock held by non-affiliates of the registrant: $41,715,378 computed on the basis of $6.51 per share, closing price of the common stock on the New York Stock Exchange on March 28, 2008. For purposes of calculating this amount only, all directors and executive officers of the registrant have been treated as affiliates. There were 8,401,179 shares of the registrant s common stock, $.001 par value, outstanding as of March 28, 2008. The net asset value of a share as of December 31, 2007 was $12.286.

Portions of the Proxy Statement (to be filed) for the 2008 Annual Shareholder s meeting are incorporated by reference in Parts II and III.

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PART I

Item 1. *Business*

Equus Total Return, Inc. (the Fund or EQS), formerly Equus II Incorporated, is a business development company that provides comprehensive financing solutions for companies in industries that it believes will benefit from significant social and demographic trends. The Fund s registered investment adviser, Moore, Clayton Capital Advisors, Inc. (the Adviser), manages its portfolio and provides access to investment opportunities throughout the United States and internationally. The Adviser is a wholly owned subsidiary of MCC Global (MCC), an international investment advisory firm that holds 15.2% of the Fund s common stock as of December 31, 2007.

The Fund s investment objective is to generate current investment income and long-term capital gains by investing in the debt and equity securities of small capitalization companies, which it defines as companies with a total enterprise value of between $15.0 million and $75.0 million. The Adviser has indicated that it generally intends to invest its assets in sectors that are, and which it believes will continue to be, driven by significant social and demographic trends, including an aging population, increased leisure time, the globalization of business and widespread concern about the environment and increasingly scarce energy resources. As its investment adviser, the Adviser intends to implement a total return-oriented investment strategy, which will include investments in a broad mix of equity and debt securities. Reflecting its change to a total return investment strategy, the Fund expects that its investments in debt and equity securities will generate both current income and capital gains and should enable it to maintain a consistent dividend policy.

The Fund believes its investment opportunities and, consequently, its returns, are limited currently by the relatively small size of it portfolio and investments. The Fund s current portfolio size limits it to relatively modest investments (averaging $6.0 million through December 31, 2007).

The Fund is a closed-end management investment company that has elected to be treated as a business development company under the Investment Company Act of 1940, or the 1940 Act. In order to remain a business development company it must meet certain specified requirements under the 1940 Act, including investing at least 70% of its assets in eligible portfolio companies and limiting the amount of leverage it incurs. The Fund is also a regulated investment company, or RIC, under Subchapter M of the U.S. Internal Revenue Code of 1986, or the Code. As such, it is not required to pay corporate-level income tax on the Fund s investment income. The Fund intends to maintain its RIC status, which will require that it qualify annually as a RIC by meeting certain specified requirements. For a discussion of these requirements necessary to maintain its status as a business development company and as a RIC, please see Regulation as a Business Development Company General and Certain U.S. Federal Income Tax Considerations Taxation as a Regulated Investment Company, respectively.

The Adviser and Equus Capital Administration Company, Inc., or the Administrator, and their respective officers and directors and the officers of the Fund are collectively referred to herein as Management. The Fund s principal office is located at 2727 Allen Parkway, 13th Floor, Houston, Texas, 77019, and the telephone number is (713) 529-0900. The Fund s corporate website is located at *www.equuscap.com*. The Fund makes available free of charge on its website the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed or furnished to the Securities and Exchange Commission (SEC). The Fund s shares are traded on The New York Stock Exchange under the ticker symbol EQS .

The Adviser and MCC

The Fund intends to build on the success it has had since its founding through its investment advisory relationship with the Adviser. The Adviser was formed by Moore, Clayton & Co., Inc. (MCCI), a wholly-owned subsidiary of MCC, for the purpose of managing the Fund and assumed responsibility as its investment adviser on June 30, 2005. The Adviser includes a mix of investment professionals from MCC and professionals retained from Equus Capital Management Corporation, or ECMC, its previous investment adviser. Among the Adviser s eight dedicated investment professionals is Sam P. Douglass, the founder and former CEO and chairman of Equus and ECMC and Paula Douglass, Vice President of ECMC. When the Adviser assumed its role as its investment adviser, it also acquired the investment management infrastructure of ECMC, which facilitated the transition between investment advisers, provided continuity in its relationships with portfolio companies and maintained its market presence.

In April 2007, MCCI became a wholly-owned subsidiary of MCC when it was acquired by IFEX Innovation Finance & Equity Exchange NV, a Dutch corporation (*naamloze vennootschap*) listed on the Frankfurt Stock Exchange. IFEX then changed its name to MCC Global NV. Immediately following the acquisition of MCCI, the former shareholders of MCCI held, collectively, 83% of the outstanding ordinary shares of IFEX.

