HEARTLAND PAYMENT SYSTEMS INC
Form 10-Q
August 02, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2005

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission File No. 000-51265

HEARTLAND PAYMENT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**22-3755714**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

47 Hulfish Street, Suite 400 Princeton, New Jersey 08542

(Address of principal executive offices) (Zip Code)

(609) 683-3831

(Registrant s telephone number, including area code)

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. o YES ý NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). o YES ý NO

As of July 15, 2005, there were 16,461,600 shares of the registrant s Common Stock, $.001 par value, outstanding.

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Heartland Payment Systems, Inc. and Subsidiary

Consolidated Balance Sheets

(unaudited)

	March 31, 2005 (As Restated See Note 17)	December 31, 2004 (As Restated See Note 17)
	(dollar amounts in thousands)	
Assets		
Current assets:		
Cash and cash equivalents	**$ 12,706**	$ 13,237
Receivables	**64,664**	64,325
Investments	**1,340**	1,100
Inventory	**362**	818
Prepaid expenses	**2,989**	2,151
Current deferred tax assets, net	**2,179**	2,129
Total current assets	**84,240**	83,760
Capitalized customer acquisition costs, net	**35,586**	34,247
Deferred tax assets, net	**4,488**	4,651
Property and equipment, net	**11,827**	10,944
Deposits and other assets	**251**	324
Total assets	**$ 136,392**	$ 133,926
Liabilities and stockholders equity		
Current liabilities:		
Due to sponsor bank	**$ 45,465**	$ 45,153
Accounts payable	**26,891**	27,103
Current portion of accrued buyout liability	**10,258**	9,327
Merchant deposits and loss reserves	**8,145**	7,175
Accrued expenses and other	**5,932**	6,701
Current portion of borrowings and financing arrangement	**5,227**	5,286
Total current liabilities	**101,918**	100,745
Long-term portion of borrowings and financing arrangements	**7,324**	7,808
Warrants with mandatory redemption provisions	**1,655**	1,566
Long-term portion of accrued buyout liability	**16,665**	17,708
Total liabilities	**127,562**	127,827
Stockholders equity		
Series A Senior Convertible Participating Preferred Stock, $80 million liquidation preference, $.001 par value, 10,000,000 shares authorized, 7,619,048 issued and outstanding	**8**	8
Common Stock, $.001 par value, 100,000,000 shares authorized, 16,451,080 and 16,437,760 issued and outstanding at March 31, 2005 and December 31, 2004, respectively	**8**	8
Additional paid-in capital	**41,110**	41,065
Accumulated other comprehensive income (loss)	**(18)**	(10)
Accumulated deficit	**(32,278)**	(34,972)
Total stockholders equity	**8,830**	6,099
Total liabilities and stockholders equity	**$ 136,392**	$ 133,926

See accompanying notes to consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiary

Consolidated Statements of Operations

(amounts in thousands, except per share data)

(unaudited)

	Three Months Ended March 31, 2005	2004 (As Restated See Note 17)
Revenue:		
Gross processing revenue	**$ 166,172**	$ 119,202
Other revenue, net	**3,693**	2,002
Total net revenue	**169,865**	121,204
Costs of Services:		
Interchange	**122,416**	86,372
Dues and assessments	**6,415**	4,785
Processing and servicing	**19,820**	14,748
Customer acquisition costs	**5,841**	4,135
Depreciation and amortization	**1,283**	876
Total costs of services	**155,775**	110,916
Selling and administrative	**8,989**	7,233
Total expenses	**164,764**	118,149
Income from operations	**5,101**	3,055
Other income (expense):		
Interest income	**110**	38
Interest expense	**(435)**	(298)
Fair value adjustment for warrants with mandatory redemption provisions	**(90)**	—
Other, net	**(3)**	833
Total other income (expense)	**(418)**	573
Income before income taxes	**4,683**	3,628
Provision for income taxes	**1,989**	1,482
Net income	**2,694**	2,146
Income allocated to Series A Senior Convertible Preferred Stock	**(1,295)**	(1,037)
Net income attributable to Common Stock	**$ 1,399**	$ 1,109
Net income	**$ 2,694**	$ 2,146
Other comprehensive income, net of tax:		
Unrealized gains (losses) on investments	**(8)**	7
Comprehensive income	**$ 2,686**	$ 2,153
Earnings per common share:		
Basic	**$ 0.09**	$ 0.07
Diluted	**$ 0.08**	$ 0.07
Weighted average number of common shares outstanding:		
Basic	**16,449**	16,296
Diluted	**34,672**	32,871

See accompanying notes to consolidated financial statements.

Heartland Payment Systems, Inc. and Subsidiary

Consolidated Statements of Stockholders Equity

(amounts in thousands)

(unaudited)

	Preferred Stock		Common Stock	
	Number of Shares Outstanding	Amount	Number of Shares Outstanding	Amount
Balance, December 31, 2004	7,619	$ 8	16,438	$ 8
Issuance of Common Stock— options exercised			13	
Accumulated other comprehensive income				
Net income for the period				
Balance March 31, 2005	7,619	$ 8	16,451	$ 8

	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders Equity
Balance, December 31, 2004	$ 41,065	$ (10)	$ (34,972)	$ 6,099
Issuance of Common Stock— options exercised	45			45
Accumulated other comprehensive income		(8)		(8)
Net income for the period			2,694	2,694
Balance March 31, 2005	$ 41,110	$ (18)	$ (32,278)	$ 8,830

See accompanying notes to consolidated financial statements.

Heartland Payment Systems, Inc. and Subsidiary

Consolidated Statements of Cash Flow

(dollar amounts in thousands)

(unaudited)

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004 (As Restated See Note 17)
Cash flows from operating activities		
Net income	**$ 2,694**	$ 2,146
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	**6,844**	4,686
Fair value adjustment for warrants with mandatory redemption provisions	**90**	—
Deferred taxes	**113**	1,003
Changes in operating assets and liabilities:		
Increase in receivables	**(338)**	(4,144)
Decrease in inventory	**456**	106
Increase in capitalized customer acquisition costs	**(6,924)**	(6,142)
Increase in prepaid expenses	**(830)**	(386)
Decrease in deposits and other assets	**24**	347
Increase in due to sponsor bank and accounts payable	**100**	5,101
(Decrease) increase in accrued expenses and other	**(768)**	612
Increase in merchant deposits and loss reserves	**970**	177
(Decrease) increase in accrued buyout liability	**(112)**	1,710
Net cash provided by operating activities	**2,319**	5,216
Cash flows from investing activities		
Purchase of investments	**(250)**	(250)
Maturities of investments	**1**	252
Purchases of property and equipment	**(2,102)**	(1,119)
Net cash used in investing activities	**(2,351)**	(1,117)
Cash flows from financing activities		
Redemption of warrants issued in connection with debt financing	—	(1,055)
Principal payments on borrowings and financing arrangements	**(544)**	(934)
Issuance of Common Stock	**45**	(37)
Net cash used in financing activities	**(499)**	(2,026)
Net (decrease) increase in cash and cash equivalents	**(531)**	2,073
Cash and cash equivalents at beginning of year	**13,237**	13,004
Cash and cash equivalents at end of period	**$ 12,706**	$ 15,077
Supplemental cash flow information:		
Cash paid during the period for:		
Interest	**$ 409**	$ 225
Income taxes	**801**	273
Supplemental schedule of non cash activities:		
Amortization of other assets	**64**	64

See accompanying notes to consolidated financial statements.

Heartland Payment Systems, Inc. and Subsidiary

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Organization and Operations

Basis of Financial Statement Presentation— The accompanying consolidated financial statements include those of Heartland Payment systems, Inc. (the Company) and its wholly-owned subsidiary, Heartland Payroll Company (HPC). The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. All intercompany balances and transactions with the Company s wholly-owned subsidiary have been eliminated upon consolidation. The accompanying consolidated financial statements are unaudited; however, in the opinion of management, they include all normal recurring adjustments necessary for a fair presentation of the consolidated financial position of the Company at March 31, 2005, the consolidated results of its operations and cash flows for the three months ended March 31, 2005 and 2004. Results of operations reported for interim periods are not necessarily indicative of results for the entire year.

The officers and directors of the Company represent a majority of the outstanding shares, and so control the Company.

As discussed in Note 16, all outstanding common shares, average common shares, earnings per common share and conversion amounts related to stock options, warrants and Series A Senior Convertible Participating Preferred Stock have been retroactively adjusted to reflect a two-for-one stock split on July 26, 2005.

Business— The Company provides payment-processing services related to bank card transactions for merchants throughout the United States. In addition, the Company provides certain other merchant services, including the sale and rental of terminal equipment and supplies. HPC provides payroll and related tax filing services throughout the United States.

Use of Estimates— The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates include, among other things, the accrued buyout liability, capitalized customer acquisition costs, loss reserves, certain accounts payable and accrued expenses and certain tax assets and liabilities as well as the related valuation allowances. Actual results could differ from those estimates.

Concentrations — The majority of the Company s merchant processing activity is processed by a single vendor. The Company believes that the vendor maintains appropriate backup systems and alternative arrangements to avoid a significant disruption of processing in the event of an unforeseen event.

Substantially all of the Company s revenue is derived from processing Visa and MasterCard bank card transactions. Because the Company is not a member bank as defined by Visa and MasterCard, in order to process these bank card transactions the Company has entered into a sponsorship agreement with a bank. The agreement with the bank sponsor requires, among other things, that the Company abide by the by-laws and regulations of the Visa and MasterCard associations and maintain a certificate of deposit with the bank sponsor. If the Company breaches the sponsorship agreement, the bank sponsor may terminate the agreement and, under the terms of the agreement, the Company would have 180 days to identify an alternative bank sponsor. The Company is dependent on its bank sponsor, Visa and MasterCard for notification of any compliance breaches. As of March 31, 2005, the Company has not been notified of any such issues by its bank sponsor, Visa or MasterCard.

The Company processes for merchants throughout the United States. California represented 15.8% of the Company s total processing volume in March 2005.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents The Company considers all highly liquid investments with original maturities of three months or less when purchased to be cash equivalents.

Receivables The Company carries receivables from its merchants resulting from the practice of advancing interchange fees to most of its merchants during the month and collecting those fees from merchants at the beginning of the following month. During each month, the Company s sponsor bank advances interchange fees to most of the Company s merchants so that during the month a payable to the sponsor bank is incurred. The payable to the sponsor bank is repaid at the beginning of the following month out of the fees the Company collects from its merchants.

Investments Investments consist of corporate and U.S. Government debt securities and certificates of deposit. The Company classifies its investments as available-for-sale and records them at the fair value of the investments based on quoted market prices. Cost is determined on a specific identification basis.

Inventories Inventories consist of point-of-sale terminal equipment held for sale to merchants, and are valued at the lower of cost or market price. Cost is arrived at using the first-in, first-out method. Market price is estimated based on current sales of equipment.

Capitalized Customer Acquisition Costs, net Capitalized customer acquisition costs consist of (1) up-front signing bonus payments made to Relationship Managers and sales managers (the Company s sales force) for the establishment of new merchant relationships, and (2) a deferred acquisition cost representing the cost of buying out the commissions of vested sales employees. Pursuant to Staff Accounting Bulletin Topic 13, *Revenue Recognition*, and FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, capitalized customer acquisition costs represent incremental, direct customer acquisition costs that are recoverable through gross margins associated with merchant contracts. The capitalized customer acquisition costs are amortized using a method which approximates a proportional revenue approach over the initial three-year term of the merchant contract.

The up-front signing bonus is based on the estimated gross margin for the first year of the merchant contract. The signing bonus, amount capitalized, and related amortization are adjusted after one year to reflect the actual gross margin generated by the merchant contract during that year. The deferred customer acquisition cost asset is accrued over the first year of merchant processing, consistent with the build-up in the accrued buyout liability, as described below.

Management evaluates the capitalized customer acquisition costs for impairment at each balance sheet date by comparing, on a pooled basis by vintage month of origination, the expected future net cash flows from underlying merchant relationships to the carrying amount of the capitalized customer acquisition costs. If the estimated future net cash flows are lower than the recorded carrying amount, indicating an impairment of the value of the capitalized customer acquisition costs, the impairment loss will be charged to operations.

Property and Equipment Property and equipment are carried at cost, net of accumulated depreciation. Depreciation is computed straight-line over periods ranging from three to ten years for furniture and equipment. Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease. The Company capitalizes the cost of computer software developed for internal use and amortizes such costs over an

estimated useful life of three years.

Long-Lived Assets The Company evaluates the potential for impairment when changes in circumstances indicate that undiscounted cash flows estimated to be generated by the related assets are less than the carrying amount. Management believes that no such changes in circumstances or impairment have occurred as of March 31, 2005.

Merchant Deposits and Loss Reserves Disputes between a cardholder and a merchant periodically arise due to the cardholder s dissatisfaction with merchandise quality or the merchant s service, and the disputes may not always be resolved in the merchant s favor. In some of these cases, the transaction is charged back to the merchant and the purchase price is refunded to the cardholder by the credit card-issuing institution. If the merchant is unable to fund the refund, the Company is liable for the full amount of the transaction. The Company may have partial recourse to the Relationship Manager originally soliciting the merchant contract, if the Relationship Manager is still receiving income from the merchant s processing activities. During 2003, the Company adopted FIN 45. Under FIN 45, the Company s obligation to stand ready to perform is minimal. The Company maintains deposits or the pledge of a letter of credit from certain merchants as an offset to potential contingent liabilities that are the responsibility of such merchants. The Company evaluates its ultimate risk and records an estimate of potential loss for chargebacks related to merchant fraud based upon an assessment of actual historical fraud loss rates compared to expected processing volume levels.

Accrued Buyout Liability Relationship Managers and sales managers are paid residual commissions based on the gross margin generated by monthly merchant processing activity. Until May 2004, Relationship Managers and sales managers had the contractual right to sell their portfolio equity at a fixed multiple to the Company. The Company has the right to buy out some or all of these commissions, and intends to do so periodically. Because of the Company s intent and ability to execute purchases of the residual commissions, and the mutual understanding between the Company and the Relationship Managers and sales managers, the Company has accounted for this deferred compensation arrangement pursuant to the substantive nature of the plan. The Company therefore records the amount currently payable (the settlement cost) to buy out non-servicing related commissions (owned commissions) from vested Relationship Managers and sales managers, and an accrual, based on their progress towards vesting, for those unvested Relationship Managers and sales managers who are expected to vest in the future. As noted above, as the liability increases over the first year of a merchant contract, the Company also records for vested Relationship Managers and sales managers a related deferred acquisition cost asset. The accrued buyout liability associated with unvested Relationship Managers and sales managers is not included in the deferred acquisition cost asset since future services are required in order to vest. Subsequent changes in the settlement cost, due to account attrition, same-store sales growth and changes in gross margin, are included in the same income statement caption as customer acquisition cost amortization expense.

The accrued buyout liability is based on the merchants under contract at the balance sheet date, the gross margin generated over the prior 12 months, and the contractual buyout multiple. The liability related to a new merchant is therefore zero when the merchant is installed, and increases over the twelve months following the installation date. The same procedure is applied to unvested commissions over the expected vesting period, but is further adjusted to reflect the Company s experience that 31% of unvested Relationship Managers and sales managers become vested.

The classification of the accrued buyout liability between current and non-current liabilities on the consolidated balance sheet is based upon the Company s estimate of the amount of the accrued buyout liability that it reasonably expects to pay over the next twelve months. This estimate is developed by calculating the cumulative annual average percentage that total historical buyout payments represent of the accrued buyout liability. That percentage is applied to the period-end accrued buyout liability to determine the current portion.

Warrants Warrants with mandatory redemption provisions are classified as debt and are recorded at estimated fair value.

Financing Arrangements Pursuant to EITF 88-18, the Company recognizes the transfer of merchant contracts as financing arrangements included under Borrowings and Financing Arrangements, until such time as the conditions for recognizing the transfer as a sale are met. The interest rates on these financing arrangements are computed based on the expected cash flows resulting from these contracts, reduced by an expected annual volume attrition rate of 15%. Any significant differences between actual future payments and expected payments will result in a change to that interest rate, which will be applied prospectively.

Revenue Revenue is mainly comprised of transaction and discount fees from the processing of merchant transactions. Revenue is recorded as bank card transactions are processed or payroll services are performed. The Company passes through to its customers any changes in interchange or association fees. Payroll revenue represents periodic and annual processing fees, which are recorded as services are performed.

Other revenue includes fees earned from customer service, termination fees on terminated contracts, fees for the sale, rental, leasing and deployment of credit card terminals and other miscellaneous revenue. These amounts are shown net of their associated direct costs, if any, and are recorded at the time the service is performed.

Income Taxes The Company accounts for income taxes by recognizing deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statements and the tax basis of assets and liabilities using enacted tax rates.

Stock Options The Company accounts for its stock options using the intrinsic value method in which no compensation expense has been recognized for its stock-based compensation plan because the options are granted at an exercise price greater than or equal to the estimated fair value at the grant date.

Basic earnings per share is computed based on the weighted average number of common shares outstanding. Diluted earnings per share is computed based on the weighted average outstanding common shares plus equivalent shares assuming exercise of stock options, warrants and conversion of Series A Senior Convertible Participating Preferred Stock, where dilutive. As discussed in Note 16, weighted average shares outstanding and dilutive securities have been adjusted to reflect a two-for-one stock split on July 26, 2005. The following table presents the effect on net income and basic and diluted net income per common share had the Company adopted the fair value method of accounting for stock-based compensation under SFAS No. 123 (in thousands, except per share data):

	Three Months Ended March 31,			
		2005		**2004**
Net income	**$**	**2,694**	$	2,146
Deduct: Total stock-based employee compensation expense determined under fair-value-based method, net of related tax expense		**1,444**		—
Pro forma net income		**1,250**		2,146
Less: Income allocated to Series A Senior Convertible Participating Preferred Stock		**(635)**		(1,037)
Pro forma net income attributable to common stock	**$**	**615**	$	1,109
Earnings per share :				
As reported:				
Basic	**$**	**0.09**	$	0.07
Diluted	**$**	**0.08**	$	0.07
Pro forma :				
Basic	**$**	**0.04**	$	0.07
Diluted	**$**	**0.04**	$	0.07

New Accounting Pronouncements On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 153, Exchanges of Nonmonetary Assets, an Amendment of APB Opinion No. 29. SFAS No. 153 addresses the measurement of exchanges of nonmonetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not believe adoption of Statement 153 will have a material effect on its consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123 revised). This statement revises SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. The most significant change resulting from this statement is the requirement for public companies to expense employee share-based payments under fair value as originally introduced in SFAS No. 123. SFAS No. 123 revised is effective, as amended on April 21, 2005 by the Securities and Exchange Commission, beginning with the first interim or annual reporting period of the registrant s first fiscal year beginning on or after June 15, 2005. The Company will adopt this statement when effective, and continues to assess its impact.

In July 2005, the FASB issued an exposure draft of a proposed Interpretation, *Accounting for Uncertain Tax Positions an interpretation of FASB Statement No. 109.* This proposed Interpretation would clarify the accounting for uncertain tax positions in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* An enterprise would be required to recognize, in its financial statements, the best estimate of the impact of a tax position, if that tax position is probable of being sustained if audited by a tax authority based solely on the technical merits of the position. Individual tax positions that fail to meet the Interpretation s recognition threshold would result in either (a) a reduction in the deferred tax asset or an increase in a deferred tax liability or (b) an increase in a liability for income taxes payable or the reduction of an income tax refund receivable. The proposed Interpretation would be effective as of the end of the first annual period ending on or after December 15, 2005. The Company does not believe the adoption of this proposed Interpretation will have a material effect on its consolidated financial position, results of operations or cash flows.