The Fund s board of directors selected the Adviser as its investment adviser in part to obtain access to the potential deal flow that it believes MCC may generate from its network of industry contacts. MCC is an international financial advisory firm, the core business of which was established in 1999. MCC has offices in London, Houston, New York, Salt Lake City, and San Francisco. MCC advises clients in structuring financial transactions which often involve investments in, and acquisitions of, growth-oriented companies. In particular, MCC seeks to capitalize on investment opportunities presented by current and anticipated demographic trends worldwide. MCC currently advises a variety of companies worldwide, providing them with introductions and commercial opportunities through a global network of professionals, financial intermediaries and business executives. MCC advises its clients on certain transactional and strategic alternatives, including joint ventures, mergers and acquisitions, divestitures, privatizations, restructurings and recapitalizations.

The principal stockholders of MCC are Anthony R. Moore, a member of the Fund s board of directors, and Sharon Clayton. MCC also has an advisory board consisting of senior executives with extensive international operating and financial experience in MCC s target industries. As of December 31, 2007, these executives were complemented by 30 other employees and professional contract personnel. The Fund believes that the Adviser and, indirectly, the Fund, benefit from access to MCC s network of professionals, contacts and commercial opportunities.

The Fund s Investment Objective

The Fund s investment objective is to maximize the total return to stockholders in the form of current investment income and long-term capital gains by investing in the debt and equity securities of small capitalization, privately owned companies. The Fund expects the Adviser to focus its investments in industries that are, and that it believes will continue to be, driven by significant social and demographic trends, including an aging population, increased leisure time, the globalization of business and widespread concern about the environment and increasingly scarce energy resources. Accordingly, the Fund expects to invest in businesses such as medical technology and services directed toward an aging population, real estate developments positioned to benefit from an increase in the number of retirees, leisure time and family entertainment industries and subsets of the energy sector developing renewable and proven alternative sources of energy.

Investment Strategy

As described under The Fund s Investment Objective above, the Fund has adopted a total return investment objective and the Adviser is now implementing an investment strategy consistent with this objective. The total return style combines both growth and income investments and is intended to strike a balance between the potential for gain and the risk of loss. In the growth category, the Fund is a growth-at-reasonable-price investor. As such, it invests primarily in privately owned companies and will consider a wide range of potential growth investments in this market. The Fund s primary aim is to identify and acquire only those equity securities

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that meet its criteria for selling at reasonable prices. With respect to income investments, the Adviser seeks to purchase debt instruments that it expects to generate consistent interest income for the Fund as well as long-term capital appreciation through the exercise and sale of warrants received in connection with such debt financing.

The Fund usually negotiates its investments in portfolio company securities directly with the owner or issuer of the securities acquired. The Fund attempts to reduce certain risks inherent in private equity-oriented investments by investing in a portfolio of companies involved in a variety of different industries. However, it expects that such companies and industries will benefit from the significant demographic and social trends previously discussed.

The Fund limits its initial investment in any portfolio company to no more than 15% of the Fund s net assets at the date of initial investment. However, its investment in a particular portfolio company may exceed this limitation due to follow-on investments or increases in the fair value of such investments.

The Fund seeks to invest in a portfolio company with co-investors. Other investment participants may include management of the portfolio company, other business development companies, small business investment companies, other institutional or individual investors or venture capital groups. In connection with its equity investments, the Fund and its co-investors typically comprise a controlling or substantial interest in the portfolio companies.

Investment Criteria

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

Competent management. The Fund generally requires that its companies have an experienced management team and seek to design compensation arrangements that align the interests of the portfolio company s management with those of the Fund.

Substantial target market. The Fund focuses on companies whose products or services have favorable growth potential. It looks for companies with strong competitive positions in their respective markets.

History or expectation of profitability. The Fund looks for companies that either have been profitable historically or have a reasonable expectation that they can become profitable as a result of the proposed investment.

Substantial equity and management participation. The Fund looks for companies that will permit it and its co-investors to take a substantial investment position in the company and to have representation on the board of directors of the company.

Plausible exit and potential for appreciation. The Fund expects to dispose of its portfolio securities through public rights offerings or negotiated private sales.

Investment Operations

The investment operations of the Fund consist principally of the following basic activities:

Investment Selection. The Fund expects that many of its investment opportunities will come from Management, other private equity investors, members of the board of directors, direct approaches from prospective portfolio companies as well as from referrals from banks, lawyers, accountants and members of the financial community. It supplements these sources through access to the relationships and network of MCC. Subject to the approval of its board of directors, the Fund may compensate certain referrals with finder s fees to the extent permissible under applicable law and consistent with industry practice.