3. Receivables

A summary of receivables by major class are as follows at March 31, 2005 and December 31, 2004:

	March 31, 2005	**December 31, 2004**
	(in thousands)	
Accounts receivable from merchants	**$ 62,432**	$ 60,739
Accounts receivable from others	**2,399**	3,753
	64,831	64,492
Less allowance for doubtful accounts	**(167)**	(167)
	$ 64,664	$ 64,325

Receipts from settlement of the accounts receivable from merchants are primarily used to satisfy the Company s due to sponsor bank.

4. Investments

The cost, gross unrealized gains (losses) and estimated fair value for available-for-sale investments by major security type and class of security are as follows at March 31, 2005 and December 31, 2004:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(in thousands)		
March 31, 2005				
Debt securities of the U.S. Government	**$ 443**	**$ —**	**$ (3)**	**$ 440**
Corporate debt securities	**360**	**—**	**(11)**	**349**
Certificates of deposit	**551**	**—**	**—**	**551**
	$ 1,354	**$ —**	**$ (14)**	**$ 1,340**
December 31, 2004				
Debt securities of the U.S. Government	$ 195	$ —	$ (1)	$ 194
Corporate debt securities	360	1	(4)	357
Certificates of deposit	549	—	—	549
	$ 1,104	$ 1	$ (5)	$ 1,100

As of March 31, 2005, all unrealized losses in investments were the result of increases in interest rates. The unrealized losses in any individual security did not exceed 1.5% of the Company s cost basis. These investments are not considered other-than-temporarily impaired because the Company has the ability and intent to hold these investments for a period of time sufficient for a forecasted recovery in value, which may be upon maturity.

The maturity schedule of all investments owned along with amortized cost and estimated fair value as of March 31, 2005 is as follows:

	Amortized Cost	Estimated Fair Value
	(in thousands)	
Due in one year or less	$ 802	$ 801
Due after one year through five years	552	539
	$ 1,354	$ 1,340

5. Capitalized Customer Acquisition Costs, Net

A summary of the capitalized customer acquisition costs, net is as follows as of March 31, 2005 and December 31, 2004:

	March 31, 2005	December 31, 2004
	(in thousands)	
Capitalized signing bonuses	**$ 42,754**	$ 40,407
Less accumulated amortization	**(17,454)**	(15,862)
Capitalized signing bonuses, net	**25,300**	24,545
Capitalized customer deferred acquisition costs	**26,576**	21,349
Less accumulated amortization	**(16,290)**	(11,647)
Capitalized customer deferred acquisition costs, net	**10,286**	9,702
Capitalized Customer Acquisition Costs, Net	**$ 35,586**	$ 34,247

A summary of the activity in capitalized customer acquisition costs, net for the three months ended March 31, 2005 and 2004 was as follows:

	Three Months Ended March 31, 2005	2004
	(in thousands)	
Balance at beginning of period	**$ 34,247**	$ 22,321
Plus additions to:		
Capitalized signing bonuses, net	**4,002**	4,057
Capitalized customer deferred acquisition costs	**2,925**	2,288
	6,927	6,345
Less amortization expense:		
Capitalized signing bonuses	**(3,251)**	(2,628)
Capitalized customer deferred acquisition costs	**(2,337)**	(1,561)
	(5,588)	(4,189)
Balance at end of period	**$ 35,586**	$ 24,477

Net signing bonus adjustments from estimated amounts to actual were $(0.5) million and $(0.1) million, respectively, for the three months ended March 31, 2005, and 2004. Net signing bonus adjustments are netted against additions in the table above. Fully amortized signing bonuses of $1.9 million and $0.1 million were written off during the three months ended March 31, 2005, and 2004, respectively.

The Company believes that no impairment has occurred as of March 31, 2005 and December 31, 2004.

6. Property and Equipment, Net

A summary of property and equipment, net is as follows as of March 31, 2005 and December 31, 2004:

	March 31, 2005	December 31, 2004
	(in thousands)	
Computer hardware and software	**$ 5,173**	$ 13,611
Furniture, fixtures and equipment	**1,713**	1,709
Leasehold improvements	**2,138**	1,601
	19,024	16,921
Less accumulated depreciation	**(7,197)**	(5,977)
	$ 11,827	$ 10,944

Depreciation expense for the three months ended March 31, 2005 and 2004 was $1.2 million and $0.7 million, respectively.

7. Borrowings and Financing Arrangements

A summary of borrowings are as follows as of March 31, 2005 and December 31, 2004:

	March 31, 2005	December 31, 2004
	(in thousands)	
Financing Arrangements	**$ 9,698**	$ 10,241
Revolver Advance Facility	**2,069**	2,069
Purpose and Ability Line of Credit	**784**	784
	12,551	13,094
Less Current Portion	**5,227**	5,286
Long-term portion of borrowings and financing arrangements	**$ 7,324**	$ 7,808

Principal payments due on borrowings and financing arrangements for the next five years are as follows:

Twelve Months Ended March 31,	(in thousands)
2006	$ 5,227
2007	2,103
2008	1,747
2009	1,457
2010	1,276
Thereafter	741

7. Borrowings and Financing Arrangements (continued)

Financing Arrangements

On December 31, 1999 the Company signed a Merchant Services Purchase and Sale Agreement with National Processing Company, which was amended by a First Modification Agreement in December 2000, and Amendment No. 1 to the First Modification Agreement in December, 2001. Under these agreements, the Company agreed to the transfer of merchant contracts generating a specified amount of net revenue to the transferee, and to pay all cash flows, net of servicing fees and chargeback losses, associated with specific lists of merchant contracts that were committed to the arrangement. This transaction has been treated as a financing arrangement, as discussed in Note 2. As a result, the Company had recorded a liability of $23.0 million on December 31, 1999, which was reduced by servicing payments and the value of converted contracts. The respective amendments of the agreements had the effect of triggering sale treatment for those contracts that were converted to the transferee s systems in 2000, 2001 and 2002. Effective August 1, 2002, the Company signed a five-year servicing agreement with the transferee, in which the Company agreed to provide servicing to those merchants in a defined final pool that had not been converted to the transferee s processing systems, and that no further conversions would be made. The servicing agreement is terminable by the transferee upon the occurrence of certain change in control events, upon material breach by the Company, if merchant losses exceed a specified threshold, or if the Company enters into bankruptcy, receivership or other like status, in which event the transferee will be responsible for the conversion of the remaining serviced merchants to their processing systems. The interest rate at March 31, 2005 was 4.26% and the outstanding balance was $0.6 million.

On November 1, 2000, the Company signed a Merchant Portfolio Purchase Agreement and an associated Servicing Agreement with Certegy Inc., each of which was amended on January 16, 2002. Under these agreements, the Company pays all cash flows, net of servicing fees and chargeback losses, related to the transferred merchant contracts to the transferee. This transaction has been treated as a financing arrangement, as discussed in Note 2. As a result, the Company recorded a liability of $22.0 million on November 1, 2000, and the payments made represent interest plus principal repayments. The interest rate at March 31, 2005 was 2.53% and the outstanding balance was $9.1 million. The servicing agreement is terminable only upon material breach by either party, or if the Company enters into bankruptcy, receivership or other like status.

Loan and Security Agreement

On August 28, 2002, the Company signed a Loan and Security Agreement for two loan instruments; this Agreement was amended on November 6, 2003 and June 23, 2004. The first instrument is a Revolver Advance Facility (Revolver), which is to be used solely to fund the buyout of future commissions from current or former Relationship Managers or from Independent Sales Organizations. The Company may draw down on the Revolver up to but not exceeding an aggregate unpaid principal amount outstanding of $3,500,000. The entire principal balance plus all accrued interest and fees is due on May 31, 2005 (subsequently extended to August 31, 2005), or on demand if there were to be a default. The Revolver accrues interest at a rate equal to the prime rate, which was 5.5% at March 31, 2005. The Company s assets, including accounts receivable, inventory, furniture and equipment and general intangibles, serve as collateral to secure the Revolver.

On May 26, 2005, the Company entered into an amendment to its Loan and Security Agreement, which extended the scheduled maturity date from May 31, 2005 to August 31, 2005.

7. Borrowing and Financing Arrangements (continued)

The second instrument is a $3,000,000 Purpose and Ability Line of Credit Facility (Line of Credit). The Line of Credit accrues interest at the prime rate, which was 5.5% at March 31, 2005, and is secured by the assets of the Company, including accounts receivable, inventory, furniture and equipment and general intangibles. The entire principal balance plus all accrued interest and fees is due upon demand.

The Company is subject to standard loan covenants and financial statement reporting requirements on both of the debt instruments and was in compliance at March 31, 2005 and December 31, 2004.

8. Merchant Deposits and Loss Reserves

The Company s merchants have the liability for any charges properly reversed by the cardholder through a mechanism known as a chargeback. If the merchant is unable to pay this amount, the Company will be liable to the Visa and MasterCard associations for the reversed charges.

During 2003, the Company adopted FIN 45. Under FIN 45, the Company determined the fair value of the obligation to stand ready to perform is minimal. The Company requires personal guarantees, merchant deposits and letters of credit from certain merchants to minimize its obligation. As of March 31, 2005 and December 31, 2004, the Company held merchant deposits totaling $7.7 million and $6.7 million, and letters of credit totaling $480,000 and $30,000, respectively.

The Visa and MasterCard associations generally allow chargebacks up to four months after the later of the date the transaction is processed or the delivery of the product or service to the cardholder. As the majority of the Company s transactions involve the delivery of the product or service at the time of the transaction, a reasonable basis for determining an estimate of the Company s exposure to chargebacks is the last four months processing volume on its portfolio, which was $9.4 billion and $9.0 billion for the four months ended March 31, 2005 and December 31, 2004, respectively. However, for the four months ended March 31, 2005 and December 31, 2004, the Company was presented with $5.5 million and $5.6 million, respectively, in chargebacks by issuing banks. In the three months ended March 31, 2005 and the year ended December 31, 2004, the Company incurred merchant credit losses of $300,000 and $940,000, respectively, on total dollar volume processed of $6.9 billion and $25.0 billion, respectively. These credit losses are included in cost of services in the Company s consolidated statements of operations.