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

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

Structuring Investments. The Fund typically negotiates investments in private transactions directly with the owner or issuer of the securities acquired. The Adviser structures the terms of a proposed investment, including the purchase price, the type of security to be purchased and the future involvement of the Fund in the portfolio company s business. The Adviser seeks to structure the terms of the investment to provide for the capital needs of the portfolio company while maximizing the Fund s opportunities for current income and capital appreciation.

Providing Management Assistance and Monitoring of Investments. Successful private equity investments typically require active monitoring of, and significant participation in, major business decisions of portfolio companies. In many cases, officers of the Fund serve as members of the boards of directors of portfolio companies. Such management assistance is required of a business development company under the 1940 Act. The Fund seeks to provide guidance and management assistance with respect to such matters as capital structure, budgets, profit goals, diversification strategy, financing requirements, management additions or replacements and development of a public or private market for the securities of the portfolio company. In connection with their service as directors of portfolio companies, officers and directors of the Fund may receive and retain directors fees or reimbursement for expenses incurred, and may participate in incentive stock option plans for non-employee directors, if any. When necessary and as requested by any portfolio company, the Adviser, on behalf of the Fund, may also assign staff professionals with financial or management expertise to assist portfolio company management on specific problems.

Follow-On Investments

Following its initial investment in a portfolio company, the company may request that the Fund make follow-on investments in the company. Follow-on investments may be made to exercise warrants or other preferential rights granted to the Fund or otherwise to increase its position in a successful or promising portfolio company. The portfolio company also may request that the Fund provide additional equity or loans needed to fully implement its business plans to develop a new line of business or to recover from unexpected business problems. The Fund may make follow-on investments in portfolio companies from cash on hand or borrow all or a portion of the funds required. If the Fund is unable to make follow-on investments due to lack of available capital, the portfolio company in need of the investment may be negatively impacted and the Fund s equity interest in the portfolio company may be reduced.

Disposition of Investments

The method and timing of the disposition of the Fund s investments in portfolio companies is critical to its ability to realize capital gains and minimize capital losses. The Fund may dispose of its portfolio securities

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through a variety of transactions, including sales of portfolio securities in underwritten public rights offerings, public sales and negotiated private sales, either to the portfolio company itself or to other investors. In addition, the Fund may distribute its portfolio securities in-kind to its stockholders. In structuring its investments, the Fund endeavors to reach an understanding with the management of the prospective portfolio company as to the appropriate method and timing of the disposition of the investment. In some cases, the Fund seeks registration rights for its portfolio securities at the time of investment which typically provide that the portfolio company will bear the cost of registration. To the extent not paid by the portfolio company, the Fund typically bears the costs of disposing of its portfolio investments.

Current Portfolio Companies

For a description of the Fund s current portfolio company investments, see Management s Discussion and Analysis of Financial Condition and Results of Operations Portfolio Investments.

Valuation

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

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

Generally, cost is the primary factor used to determine fair value until a significant development affecting the portfolio company (such as updated financial results or a change in general market conditions) provides a basis for an adjustment to the valuation. The Fund bases adjustments upon such factors as the portfolio company s earnings, cash flow and net worth, the market prices for similar securities of comparable companies, an assessment of the company s current and future financial prospects and various other factors and assumptions. In the case of unsuccessful operations, the Fund may base a portfolio company s fair value upon the company s estimated liquidation value. Fair valuations are necessarily subjective, and the Adviser s estimate of fair value may differ materially from amounts actually received upon the disposition of its portfolio securities. Also, any failure by a portfolio company to achieve its business plan or obtain and maintain its financing arrangements could result in a significant and rapid change in its value.

The Fund may also use, when available, third-party transactions in a portfolio company s securities as the basis for its valuation. The Fund uses this method only with respect to completed transactions or firm offers made by sophisticated, independent investors.

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

The Fund s board of directors reviews the valuation policies on a quarterly basis to determine their appropriateness and reserves the right to hire independent valuation firms to review the Adviser s valuation methodology or to conduct an independent valuation.

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On a daily basis, the Fund adjusts its net asset value for the changes in the value of its publicly held securities and material changes in the value of its private securities and reports those amounts to Lipper Analytical Services, Inc. The Fund s weekly and daily net asset values appear in various publications, including *Barron s* and *The Wall Street Journal*.

Competition

The Fund competes with a large number of public and private equity and mezzanine funds and other financing sources, including traditional financial services companies such as finance companies and commercial banks. Many of its competitors are substantially larger and have considerably greater financial, technical and marketing resources than it does. The Fund s competitors may have a lower cost of funds and many have access to funding sources that are not available to it. In addition, certain of its competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships and build their market shares. In addition, many of the Fund s competitors are not subject to the regulatory restrictions that the 1940 Act imposes on it as a business development company.

There is no assurance that the competitive pressures the Fund faces will not have a material adverse effect on its business, financial condition and results of operations. In addition, because of this competition, the Fund may be foreclosed from taking advantage of attractive investment opportunities and may not be able to identify and make investments that satisfy its investment objectives or meet its investment goals.

Properties

The Fund s principal executive offices are located at 2727 Allen Parkway, 13th Floor, Houston, Texas 77019. The Fund believes that its office facilities are suitable and adequate for its operations as currently conducted and contemplated.

Legal Proceedings

Neither the Fund nor the Adviser is currently subject to any material legal proceedings.

Business Development Company Requirements

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

securities purchased in transactions not involving any public offering from an issuer that is an eligible portfolio company. An eligible portfolio company is any issuer that (a) is organized and has its principal place of business in the United States, (b) is not an investment company other than a small business investment company wholly-owned by the business development company, and (c) either (i) (A) does not have any class of securities with respect to which a broker or dealer may extend margin credit, (B) is controlled by the business development company either singly or as part of a group and an affiliated person of the business development company is a member of the issuer s board of directors, or (C) has total assets of not more than $4 million and capital and surplus of at least $2 million, or (ii) does not have any class of securities listed on a national securities exchange. Qualifying assets may also include follow-on investments in a company that was a particular type of eligible portfolio company at the time of the business development company s initial investment, but subsequently did not meet the definition;

securities received in exchange for or distributed with respect to securities described above, or pursuant to the exercise of options, warrants or rights relating to such securities; and

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cash, cash items, government securities, or high quality debt securities maturing in one year or less from the time of investment. The Fund may not change the nature of its business so as to cease to be, or withdraw its election as, a business development company unless authorized by vote of the holders of the majority of its outstanding voting securities, as defined in the 1940 Act.

To include certain securities above as qualifying assets for the purpose of the 70% test, a 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. The Fund offers to provide significant managerial assistance to each of its portfolio companies.

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

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

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

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

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

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Regulated Investment Company Tax Status

The Fund operates to qualify as a regulated investment company under Subchapter M of the Code. If the Fund qualifies as a regulated investment company and annually distribute to its stockholders in a timely manner at least 90% of its investment company taxable income, the Fund will not be subject to federal income tax on the portion of its taxable income and capital gains the Fund distributes to its stockholders. Taxable income generally differs from net income as defined by accounting principles generally accepted in the United States of America due to temporary and permanent timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation.

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

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

If the Fund fails to satisfy the 90% distribution requirement or otherwise fail to qualify as a regulated investment company in any taxable year, it will be subject to tax in such year on all of its taxable income, regardless of whether the Fund makes any distribution to its stockholders. In addition, in that case, all of the Fund s distributions to its stockholders will be characterized as ordinary income (to the extent of its current and accumulated earnings and profits). The Fund has distributed and currently intends to distribute sufficient dividends to eliminate its investment company taxable income.

Advisory and Administration Fees

The Adviser. The Adviser manages the Fund s portfolio investments pursuant to an Advisory Agreement. The Adviser s services include, among other services:

- Determining the composition of the portfolio of the Fund, the nature and timing of the changes therein, and the manner of implementing such changes;

- Identifying, evaluating, and negotiating the structure of the investments made by the Fund;

- Monitoring the performance of, and managing the Fund s investments;

- Determining the securities and other assets that the Fund will purchase, retain, or sell and the terms on which any such securities are purchased and sold;

Arranging for the disposition of investments for the Fund; and

Other specified services.

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The Adviser receives a base advisory fee at an annual rate of 2% of the net assets of the Fund, paid quarterly in arrears, as well as incentive fees in the following amounts: (i) 20% of the excess, if any, of the Fund s net investment income for a quarter that exceeds a quarterly hurdle rate equal to 2% (8% annualized) of the Fund s net assets, and (ii) 20% of the Fund s net realized capital gain less unrealized capital depreciation, paid on an annual basis. The Fund is responsible for the costs and expenses of the Fund s business, operations, and investments. These costs and expenses, include among other items:

- Administration fees and expenses payable under the Administration Agreement;
- Costs of proxy solicitation and meetings of stockholders and the Board;
- Charges and expenses of the Fund s custodian, administrator, and transfer and dividend disbursing agent;
- Compensation and expenses of the Fund s independent directors;
- Legal and auditing fees and expenses; and
- Subject to Board approval, certain other reasonable costs and expenses directly allocable and identifiable to the Fund or its business or investments.

The Advisory Agreement presently continues year-to-year, provided such continuance is approved at least annually by (i) a vote of a majority of the outstanding shares of the Fund, or (ii) a majority of the independent directors of the Fund. The Advisory Agreement may be terminated at any time, without the payment of any penalty, by the board of directors or the holders of a majority of the Fund s shares on 60 days written notice to the Adviser, and would automatically terminate in the event of its assignment (as defined in the 1940 Act).