The loss recorded by the Company for chargebacks associated with any individual merchant is typically small, due both to the relatively small size and the processing profile of the Company s clients. However, from time to time the Company will encounter instances of merchant fraud, and the resulting chargeback losses may be considerably more significant to the Company. The Company has established a reserve for estimated credit and fraud losses on its consolidated balance sheets, amounting to $471,000 and $468,000 on March 31, 2005 and December 31, 2004, respectively. This reserve is determined by performing an analysis of the Company s historical loss experience applied to current processing volume and exposures.

A summary of the activity in the loss reserve for the three months ended March 31, 2005 and 2004 is as follows:

	Three Months Ended March 31,	
	2005	**2004**
	(in thousands)	
Beginning balance	**$ 468**	$ 558
Additions to reserve	**303**	311
Charges against reserve	**(300)**	(311)
Ending Balance	**$ 471**	$ 558

9. Accrued Buyout Liability

A summary of the accrued buyout liability is as follows as of March 31, 2005 and December 31, 2004:

	March 31, 2005	December 31, 2004
	(in thousands)	
Vested Relationship Managers and sales managers	**$ 25,709**	$ 25,788
Unvested Relationship Managers and sales managers	**1,214**	1,247
	26,923	27,035
Less current portion	**10,258**	9,327
Long-term portion of accrued buyout liability	**$ 16,665**	$ 17,708

A summary of the activity in the accrued buyout liability for the three months ended March 31, 2005 and 2004 is as follows:

	Three Months Ended March 31, 2005	2004
	(in thousands)	
Beginning balance	**$ 27,035**	$ 17,985
Increase in settlement obligation, net	**3,175**	2,436
Buyouts	**(3,287)**	(726)
Ending balance	**$ 26,923**	$ 19,695

The increase in settlement obligation is due to new merchant account signings, as well as same-store sales growth and changes in gross margin, primarily attributable to account attrition.

In calculating the accrued buyout liability for unvested Relationship Managers and sales managers, the Company has assumed that 31% of the unvested Relationship Managers and sales managers will vest in the future, which represents the Company s historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested Relationship Managers and sales managers by $196,000 at March 31, 2005 and $201,000 at December 31, 2004.

10. Convertible Preferred Stock and Warrants

The Series A Senior Convertible Participating Preferred Stock (the Convertible Preferred) is convertible by the holders at any time and automatically converts upon the closing of a qualified public offering up to 15,238,096 shares of the Company s Common Stock, participates equally in dividends and distributions with the Common Stock, pays no other dividends and has a liquidation preference of $80 million. The Convertible Preferred was redeemable at the option of two-thirds of the holders after October 1, 2006 at the higher of the liquidation preference or value per common share. The carrying value of the Convertible Preferred was accreted to its mandatory redeemable value by $6,509,019 in the year ended December 31, 2002, using the effective interest rate method. During 2002, the Company stopped accreting the Convertible Preferred because the terms of the Certificate of Designations for the Convertible Preferred and the Shareholders Agreement by and among the holders of the Company s Common Stock and the Convertible Preferred were amended to eliminate certain rights of the holders of the Convertible Preferred that might, in certain circumstances, have allowed those holders to cause redemption of the Convertible Preferred. The holders of the Convertible Preferred have the right to elect three directors to the Company s Board and have certain other rights with respect to the governance of the Company.

In addition, the holders of the Convertible Preferred received five-year warrants to purchase an additional 2,000,000 shares of the Company s Common Stock at a price of $2.63 per share, which were valued at $1.5 million. The Company redeemed these warrants on September 28, 2004 by paying the holders the net consideration of $5.25 million.

In August 2004, the Certificate of Designations of the Convertible Preferred was amended to eliminate after October 1, 2006 certain rights of the holders to treat a merger of the Company as a liquidation event. This amendment was in addition to amendments made in 2002 to the terms of the Certificate of Designations for the Convertible Preferred and the Shareholders Agreement by and among the holders of the Company s Common Stock. As a result of the amendment, the Company has classified the Convertible Preferred as a part of stockholders (deficit) equity in its December 31, 2004 and March 31, 2005 financial statements.

The Board of Directors is authorized to issue shares of preferred stock in one or more classes or series without any further action by the Company s stockholders.

On July 26, 2001, the Company signed a Loan and Security Agreement with BHC Interim Funding, L.P., and received a Term Loan (the BHC Bridge Loan) in the amount of $4.76 million, which accrued interest at a rate of 13.75%, and was secured by a first priority lien on the Company s merchant contracts and certain other assets. The BHC Bridge Loan was repaid on October 11, 2001. In connection with this agreement, the Company issued 337,810 five-year mandatory redeemable warrants to purchase its Common Stock for $0.005, which were valued at $605,049. Commencing July 26, 2003, the holder can require the Company to redeem these warrants at their per share fair value. The Company records these warrants at their estimated fair value and adjusted these warrants by $0.5 million and $0.9 million in December 2002 and 2003 because transactions indicated that $3.61 and $6.25 per share, respectively, was an appropriate fair value. On January 8, 2004, the warrant holder elected to cause the Company to redeem 168,906 shares at the fair value of $6.25 per share. The Company has adjusted the warrants by an additional $0.5 million in the period ending December 31, 2004 and by $0.1 million during the three months ended March 31, 2005 to reflect the estimated fair value of $9.28 and $9.80 per share, respectively.

11. Income Taxes

The provision for income taxes for the three months ended March 31, 2005 and 2004 consists of the following:

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
	(in thousands)	
Current		
Federal	**$ 1,531**	$ 356
State	**345**	122
Deferred		
Federal	**92**	847
State	**21**	157
Total provision for income taxes	**$ 1,989**	$ 1,482

The net deferred tax asset was comprised of the following at March 31, 2005 and December 31, 2004:

	March 31, 2005	December 31, 2004
Deferred tax assets:		
Merchant contract costs	**$ 15,671**	$ 5,317
Borrowings and financing arrangement	**4,123**	4,353
Loss reserve and accounts receivable allowance	**271**	270
Other	**2**	1
	20,067	19,941
Deferred income tax liabilities:		
Capitalized signing bonus	**10,753**	10,432
Deferred state tax liability	**439**	447
Software development	**1,193**	1,065
Property and equipment	**1,015**	1,217
	13,400	13,161
Net deferred income tax asset	**6,667**	6,780
Less current portion	**2,179**	2,129
Net deferred income tax asset - non current portion	**$ 4,488**	$ 4,651

At December 31, 2004 the Company has fully utilized all federal and state net operating loss carryforwards.

11. Income Taxes (continued)

The differences in federal income taxes provided and the amounts determined by applying the federal statutory tax rate of 35% to income before income taxes for the three months ended March 31, 2005 and 2004 are:

	Three Months Ended March 31, 2005			**Three Months Ended March 31, 2004**		
	%		**Amount (in thousands)**	**%**		**Amount (in thousands)**
U.S. federal income tax at statutory rate	**35.00%**	**$**	**1,639**	35.00%	$	1,237
U.S. state and local income taxes, net	**5.08%**		**238**	5.12%		181
Warrants	**1.24%**		**58**	1.17%		42
Nondeductible expenses	**0.25%**		**12**	0.59%		23
Other, net	**0.91%**		**42**	(0.01)%		(1)
Provision for income taxes	**42.48%**	**$**	**1,989**	41.87%	$	1,482

Tax contingencies are recorded for probable exposures involving tax positions taken that could be challenged by taxing authorities. These probable exposures result from the varying application of statutes, rules, regulations and interpretations. The Company does not have income tax contingencies.

12. Commitments and Contingencies

Litigation The Company is involved in certain legal proceedings and claims, which arise in the ordinary course of business. In the opinion of the Company, the results of any of these matters, individually and in the aggregate, are not expected to have a material effect on its results of operations, financial condition or cash flows.

Leases The Company leases various office spaces and certain equipment under operating leases with remaining terms ranging up to eight years. The majority of the office space lease agreements contain renewal options and generally require the Company to pay certain operating expenses.

Future minimum lease commitments under noncancelable leases as of March 31, 2005 are as follows:

Twelve Months Ended March 31,		**(in thousands)**
2006	$	1,315
2007		1,538
2008		1,347
2009		1,110
2010		387
Thereafter		950

	$	6,647

Rent expense for leased property was $288,000 and $258,000, respectively, for the three months ended March 31, 2005 and 2004.

Commitments—Certain officers of the Company have entered into an employee confidential information and noncompetition agreement under which they are entitled to severance pay equal to their base salary and medical benefits for 12 months and a pro-rated bonus in the event they are terminated by the Company other than for cause.

12. Commitments and Contingencies (continued)

Contingencies — The Company collects and stores sensitive data about its merchant customers and bank cardholders. If the Company s network security is breached or sensitive merchant or cardholder data is misappropriated, the Company could be exposed to assessments, fines or litigation costs.

13. Related Party Transactions

In November 2004, Carr Holdings, L.L.C., a New Jersey limited liability company, which is owned and managed by the Company s Chief Executive Officer and his wife sold an aggregate of 108,000 shares of the Company s Common Stock to Greenhill Capital Partners, L.P. and its affiliated investment funds and LLR Equity Partners, L.P. and its affiliated investment fund at a price of $9.28 per share. Various officers, directors, partners and members of Greenhill Capital Partners, L.P. and its affiliated investment funds and LLR Equity Partners, L.P. and its affiliated investment fund are members of the Company s board of directors.

14. Segments

The determination of the Company s business segments is based on how the Company monitors and manages the performance of its operations. The Company has two operating segments, as follows: (1) Card, which provides payment processing and related services related to bank card transactions; and (2) Payroll, which provides payroll and related tax filing services.

The Company s operating segments are strategic business units that offer different products and services. They are managed separately because each business requires different marketing strategies, personnel skill sets and technology.

The Company allocates revenues, expenses, assets and liability to segments only where directly attributable. The unallocated corporate administration amounts are costs attributed to finance, corporate administration, human resources and corporate services. For the reported periods, between 70% and 90% of the payroll segment total assets are funds that the Company holds as a fiduciary for payment to taxing authorities. The Company only operates in the United States and does not have any major individual customers.

14. Segments (continued)

A summary of the Company s segments for the three months ended March 31, 2005 and 2004 are as follows:

	Card	Payroll	Unallocated Corporate Administration Amounts	Total Amount
		(in thousands)		
Three Months EndedMarch 31, 2005				
Total net revenue	$ 168,623	$ 1,242	$	$ 169,865
Depreciation and amortization	1,198	28	57	1,283
Interest income	20	90		110
Interest expense	435			435
Net income (loss)	3,821	423	(1,550)	2,694
Total assets	128,059	8,333		136,392
Three Months EndedMarch 31, 2004				
Total net revenue	120,157	1,047		121,204
Depreciation and amortization	836	29	11	876
Interest income	16	22		38
Interest expense	298			298
Net income (loss)	3,288	233	(1,375)	2,146
Total assets	102,437	5,212		107,649

15. Earnings Per Share

The Company presents earnings per share data in accordance with SFAS No. 128, Earnings Per Share (SFAS 128), which establishes the standards for the computation and presentation of basic and diluted earnings per share data. Under SFAS 128, the dilutive effect of stock options is excluded from the calculation of basic earnings per share but included in diluted earnings per share.

Weighted average shares outstanding and dilutive securities have been adjusted to reflect a two-for-one stock split on July 26, 2005. The following is a reconciliation of the amounts used to calculate basic and diluted earnings per share using the two-class method:

	Three Months Ended March 31,			
	2005		2004	
	(in thousands, except per share data)			
Basic				
Weighted average common stock outstanding		**16,449**		**16,296**
Earnings per share	**$**	**0.09**	**$**	**0.07**
Diluted:				
Net income attributable to common	**$**	**1,399**	$	1,109
Plus: income allocated to Series A Senior Convertible Participating Preferred Stock		**1,295**		1,037
Net income	**$**	**2,694**	$	2,146
Basic weighted average common stock outstanding		**16,449**		16,296
Effect of dilutive instruments:				
Stock options		**2,816**		1,168
Warrants		**169**		169
Series A Senior Convertible Participating Preferred Stock		**15,238**		15,238
Diluted weighted average shares outstanding		**34,672**		32,871
Earnings per share	**$**	**0.08**	$	0.07

16. Subsequent Events

On May 26, 2005, the Company entered into an amendment to its Loan and Security Agreement, which extended the scheduled maturity date from May 31, 2005 to August 31, 2005. See Note 7 Borrowings and Financing Arrangements for more information regarding the Loan and Security Agreement.

In connection with the proposed public offering of the Company s common stock during 2005, the Board of Directors and stockholders approved a two-for-one stock split of the Company s common stock on July 26, 2005. All common shares, per share and conversion amounts related to stock options, warrants and Convertible Preferred included in the accompanying consolidated financial statements and footnotes have been adjusted to reflect the stock split for all periods presented. The Company s Board of Directors and stockholders also increased the number of authorized shares of common stock to 100,000,000 and the number of shares authorized under the Equity Incentive plan to 11,000,000.

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17. Financial Statement Restatement

The Company s income statement for the three months ended March 31, 2004 originally reported the estimated fair value of the liability associated with the deferred compensation arrangement, based on the present value of estimated future residual commission payments not associated with ongoing service requirements, as well as estimated buyouts from employees of those commissions. In connection with filing Amendment No. 1 to the Form S-1 in March 2005, the Company has subsequently determined that the appropriate accounting was to record an accrued buyout liability for the settlement cost of buying out the commissions of all vested and expected-to-be vested Relationship Managers and sales managers at each balance sheet date, and a deferred customer acquisition cost asset associated with the liability for new merchants, as discussed in notes 5 and 9 above. Cash payments for buyouts thus become the satisfaction of the liability, and the capitalized customer acquisition costs are amortized into income over the initial three-year contract term. The net change in this liability is reflected in the relevant period within expenses; accordingly, the accompanying financial statements were restated.

The Company also determined that given the term and conditions of the servicing contract associated with merchant contracts that were transferred in 2000 to a third party (as discussed in Notes 2 and 7), the previous recognition of the transfer as a sale was not appropriate. Consequently, and pursuant to the provisions of EITF 88-18, the proceeds have been recorded as a financing arrangement in the consolidated financial statements. The Company records revenue and cost of services associated with the transferred contracts. Cash paid to the transferee represents payments of principal and interest on the obligation.

Subsequent to filing Amendment No. 1 to the Form S-1 in March 2005, the Company determined that given the revenue guaranties and servicing agreements associated with a transfer of merchant contracts to a third party in 1999 (as discussed in Notes 2 and 7), the previous recognition of the transfer as a sale was not appropriate. Consequently, and pursuant to the provisions of EITF 87-34, EITF 90-21 and EITF 95-5, the Company recognized the transfer as a financing arrangement until such time as the conditions for recognizing the transfers of individual merchant contracts as sales were met. Cash paid to the transferee represents principal repayment and interest on the financing arrangement. Payments include all cash flows, net of servicing fees and charge back losses, associated with specific lists of merchant contracts that were committed to the arrangement prior to a merchant s conversion to the transferee s processing systems. Until the efforts to convert merchants to the transferee s processing systems ceased in 2002, payments also included the estimated fair value of merchant contracts that had converted and which were recognized as sales. The Company currently records revenue and costs of services associated with the unconverted merchant contracts.

The Company previously presented unclassified balance sheets. The Company determined that classified balance sheets should be presented and made the appropriate reclassifications. Amounts related to short-term and long-term assets and liabilities, including prepaid expenses, deferred taxes and borrowings and financing arrangements were reclassified in Amendment No. 3 to the Form S-1 filed by the Company in June 2005. In addition, the Company restated its classification of the accrued buyout liability to present the current and non-current portion of the liability.

The tables below provides a summary of the significant effects of the Company s restatement of its consolidated financial statements as originally reported in the Form S-1 filed in August 2004, and as previously reported in Amendment No. 1 to the Form S-1 filed in March 2005. In addition, the classification of the accrued buyout liability and deferred taxes in the As Restated column have been restated from the manner it was previously reported in Amendment No. 3 to the Form S-1 filed by the Company in June 2005. As of December 31, 2004 and March 31, 2005, the current portion of the accrued liability in the amounts of $9.3 million and $10.3 million, respectively, were reclassified from long-term. As of December 31, 2004 and March 31, 2005, the current deferred tax asset was restated from $0.1 million and $0.2 million, respectively, to $2.1 million and $2.2 million, respectively. As of December 31, 2004 and March 31, 2005, the non-current deferred tax asset was restated from $6.7 million and $6.5 million, respectively, to $4.7 million and $4.5 million, respectively.

	March 31, 2005		December 31, 2004	
	As Previously Reported	**As Restated**	**As Previously Reported**	**As Restated**
Prepaid expenses	$ 2,989	$ 2,989	$	$ 2,151
Deposits and other assets	251	251	—	324
Prepaid expenses and other assets	—	—	2,475	—
Current deferred tax asset, net	184	2,179	—	2,129
Deferred tax asset, net	6,483	4,488	6,715	4,651
Total assets	136,392	136,392	133,861	133,926
Current portion of accrued buyout liability	—	10,258	—	9,327
Accrued expenses and other	5,932	5,932	7,153	6,701
Current portion of borrowings and financing arrangements	5,227	5,227	—	5,286
Long-term portion of borrowings and financing arrangements	7,324	7,324	12,382	7,808
Accrued buyout liability	26,923	16,665	27,035	17,708
Total liabilities	127,562	127,562	127,577	127,827
Accumulated deficit	(32,278)	(32,278)	(34,787)	(34,972)
Total stockholders equity	8,830	8,830	6,284	6,099

	For the three months ended March 31, 2004	
	As Originally Reported	**As Restated (1)**
Gross processing revenue	$ 108,797	$ 119,202
Other revenue, net	3,088	2,002
Interchange	78,532	86,372
Dues and assessments	4,350	4,785
Processing and servicing	14,261	14,748
Customer acquisition costs	3,604	4,135
Depreciation and amortization	3,301	876
Interest expense	176	298
Provision for income taxes	698	1,482
Net income	562	2,146

(1) The financial statements for the three months ended March 31, 2004 were previously reported in the Form S-1 filed with the SEC in August 2004. These financial statements have been restated to correct for matters discussed in this footnote.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Our consolidated financial information set forth below should be read in conjunction with the consolidated financial statements and the accompanying notes to consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q, and the consolidated financial statements, notes to consolidated financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations and the risk factors contained in our Form 10/A filed on July 21, 2005.

Forward Looking Statements

Some of the information in this Quarterly Report on Form 10-Q may contain forward-looking statements that are based on our management s beliefs and assumptions and on information currently available to our management. Forward-looking statements include the information concerning our possible or assumed future results of operations, business strategies, financing plans, competitive position, industry environment, potential growth opportunities, the effects of future regulation and the effects of competition. Forward-looking statements include all statements that are not historical facts and can be identified by the use of forward-looking terminology such as the words believe, expect, anticipate, plan, estimate or similar expressions.

Forward-looking statements involve risks, uncertainties and assumptions. Actual results may differ materially from those expressed in the forward-looking statements. You should understand that many important factors, in addition to those discussed elsewhere in this report, could cause our results to differ materially from those expressed in the forward-looking statements. These factors include, without limitation, our competitive environment, the business cycles and credit risks of our merchants, chargeback liability, merchant attrition, problems with our bank sponsor, our reliance on other bank card payment processors, our inability to pass increased interchange fees along to our merchants, the unauthorized disclosure of merchant data, economic conditions, system failures and government regulation.

Overview

General

We provide bank card-based payment processing services to merchants in the United States. As of March 31, 2005, we provided our payment processing services to approximately 94,000 active merchants located across the United States. Our processing volume for the three months ended March 31, 2005 was $6.9 billion, a 35.3% increase from the $5.1 billion processed during the same period in 2004. In 2004, 2003 and 2002, our processing volume was $25.0 billion, $17.9 billion and $14.4 billion, respectively.