The Administrator. The Administrator manages the Fund s administrative and business operations pursuant to an Administration Agreement. The Administrator provides the Fund, at the Administrator s expense, with office space, facilities, equipment and personnel necessary for the conduct of its business. The Fund reimburses the Administrator for the costs and expenses incurred by the Administrator in performing its obligations and providing personnel and facilities under the Administrative Agreement, provided that such reimbursements do not exceed $0.5 million per year. The Administration Agreement may be terminated by either party without penalty upon 60 days written notice to the other party.

Custodian

The Fund acts as the custodian of its securities to the extent permitted under the 1940 Act and are subject to the restrictions imposed on self-custodians by the 1940 Act and the rules and regulations thereunder. The Fund has entered into an agreement with Frost National Bank with respect to the safekeeping of its securities. The principal business office of the custodian is 100 West Houston, San Antonio, Texas 78205.

Transfer and Disbursing Agent

The Fund employs American Stock Transfer & Trust Company as its transfer agent to record transfers of the shares, maintain proxy records and to process distributions. The principal business office of the Fund s transfer agent is 59 Maiden Lane, Plaza Level, New York, NY 10007.

Certifications

In July 2007, the Fund submitted to the New York Stock Exchange pursuant to Section 303A.12(a) of its Listed Company Manual, an unqualified certification of the Fund s Chief Executive Officer. In addition, certifications by the Fund s Chief Executive Officer and Chief Financial Officer have been filed as exhibits to this annual report on Form 10-K as required by the Securities Exchange Act of 1934, as amended, and the Sarbanes-Oxley Act of 2002.

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Forward-Looking Statements

All statements contained herein that are not historical facts including, but not limited to, statements regarding anticipated activity are forward-looking statements within the meaning of the federal securities laws, involve a number of risks and uncertainties, and are based on the beliefs and assumptions of management, based on information currently available to management. Actual results may differ materially. In some cases, readers can identify forward-looking statements by words such as may, will, should, expect, objective, plan, intend, anticipate, believe, management believes, estimate, predict, project, potential, forecast, continue, strategy, or position or the negative of such terms or other variations of them or by comparable terminology. In particular, statements, express or implied, concerning future actions, conditions, or events, future operating results, or the ability to generate sales, income, or cash flow are forward-looking statements.

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

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

The following discussion outlines certain risk factors that could affect the Fund s results for 2007 and beyond and cause them to differ materially from those that may be set forth in any forward-looking statement made by us or on its behalf. Readers should carefully consider these risks and all other information contained in the annual report on Form 10-K, including the Fund s consolidated financial statements and the related notes thereto. The risks and uncertainties described below are not the only ones facing the Fund. Additional risks and uncertainties not presently known to the Fund, or not presently deemed material by the Fund, may also impair its operations and performance.

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

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Risks Related to the Fund s Investments

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

The Fund currently invests, and will continue to invest, in private, small or new companies that may be in their early stages of development. Investments in these types of companies involve a number of significant risks including the following:

- They typically have shorter operating histories, narrower product lines and smaller market shares than public companies, which tend to render them more vulnerable to competitors actions and market conditions as well as general economic downturns;

- They may have no earnings or experienced losses or may have limited financial resources and may be unable to meet their obligations under their securities, which may be accompanied by a deterioration in the value of their equity securities or any collateral or guarantees provided with respect to their debt;

- They are more likely to depend on the management talents and efforts of a small group of persons and, as a result, the death, disability, resignation or termination of one or more of those persons could have a material adverse impact on their business and prospects and, in turn, on its investment;

- They may have difficulty accessing the capital markets to meet future capital needs;

- They generally have less predictable operating results, may from time to time be parties to litigation, may be engaged in rapidly changing businesses with products subject to a substantial risk of obsolescence and may require substantial additional capital to support their operations, finance expansion or maintain their competitive position; and

- Generally little public information exists about these companies and investors in those companies generally must rely on the ability of the equity sponsor to obtain adequate information for the purposes of evaluating potential returns and making a fully informed investment decision.

There is uncertainty regarding the value of the Fund s privately held securities.