Our revenue is recurring in nature, as we typically enter into three-year service contracts that, in order to qualify for the agreed-upon pricing, require the merchant to achieve processing volume minimums. Most of our gross revenue is payment processing fees, which are a combination of a fee equal to a percentage of the dollar amount of each Visa or MasterCard transaction we process plus a flat fee per transaction. We make mandatory payments of interchange fees to card-issuing banks and dues and assessment fees to Visa and MasterCard. Our business volume, and consequently gross processing revenue, is largely driven by the cumulative growth in the number of merchants with whom we have processing contracts. This in turn is the result of the number of merchants that we install during a period, offset by the number of merchants who cease processing with us during that period. We also generally benefit from consumers increasing use of bank cards in place of cash and checks.

Since our inception in 1997, our success at signing new merchants has generally led to significant annual gross processing revenue increases. However, our limited capital resources and our desire to buy out the equity of our former 50% owner led us to economically transfer approximately two-thirds of our merchant contracts in late 1999 and early 2000 to National Processing Company and Heartland Bank. In October 2001, we raised an aggregate of $40 million from Greenhill Capital Partners, L.P. and its affiliated investment funds and LLR Equity Partners, L.P. and its affiliated investment fund in exchange for a significant interest in our company. These additional financial resources allowed us to begin the rapid growth of our sales force, a process that was accelerated in late 2002 by a restructuring of our sales management structure. This restructuring included the creation of eight regions (now 12), with the sales managers in these regions being compensated based on their success in growing the sales

force and increasing the merchant base in their regions. The result has been a significant increase in the number of new Relationship Managers and new merchants installed, with the number of new merchants growing by approximately 42% from 19,687 in 2002 to 27,911 in 2003, and by approximately 41% to 39,403 in 2004. During the three months ended March 31, 2005, we installed 10,317 new merchants. In order to continue to increase our gross processing revenue, we intend to increase both the size and productivity of our sales force. As a result of our commission-only compensation system for our sales force, which is required to work exclusively for us, we are able to increase the size of our sales force with minimal upfront costs. However, since we pay signing bonuses and commissions approximating 92% of the gross margin generated by a merchant in its first year, growth in merchant accounts consumes significant capital, as it typically takes approximately 11 months of processing to cover the signing bonus and commission outlays. During 2003 and 2004 we also experienced an improvement in our same store sales statistics, which represent the change in processing volume for all merchants that were processing with us in the same month a year earlier. Same store sales grew 5.0% on average in 2003, and grew 7.5% on average in 2004; this same store sales growth declined somewhat to 6.9% on average in the three months ended March 31, 2005. This same store sales growth resulted from the combination of the increasing use by consumers of bank cards for the purchase of goods and services at the point of sale, and sales growth experienced by our retained merchants, some of which was likely the result of an improving economy.

Our principal revenues fall into two categories, gross processing revenue and other revenue, net. Our gross processing revenue primarily consists of discount, per-transaction and periodic (primarily monthly) fees from the processing of bank card transactions, primarily Visa and MasterCard transactions, for merchants. These fees are negotiated by our Relationship Managers with each merchant. Gross processing revenue also includes fees charged by Heartland Payroll Company for payroll processing services. Gross processing revenue is recorded as services are performed.

Other revenue, net includes American Express and Discover fees, customer service fees, fees for processing chargebacks, fees for the sale, rental, leasing and deployment of bank card terminals, termination fees on terminated contracts, and other miscellaneous revenue. These amounts are shown net of their associated direct costs, if any, and are recorded at the time the service is performed. Most of these other fees and revenue items will tend to grow with our merchant growth.

Our most significant expense is interchange fees, which are set by the Visa and MasterCard card associations, and are paid to the card issuing banks. Interchange fees are calculated as a percentage of the dollar volume processed plus a per transaction fee. We also pay Visa and MasterCard association dues and assessments, which are calculated as a percentage of the dollar volume processed. Interchange fees and dues and assessments are recognized at the time transactions are processed. It is our policy to pass along to our merchants any changes in interchange fees and card association dues and assessments. Consequently, after Visa and MasterCard decreased their debit interchange rates in August 2003, both our discount and our interchange fees as a percentage of processing volume decreased by approximately 0.1%, with both income and expense decreasing by approximately the same amount. Our income from operations was therefore not affected by the reduction in debit interchange fee rates. Since the card associations have recently implemented significant increases in those rates, our gross processing revenue will increase, but all the benefit will be paid to the card issuing banks and our income from operations will not be affected.

Costs of services also include processing and servicing costs, customer acquisition costs, and depreciation and amortization. Processing and servicing costs include:

residual commission payments to our Relationship Managers, sales managers and trade associations, agent banks and value-added resellers, which are a percentage of the gross margin we generated from our merchant contracts during the accounting period;

processing costs, which are either paid to third parties, or represent the cost of our own authorization/capture system. During 2004, third party costs represented about 77% of our processing costs, with internal costs representing

the remainder. Approximately 72% of our third-party processing costs were paid to Vital; and

miscellaneous items, including telecommunications costs, personnel costs, occupancy costs, losses due to merchant defaults, bank sponsorship costs and other direct merchant servicing expenses.

Customer acquisition costs reflect the amortization over the initial three-year contract term of the cash signing bonus paid, the deferred acquisition costs for vested Relationship Managers and sales managers, and changes in the accrued buyout liability, which reflect the impact of buyouts and volume attrition.

Depreciation and amortization expenses are primarily recognized on a straight-line basis over the estimated useful life of the asset. We have made significant capital expenditures for computer hardware and software and such costs are generally depreciated over three years.

Selling and administrative expenses include salaries and wages and other administrative expenses. The two most significant elements in these expenses are our information technology infrastructure costs and our marketing expenses.

Other income (expense) consists of interest income on cash and investments, the interest cost on our borrowings, the gains or losses on the disposal of property, plant and equipment and other non-recurring income or expense items. Other income (expense) also includes the adjustment to the fair value of our outstanding warrants with mandatory redemption provisions.

Critical Accounting Estimates

The discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. These financial statements are unaudited; however, in the opinion of management, they include all normal recurring adjustments necessary for a fair presentation of our consolidated financial position at March 31, 2005, our consolidated results of its operations and cash flows for the three months ended March 31, 2005 and 2004. Results of operations reported for interim periods are not necessarily indicative of results for the entire year. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. Actual results could differ from those estimates. Our significant accounting policies are more fully described in note 2 to our consolidated financial statements included elsewhere in this report and in our annual report filed on Form 10. The critical accounting estimates described here are those that are most important to the depiction of our financial condition and results of operations, including those whose application requires management s most subjective judgment in making estimates about the effect of matters that are inherently uncertain. The line items on our income statement and balance sheet impacted by management s estimates are described below.

Revenue

Nearly 75% of our reported gross processing revenue is paid by us as interchange fees to the card issuing banks. Certain of our competitors report their revenue net of interchange fees. This is because the issuing banks make their payments to these competitors net of those interchange fees, and these acquirers pay this reduced amount to their merchants. We do not offset gross processing revenue and interchange fees because our business practice is to arrange for our banks to advance the interchange fees to most of our merchants when settling their transactions (thus paying the full amount of the transaction to the merchant), and then to collect our full discount fees from our merchants on the first business day of the next month. We believe this policy aids in new business generation, as our merchants benefit from bookkeeping simplicity. However, it results in our carrying a large receivable from our merchants at each period-end, and a corresponding but smaller payable to the banks, both of which are settled on the first business day after the period-end. As we are at risk for the receivables, we record the associated revenues on a gross processing revenue basis in our income statements.

Capitalized Customer Acquisition Costs

Capitalized customer acquisition costs consist of (1) up-front signing bonus payments made to Relationship Managers and sales managers for the establishment of new merchant relationships, and (2) deferred acquisition cost representing the cost of buying out the commissions of vested Relationship Managers and sales managers. The capitalized customer acquisition costs are amortized using a method, which approximates a proportional revenue approach over the initial three-year term of the merchant contract.

The amount of the up-front signing bonus paid is based on the estimated gross margin (calculated by deducting interchange fees, dues and assessments and all costs incurred in underwriting, processing and reviewing an account from gross processing revenue) for the first year of the merchant contract. The signing bonuses paid during the three months ended March 31, 2005 and the year ended December 31, 2004 were $4.6 million and $21.6 million, respectively. The signing bonus paid, amount capitalized, and related amortization are adjusted at the end of the first year to reflect the actual gross margin generated by the merchant contract during that year. The deferred acquisition cost is accrued over the first year of merchant processing, consistent with the build-up in the accrued buyout liability, which is described below.

The amount of signing bonus paid which remained subject to adjustment at March 31, 2005 and December 31, 2004 was $21.9 million and $21.6 million, respectively. The net signing bonus adjustments made during the

three months ended March 31, 2005 and the year ended December 31, 2004 were $(0.6) million and $(1.4) million, respectively. Negative signing bonus adjustments result from the overpayment of signing bonuses previously paid, which are recovered from the relevant salesperson.

Management evaluates the capitalized customer acquisition costs for impairment at each balance sheet date by comparing, on a pooled basis by vintage month of origination, the expected future net cash flows from underlying merchant relationships to the carrying amount of the capitalized customer acquisition costs. If the estimated future net cash flows are lower than the recorded carrying amount, indicating an impairment of the value of the capitalized customer acquisition costs, the impairment loss will be charged to operations. We have not recognized an impairment loss for the three months ended March 31, 2005 and the year ended December 31, 2004.

Accrued Buyout Liability

We pay our Relationship Managers and sales managers, referred to as the salesperson or salespersons, residual commissions based on the gross margin generated from the monthly merchant processing activity of merchants signed by them. A portion, typically 25%, of the residual commissions we owe to the salesperson is deemed to be a servicing fee and is not accrued. For the remainder of their residual commissions (referred to as the owned portion of such commissions, or portfolio equity), the salesperson has no obligation to perform services for so long as the merchant continues processing with us. We accrue the buyout liability, which represents the current settlement cost of buying out all vested and expected-to-vest salespersons for the owned portion of such commissions. We also record a deferred acquisition cost asset related to those buyouts, and amortize that asset as an expense over the initial 3-year contract term.

We consider the salesperson to be vested once they have established merchant relationships that generate the equivalent of $2,000 of monthly residual commissions. Vested status entitles the salesperson to his or her residual commissions for as long as the merchant processes with us, even if the salesperson is no longer employed by us.

The accrued buyout liability is based on the merchants we have under contract at the balance sheet date, the gross margin (calculated by deducting interchange fees, dues and assessments and all costs incurred in underwriting, processing and reviewing an account from gross processing revenue) we generated from those accounts in the prior twelve months, and the fixed buyout multiple. The liability related to a new merchant is therefore zero when the merchant is installed, and increases over the twelve months following the installation date.

For unvested salespersons, the accrued buyout liability is accrued over the expected vesting period; however, no deferred acquisition cost is capitalized as future services are required in order to vest. In calculating the accrued buyout liability for unvested salespersons, we have assumed that 31% of unvested salespersons will vest in the future, which represents our historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested salespersons by $196,000 at March 31, 2005 and $201,000 at December 31, 2004.

Buyout payments we make to our salespersons reduce the outstanding accrued buyout liability. Given our view of the duration of the cash flows associated with a pool of merchant contracts, we believe that the benefits of such buyouts significantly exceed the cost, which typically represents 2 to 2 1/2 years of commissions. If the cash flows associated with a pool of bought out contracts does not exceed this cost, we will incur a loss on the transaction. During the three months ended March 31, 2005 and the year ended December 31, 2004, we made buyout payments of approximately $3.3 million and $2.2 million, respectively. In 2004, we processed fewer buyouts as a result of the contract modifications and initial public offering process. We expect to make significant buyout payments in the future, as such buyouts reduce the

monthly payments we will have to make to our salespersons for such merchants in the future.

Chargebacks, Reject Losses and Merchant Deposits

Disputes between a cardholder and a merchant periodically arise as a result of, among other things, the cardholder s dissatisfaction with merchandise quality or merchant services. Such disputes may not be resolved in the merchant s favor. In these cases, the transaction is charged back to the merchant, which means the purchase price is refunded to the customer by the card-issuing bank and charged to the merchant. If the merchant is unable to fund

the refund, we must do so. If the Relationship Manager who installed the merchant is still employed by us, that Relationship Manager bears a portion of this loss through a reduction in our payment of residual commissions or signing bonuses to such Relationship Manager. We also bear the risk of reject losses arising from the fact that we collect our fees from our merchants on the first day after the monthly billing period. If the merchant has gone out of business during such period, we may be unable to collect such fees. We maintain cash deposits or require the pledge of a letter of credit from certain merchants, generally those with higher average transaction size where the card is not present when the charge is made or the product or service is delivered after the charge is made, in order to offset potential contingent liabilities such as chargebacks and reject losses that would arise if the merchant went out of business. The owners of the serviced portfolios bear the credit risk for their merchants. At March 31, 2005 and December 31, 2004, we held merchant deposits totaling $7.7 million, and $6.7 million, respectively. Most chargeback and reject losses are charged to processing and servicing as they are incurred. However, we also maintain a loss reserve against losses including major fraud losses, which are both less predictable and involve larger amounts. The loss reserve was established using historical loss rates, applied to recent processing volume. At March 31, 2005 and December 31, 2004, our loss reserve totaled $471,000 and $468,000, respectively. Aggregate merchant losses, including losses charged to operations and the loss reserve, were $300,000 and $940,000 for the three months ended March 31, 2005 and the year ended December 31, 2004, respectively.

Stock Options

We account for our stock options using the intrinsic value method, with no compensation expense being recognized for the stock-based compensation plan because the options are granted at an exercise price that in most cases was higher than, and in all cases was at least equal to, the estimated fair value at the grant date. As a company with no established market for our common stock, and consistent with existing accounting literature, prior to the initial filing of our registration statement with the Securities and Exchange Commission in August 2004, we assumed a volatility factor of 0%. As a result, had the compensation been determined based on the fair value method, our net income would remain unchanged. For those periods after the filing of our initial registration statement, a 50% volatility assumption was used in estimating the fair value of options. As a result of applying the 50% volatility assumption, had compensation expense been determined based on the fair value method, reported net income for the three months ended March 31, 2005 would have been reduced $1.4 million, or $0.04 per diluted share and reported net income for the year ended December 31, 2004 would have been reduced by $5.5 million, or $0.16 per diluted share. The 50% volatility assumption was determined by referencing the average volatility assumed by six of our public company peers.

Our principal approach to determining the fair value of the stock in the 2002 to 2003 period was our value as a potential acquisition candidate. Consequently, we used the portfolio purchase multiple established in our portfolio transfer to National Processing Company at year-end 1999, as adjusted for net working capital and a separate multiple of revenue for our payroll operations. This resulted in steadily increasing share values, which were all at least 15% below the $5.00 and $6.25 per share exercise price we set for virtually all options issued in the period. This valuation method generated results that were consistent with, and in fact higher than, valuations performed by valuation specialists engaged for other stock value purposes for periods ending as recently as March 2003. We have not typically employed valuation specialists to value our stock for purposes of establishing the exercise price of options, particularly since we grant options on a quarterly basis and such valuations are costly and divert our management s time and resources from our core business. In addition, our board of directors, which is comprised of several individuals with experience in valuing companies, determined that the results of a valuation specialist would not likely result in higher exercise prices than those established by our board of directors.

We believe that these judgments have been validated by certain recent transactions in our stock. In July 2003, our board of directors raised the exercise price for option grants to $6.25 per share after six months of additional growth. In December 2003 and January 2004, the first two transactions with third parties since the sale of preferred stock in 2001 occurred. In one transaction, an institutional investor purchased 90,000 shares of our common stock from certain of our executives, senior managers and consultants, at a price of $3.25 per share. In the second, BHC Interim Funding, L.P. redeemed 168,906 of our warrants pursuant to a contractual put option at their fair value, which they agreed was $6.25 per share. Recognizing our intention to go public, and the potential that the stock could have a higher value in the public marketplace, we raised that exercise price by 20% to $7.50 for options issued in April 2004. During our fiscal third quarter of 2004, this exercise price was raised again to $9.28 per share. This represented a 30% discount to the estimated value of our common stock if we could have gone public at that time, and so reflects a private company discount that is typically applied by valuation specialists to private companies. In October, our former President and Chief Operating Officer sold 129,000 shares of common stock back to us at a price of $9.28 per share. In November, our CEO sold an aggregate of 108,000 shares of common

stock to Greenhill Capital Partners, L.P., LLR Equity Partners, L.P., and their affiliated investment funds at a price of $9.28 per share. We believe that these transactions support our board of directors determination that $9.28 is the fair value of our common stock at December 31, 2004. During our fiscal first quarter of 2005, this price was raised to $9.80 per share, again reflecting a 30% private company discount to the estimated value of our common stock as indicated by the proposed underwriters of the offering.

Financing Arrangements

Pursuant to EITF 88-18, we recognize the transfer of merchant contracts as financing arrangements included under Borrowings and Financing Arrangements, until such time as the conditions for recognizing the transfer as a sale are met. The interest rates on these financing arrangements are computed based on the expected cash flows resulting from these contracts, reduced by an expected annual volume attrition rate of 15%. Any significant differences between actual future payments and expected payments will result in a change to that interest rate, which will be applied prospectively.

Income Taxes

We account for income taxes pursuant to the provisions of Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes.* Under this method, deferred tax assets and liabilities are recorded to reflect the future tax consequences attributable to the effects of differences between the carrying amounts of existing assets and liabilities for financial reporting and for income tax purposes. Judgments are required in determining the amount and probability of future taxable income, which in turn is critical to a determination of whether a valuation reserve against the deferred tax asset or liability is appropriate.

Results of Operations

Three Months Ended March 31, 2005 Compared to Three Months Ended March 31, 2004

The following table shows certain financial data as a percentage of revenue for the periods indicated (in thousands of dollars):

	Three Months Ended March 31, 2005	% of Total Net Revenue	Three Months Ended March 31, 2004	% of Total Net Revenue	Change Amount	%
Revenue:						
Gross processing revenue	$ 166,172	97.8%	$ 119,202	98.3%	$ 46,970	39.4%
Other revenue, net	3,693	2.2%	2,002	1.7%	1,691	84.5%
Total net revenue	169,865	100.0%	121,204	100.0%	48,661	40.1%
Costs of Services:						
Interchange	122,416	72.1%	86,372	71.3%	36,044	41.7%
Dues and assessments	6,415	3.8%	4,785	3.9%	1,630	34.1%
Processing and servicing	19,820	11.7%	14,748	12.2%	5,072	34.4%
Customer acquisition costs	5,841	3.4%	4,135	3.4%	1,706	41.3%
Depreciation and amortization	1,283	0.8%	876	0.7%	407	46.5%
Total costs of services	155,775	91.7%	110,916	91.5%	44,859	40.4%
Selling and administrative	8,989	5.3%	7,233	6.0%	1,756	24.3%
Total expenses	164,764	97.0%	118,149	97.5%	46,615	39.5%
Income from operations	5,101	3.0%	3,055	2.5%	2,046	67.0%
Other income (expense):						
Interest income	110	0.1%	38	0.0%	72	189.5%
Interest expense	(435)	(0.3)%	(298)	(0.2)%	(137)	(46.0)%
Fair value adjustment for warrants with mandatory redemption provisions	(90)	(0.1)%		0.0%	(90)	(100.0)%
Other, net	(3)	0.0%	833	0.7%	(836)	(100.4)%
Total other income (expense)	(418)	(0.2)%	573	0.5%	(991)	(172.9)%
Income before income taxes	4,683	2.8%	3,628	3.0%	1,055	29.1%
Provision for income taxes	1,989	1.2%	1,482	1.2%	507	34.2%
Net income	$ 2,694	1.6%	$ 2,146	1.8%	$ 548	25.5%

Revenue. Total net revenue increased 40.1% from $121.2 million for the three months ended March 31, 2004 to $169.9 million for the three months ended March 31, 2005, primarily as a result of a 39.4% increase in our gross processing revenue from $119.2 million for the three months ended March 31, 2004 to $166.2 million for the three months ended March 31, 2005. These gross processing revenue and dollar volume increases were primarily attributable to a net increase in merchant accounts, with the number of merchant accounts growing by 30.0% from 72,000 as of March 31, 2004 to 94,000 as of March 31, 2005. The increase in new merchant accounts during this period was primarily the result of the growth in our sales force, combined with improved production from our existing sales force. The sales force grew by 12.4% from 769 at March 31, 2004 to 864 at March 31, 2005. Gross processing revenue also includes payroll processing fees, which increased by 20.0% from $1.0 million for the three months ended March 31, 2004 to $1.2 million for the three months ended March 31, 2005. Total net revenue also includes other revenue, net, which increased by 84.5% from $2.0 million for the three months ended March 31, 2004 to $3.7 million for the three months ended March 31, 2005. The increase in other revenue was primarily due to increases in annual fees, and equipment related income.