The Fund s net asset value is based on the value the Fund assigns to its portfolio investments. The Fund determines the value of its investments in securities for which market quotations are not available as of the end of each calendar quarter, unless there is a significant event requiring a change in valuation in the interim. Because of the inherent uncertainty of the valuation of portfolio securities that do not have readily ascertainable market values, its fair value determination may differ materially from the value that would have been used had a ready market existed for the securities. The Fund determines the fair value of investments for which no market quotations are available based upon a methodology that the Fund believes reaches a reasonable estimation of fair value. However, the Fund does not apply multiple valuation metrics in reaching this determination, and the Fund does not obtain any third party valuations before reaching this determination. The Fund s determinations of the fair value of its investments have a material impact on its net earnings through the recording of unrealized appreciation or depreciation of investments as well as its assessment of interest income recognition. These accounting items, in turn, dictate the amount of management fees the Fund pays to its investment adviser. The Fund s net asset value could be affected materially if its determinations of the fair value of its investments differ materially from values based on a ready market for these securities.

As of December 31, 2007, none of the securities in which the Fund has invested are publicly traded or have readily available market quotations. If, in the future, the Fund makes investments in companies whose securities are publicly traded and valued at their quoted market price (less a discount to reflect the estimated effects of restrictions on the sale of such securities), the Fund will adjust its net asset value for changes in the value of any publicly held securities on a daily basis.

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The Fund depends upon Management, including its investment adviser, for its future success.

The Fund depends upon the diligence and skill of Management, including its investment adviser, Moore, Clayton Capital Advisors, Inc., or the Adviser, to select, structure, close and monitor its investments. Effective June 30, 2005, the Fund entered into an investment advisory agreement with the Adviser (the Advisory Agreement) concurrently with the Adviser s acquisition of the Fund s previous adviser, ECMC. Under the Advisory Agreement, Management identifies, evaluates, structures, monitors and disposes of the Fund s investments, and the services Management provides significantly impact the Fund s results of operations. The Fund s future success will depend to a significant extent on the continued service and coordination of Management. The Fund s Chief Investment Officer, Gary Forbes, has announced his intention to retire in the near future. Since Mr. Forbes has substantial investment experience and expertise and has generally been responsible for monitoring the status of the Fund s investments and maintaining relationships with its portfolio companies, his retirement could adversely affect the Fund. The Fund is currently in the process of hiring a new chief investment officer. Its success will depend on its ability to recruit and retain a chief investment officer and other highly qualified individuals. In addition, if the Fund is unable to integrate into Management its new chief investment officer effectively, the Fund may be unable to achieve its desired investment results. Although some of the professionals employed by ECMC were retained by the Adviser, the Adviser has a limited history in operating a business development company, and this lack of experience could adversely affect its future performance.

The Adviser may not be able to implement its new investment objective successfully.

Pursuant to advice from the Adviser, the Fund has refocused its investment objective and areas of investment from a regional focus and a record of investing in basic manufacturing and service companies to an investment strategy focused in sectors that are, and which the Fund believes will continue to be, driven by significant social and demographic trends, such as an aging population, increased leisure time, the globalization of business and widespread concern about the environment and increasingly scarce energy resources. The Fund s prior investment objective was to achieve capital appreciation and, as of August 2006, the Fund formally adopted a total return investment strategy. In order to implement this strategy, Management must analyze, due diligence, invest in, monitor and sell companies in industries in which many of them have not previously been involved. Also, its new investment strategy will require Management to investigate and monitor investments that are much more broadly dispersed geographically. In addition, Management will be required to provide valuations for investments in a broader range of securities, including debt securities, which will require expertise beyond that previously required of Management. The Fund cannot assure investors that the overall risk of their investment in the Fund will be reduced as a result of its change in investment strategy. If Management cannot achieve its investment objective successfully, the value of the shareholders investment in the Fund s common stock could decline substantially.

There are significant potential conflicts of interest that could impact the Fund s investment returns.

The Fund s executive officers and directors and the partners of the Adviser serve or may in the future serve as officers, directors or principals of entities that operate in the same or related lines of business as the Fund does or of investment funds managed by its affiliates. Accordingly, they may have obligations to investors in those entities, the fulfillment of which might not be in the best interests of the Fund or its stockholders. For example, Anthony R. Moore, a director of the Fund, is a co-founder of MCCI, and the chairman of the Supervisory Board of MCC. MCC regularly advises companies and other entities on investments and acquisitions that may be suitable investments for the Fund. The Fund also notes that, while the Adviser does not currently advise other funds, it may do so in the future, and such funds, including potential new affiliated pooled investment vehicles or managed accounts not yet established, may have overlapping investment objectives and, accordingly, invest, whether principally or secondarily, in asset classes similar to those targeted by the Fund. As a result, Management may face conflicts in the allocation of investment opportunities between the Fund and other entities. Although the Adviser will endeavor to allocate investment opportunities in a fair and equitable manner, it is

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possible that the Fund may not be able to participate in certain investments directed by investment managers affiliated with the Adviser.

When Management identifies an investment, it must choose which investment fund should make the investment. The Fund does not invest in any portfolio company in which the Adviser or any of its affiliates has a pre-existing investment. The Fund may, in the future, co-invest on a concurrent basis with other affiliates of the Adviser, subject to compliance with existing regulatory guidance, applicable regulations and the Adviser s allocation procedures.

In the course of its investing activities, the Fund pays the Adviser management and incentive fees, and reimburses the Adviser for certain expenses it incurs. As a result, investors in the Fund s common stock invest on a gross basis and receive distributions on a net basis after expenses, resulting in a lower rate of return than one might achieve through direct investments. As a result of this arrangement, there may be times when the management team of the Adviser has interests that differ from those of the Fund s stockholders, giving rise to a conflict.

The Adviser receives a quarterly incentive fee based, in part, on the Fund s pre-incentive fee income, if any, for the immediately preceding calendar quarter. This incentive fee is subject to a quarterly hurdle rate before providing an incentive fee return to the investment adviser. To the extent the Fund or the Adviser is able to exert influence over the Fund s portfolio companies, the quarterly pre-incentive fee may provide the Adviser with an incentive to induce the Fund s portfolio companies to accelerate or defer interest or other obligations owed to the Fund from one calendar quarter to another.

The Fund may not realize gains from its equity investments.

The Fund frequently invests in the equity securities of its portfolio companies. Also, when the Fund makes a loan, it generally receives warrants to acquire stock issued by the borrower. Ultimately, the Fund s goal is to sell these equity interests and realize gains. These equity interests may not appreciate and, in fact, may depreciate in value. Several of its portfolio companies have experienced net losses in recent years or have negative net worth as of the most recent available balance sheet date. In addition, although the Fund realized a net capital gain in 2007 from the sale or disposition of portfolio companies, it incurred capital losses of $1.0 million from the sale of its investment in TurfGrass, LLC. Also, the market value of the Fund s equity investments may fall below its estimate of the fair value of such investments before it sells them. Given these factors, there is a risk that the Fund will not realize gains upon the sale of those or other equity interests that it holds.

The Fund may not be able to make additional investments in its portfolio companies from time to time, which may dilute its interests in such companies.

After its initial investment in a portfolio company, the Fund may be called upon from time to time to provide additional funds to such company, or may have the opportunity to increase its investment in that company through the exercise of a warrant to purchase common stock or through follow-on investments in the debt or equity of that company. There is no assurance that the Fund will make, or have sufficient funds to make, any such follow-on investments. Any decision by the Fund not to make a follow-on investment or any inability on its part to make such an investment may have a negative impact on a portfolio company in need of investment and may result in a missed opportunity for the Fund to increase its participation in a successful operation. A decision not to make a follow-on investment may also dilute its equity interest in, or reduce the expected yield on, its investment.

The Fund has invested in a limited number of portfolio companies.

The Fund is classified as a non-diversified investment company under the 1940 Act, which means the Fund is not limited in the proportion of its assets that may be invested in the securities of a single issuer. As a

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matter of policy, the Fund does not initially invest more than 15% of the value of its net assets in a single portfolio company. However, follow-on investments, disproportionate increases or decreases in the fair value of certain portfolio companies or sales of investments may result in more than 15% of its net assets being invested in a single portfolio company at a particular time.

As of December 31, 2007, the Fund had investments in 13 entities. A consequence of a limited number of investments is that changes in business or industry trends or in the financial condition, results of operations or the market s assessment of any single portfolio company will affect the Fund s net asset value and the market price of its common stock to a greater extent than would be the case if the Fund were a diversified company holding a greater number of investments.

The lack of liquidity of the Fund s privately held securities may adversely affect its business.

The Fund s portfolio investments consist principally of securities that are subject to restrictions on sale because they are not listed or publicly traded securities. If any of these securities were to become publicly traded, the Fund s ability to sell them would still be restricted because it acquired them from the issuer in private placement transactions or because the Fund may be deemed to be an affiliate of the issuer. The Fund will not be able to sell these securities publicly without the expense and time required to register the securities under the Securities Act of 1933, as amended, and applicable state securities laws, unless an exemption from such registration requirements is available. In addition, contractual or practical limitations may restrict its ability to liquidate its securities in portfolio companies because those securities are privately held and the Fund may own a relatively large percentage of the issuer s outstanding securities. Sales may also be limited by market conditions, which may be unfavorable for sales of securities of particular issuers. The illiquidity of the Fund s investments may preclude or delay any disposition of such securities, which may make it difficult for it to obtain cash equal to the value at which it records its investments if the need arises.

The Fund has limited public information regarding the companies in which it invests.

The Fund s portfolio consists entirely of securities issued by privately held companies. There is generally little or no publicly available information about such companies, and the Fund must rely on the diligence of Management to obtain the information necessary for its decision to invest in them and in order to monitor them effectively. There can be no assurance that such diligence efforts will uncover all material information about such privately held businesses necessary to make fully informed investment decisions.

The Fund s portfolio companies may be highly leveraged.

Investments in leveraged buyouts and in highly leveraged companies involve a high degree of business and financial risk and can result in substantial losses. A leveraged company s income and net assets will tend to increase or decrease at a greater rate than if borrowed money were not used. The use of leverage by portfolio companies also magnifies the increase or decrease in the value of a Fund investment as compared to the overall change in the enterprise value of a portfolio company.

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

A substantial portion of the debt incurred by portfolio companies may bear interest at rates that fluctuate in accordance with a stated interest rate index or the prime lending rate. The cash flow of a portfolio company may not be sufficient to meet increases in interest payments on its debt. Accordingly, the profitability of the Fund s

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portfolio companies, as well as the value of its investments in such companies, will depend significantly upon prevailing interest rates. In recent months the level of interest rates have increased, which will have an adverse effect on the ability of its portfolio companies to service their floating rate debt and on their profits.

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

The Fund s business depends on external financing.

The Fund s business requires a substantial amount of cash to operate. The Fund may borrow funds to pay contingencies or expenses or to make investments, to maintain its pass-through tax status as a RIC under Subchapter M of the Code. The Fund is permitted under the 1940 Act to borrow if, immediately after the borrowing, the Fund has an asset coverage ratio of at least 200%. That is, the Fund may borrow an amount equal to as much as 50% of the fair value of its total assets (including investments made with borrowed funds). The amount and nature of any such borrowings depend upon a number of factors over which the Fund has no control, including general economic conditions, conditions in the financial markets and the impact of the financing on the tax treatment of its stockholders. On August 18, 2006, the Fund entered into a loan agreement with Regions Bank providing it with a credit facility not to exceed $10.0 million. The agreement expired on December 31, 2007. The use of leverage, even on a short-term basis, could have the effect of magnifying increases or decreases in its net asset value. While the spread between the current yield on its investments and the cost of any loan would augment the stockholders return from the Fund, if the spread narrows (because of an increase in the cost of debt or insufficient income on its investments), distributions to the stockholders could be adversely affected. This may render the Fund unable to meet its obligations to its lenders, which might then require it to liquidate some or all of its investments. There can be no assurance that the Fund would realize full value for its investments or recoup all of its capital if the Fund needed to liquidate its portfolio investments.

Many financial institutions today are unwilling to lend against a portfolio of illiquid, private securities. The make-up of the Fund s portfolio has made it more difficult for it to borrow at the level and on the terms that the Fund desires. Its borrowings have historically consisted of a revolving line of credit, the proceeds of which the Fund has used to provide liquidity for expenses and contingencies and to make new or follow-on investments, and a line of credit promissory note or margin account used quarterly to enable the Fund to achieve adequate diversification to maintain its pass-through tax status as a RIC.

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

Dividends will likely vary or not grow over time and there is a risk that the shareholder may not receive dividends.

On October 23, 2006, the Fund announced a quarterly managed distribution policy where the Fund hoped to issue quarterly distributions at a minimum annual rate of $0.50 per share. On February 19, 2008, the Fund revised its managed distribution policy to issue quarterly distributions at a minimum rate of 10% of the closing price per share on December 31, 2007. However, the Fund cannot assure shareholders that it will achieve investment results or maintain a tax status that will ensure a specified level of cash distributions or year-to-year increases in cash distributions.

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The Fund operates in a highly competitive market for investment opportunities.

The Fund competes with a large number of private equity funds and mezzanine funds, investment banks and other equity and non-equity based investment funds, investment entities, foreign investors and individuals and other sources of financing, including tradition financial services companies such as commercial banks. In recent years, the number of investment vehicles seeking small capitalization investments has increased dramatically. Many of the Fund s competitors are substantially larger and have considerably greater financial resources, and some may be subject to different and frequently less stringent regulation. As its portfolio size gets larger, the Fund expects that some of its investments will be larger as well. The Fund believes that it will face increased competition to participate in these larger transactions. These competitors may have a lower cost of funds and many have access to funding sources that are not available to the Fund. In addition, some of its competitors may have higher risk tolerances or difference risk assessments, which could allow them to consider a wider variety of investments and establish more relationships and build their market shares. As a result of this competition, the Fund may not be able to take advantage of attractive investment opportunities from time to time. There is no assurance that the competitive pressures the Fund faces will not have a material adverse effect on its business, financial condition, and results of operations.

The Fund s investments in foreign securities, if any, may involve significant risks in addition to the risks inherent in U.S. investments.

The Fund s investment strategy contemplates that a portion of its investments may be made in securities of foreign companies. Investing in foreign companies may expose the