Costs of services. Costs of services increased 40.4% from $110.9 million for the three months ended March 31, 2004 to $155.8 million for the three months ended March 31, 2005 due primarily to an increase in interchange fees, which resulted from higher processing volume. Cost of services represented 91.5% and 91.7% of total net revenue for the three months ended March 31, 2005 and 2004, respectively. Interchange fees represented 71.3% of total net revenue for the three months ended March 31, 2005 and 72.1% of total net revenue for the three months ended March 31, 2004. The incremental deterioration in the ratio of interchange fees to total net revenue is primarily the result of interchange increases from Visa and Master Card, which we pass through to our merchants without mark-up. Dues and assessments as a percentage of total net revenue declined from 3.9% to 3.8% for the three months ended March 31, 2005 and 2004, respectively, as the rate paid for dues and assessments did not change, but interchange increased. Processing and servicing increased by $5.1 million, or 34.4%, and as a percentage of total net revenue declined from 12.2% for the three months ended March 31, 2004 to 11.7% for the three months ended March 31, 2005. The increase in processing and servicing was due primarily to costs associated with increased volume, the addition of 56 sales, risk and underwriting support personnel in the service center, and a $1.8 million increase in residual commission payments to our Relationship Managers and sales management related to their portion of the growth in our gross margin. Since our sales organization is 100% commission-based, increases in processing income directly impact commissions in cost of services. Processing and servicing as a percentage of total net revenue decreased primarily due to improved merchant pricing, leveraging the lower costs of our internally developed front-end processing system, HPS Exchange, and growth in our services center staff that was slower than our revenue growth. Over 58% of new merchants during the three months ended March 31, 2005 were installed on HPS Exchange, and we have completed some conversions from other front-end processors, so that HPS Exchange represented approximately 41% of our total volume for the three months ended March 31, 2005, up significantly from 29% for the three months ended March 31, 2004. We expect the increasing share of HPS Exchange in our total merchant base to continue in the future. Included in processing and servicing was $387,000 of payroll processing costs for the three months ended March 31, 2005, which increased 9.5% from $353,000 for the three months ended March 31, 2004.

Customer acquisition costs increased 41.3% from $4.1 million for the three months ended March 31, 2004 to $5.8 million for the three months ended March 31, 2005. The amortization of signing bonuses increased from $2.6 million for the three months ended March 31, 2004 to $3.7 million for the three months ended March 31, 2005, while the accrued buyout cost amortization grew from $1.6 million for the three months ended March 31, 2004 to $2.3 million for the three months ended March 31, 2005. Increases in new account generation activity, reflected by the increase in signing bonus

payments from $4.2 million for the three months ended March 31, 2004 to $4.6 million for the three months ended March 31, 2005, were responsible for increases in the amortization of both the accrued buyout costs and signing bonuses.

Depreciation and amortization expenses increased 46.5% from $0.9 million for the three months ended March 31, 2004 to $1.3 million for the three months ended March 31, 2005. The increase was primarily due to the purchase of information technology equipment to support the network and the development of HPS Exchange. Additionally, we capitalized salaries and fringe benefits and other expenses incurred by employees that worked on

internally developed software projects. Amortization does not begin on the internally developed software until the project is complete and placed in service, at which time we begin to amortize the asset over three years. The capitalized amounts increased from $224,000 for the three months ended March 31, 2004 to $434,000 for the three months ended March 31, 2005. The total amount of capitalized projects placed in service for the three months ended March 31, 2004 and 2005 was $0 and $62,000, respectively.

Selling and administrative. Selling and administrative expenses increased 24.3% from $7.2 million for the three months ended March 31, 2004 to $9.0 million for the three months ended March 31, 2005. The increase was primarily due to added costs necessary to continue building our corporate and marketing infrastructure to meet our sales initiatives. Selling and administrative expenses as a percentage of total net revenue declined from 6.0% for the three months ended March 31, 2004 to 5.3% for the three months ended March 31, 2005, as revenue growth outpaced the increase in expenses. The payroll operation s selling and administrative expenses increased by increased 0.2% from $454 ,000 for the three months ended March 31, 2004 to $456,000 for the three months ended March 31, 2005.

Income from operations. For the reasons described above, income from operations improved from $3.1 million for the three months ended March 31, 2004 to $5.1 million for the three months ended March 31, 2005

Interest income. Interest income increased from $38,000 to $110,000 in the three months ended March 31, 2004 and 2005, respectively, due primarily to increased interest rates.

Interest expense. Interest expense increased from $0.3 million for the three months ended March 31, 2004 to $0.4 million for the three months ended March 31, 2005. Most of our interest expense arises from the fact that our sponsor bank advances interchange fees to most of our merchants, and we pay the sponsor bank prime rate on those balances. Those balances were higher for the three months ended March 31, 2005 due to increased processing volume. This was partially offset by a decrease in interest expense resulting from repayments of the principal of the financing arrangements as the outstanding balance declined from $12.2 million as of March 31, 2004 to $9.7 million as of March 31, 2005.

Fair value adjustment for warrants with mandatory redemption provisions. We recognized expense of $0.1 million during the three months ended March 31, 2005 to adjust the warrants value to $9.80 per share, the estimated fair value. For the three months ended March 31, 2004, we did not adjust the warrant s value because there was no change in the estimated fair value of our common stock.

Other, net. Other, net decreased from $0.8 million of income for the three months ended March 31, 2004 to $3,000 of expense for the three months ended March 31, 2005. This decrease was attributable to a payment we received in connection with a legal settlement in the first quarter of 2004.

Income Tax. Income taxes for the three months ended March 31, 2005 were $2.0 million using an effective tax rate of 42.5%. This represented an increase from the 40.8 % effective rate for the third quarter of 2004 which resulted in taxes of $1.5 million.

Net income. As a result of the above factors, net income increased from $2.1 million for the three months ended March 31, 2004 to $2.7 million for the three months ended March 31, 2005.

Balance Sheet Information

Balance Sheet Data	March 31 2005	December 31, 2004
	(in thousands, except per share)	
Cash and cash equivalents	$ 12,706	$ 13,237
Receivables	64,664	64,325
Capitalized customer acquisition costs, net	35,586	34,247
Property and equipment, net	11,827	10,944
Total assets	136,392	133,926
Due to sponsor bank	45,465	45,153
Accounts payable	26,891	27,103
Total liabilities	127,562	127,827
Total stockholders equity	8,830	6,099

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March 31, 2005 Compared to December 31, 2004

Total assets increased $2.5 million, or 1.8%, to $136.4 million at March 31, 2005 from $133.9 million at December 31, 2004 primarily due to increases in capitalized customer acquisition costs, property and equipment, net, and prepaid expenses. Decreases in cash and inventory partially offset these increases.

Cash and cash equivalents decreased $0.5 million, to $12.7 million at March 31, 2005 from $13.2 million at December 31, 2004 primarily due to cash applied in operating activities, including customer acquisition costs which increased $1.3 million, or 3.9%, and cash applied in investing activities related to continued building of our technology infrastructure, primarily for hardware and software needed for the expansion of HPS Exchange and our own back-end processing system. Prepaid expenses increased $0.8 million, or 39.0%, due to a prepayment of income taxes.

Liquidity and Capital Resources

General. Liquidity and capital resource management is a process focused on providing the funding to meet our short and long-term cash and working capital needs. We have used our funding sources to build our merchant portfolio and our servicing technology platforms with the expectation that these investments will generate cash flows sufficient to cover our working capital needs and other anticipated needs for capital.

Our cash requirements include funding payments to Relationship Managers and sales managers for signing bonuses, residual commissions and accrued residual buyouts, paying interest expense and other operating expenses, including taxes. At times, we have used cash to repurchase our common stock and could in the future use cash for unspecified acquisitions of related businesses or assets (although no acquisitions are currently contemplated).

Cash flow from our operating activities and our lines of credit fund our cash needs. We believe that our current cash and investment balances, cash generated from operations and existing lines of credit will provide sufficient liquidity to meet our anticipated needs for capital for at least the next twelve months. While our working capital, defined as current assets less current liabilities, was negative at March 31, 2005 and December 31, 2004, we historically have generated sufficient cash flow from our operating activities and we expect to continue to do so. Each funding source is described in more detail below.

Cash Flow from Operating Activities. At March 31, 2005, we had cash and cash equivalents totaling $12.7 million and at December 31, 2004, we had cash and cash equivalents totaling $13.2 million. Net cash provided by operating activities was $2.3 million for the three months ended March 31, 2005, compared to $5.2 million for the three months ended March 31, 2004. Key sources of operating cash flows in all periods were net income as adjusted for changes in deferred taxes, plus depreciation and amortization. Contained within changes in operating assets and liabilities are the increase in receivables, which is essentially offset by changes in due to sponsor bank and accounts payable. This is because the largest receivable is from our merchants, the majority of which is associated with the interchange that we cause our sponsor bank, Key Bank, to advance to our merchants, while the largest payable is to Key Bank for the interchange. These amounts tend to rise and fall together, depending on our processing activity in the final month of the reporting period. The other major determinants of operating cash flow are increases in capitalized customer acquisition costs, which consume increasing amounts of operating cash as our new merchant installation activity rises, and payouts on the accrued buyout liability, which represent the costs of buying out residual commissions owned by our Relationship Managers and sales managers. Included in the amount of cash consumed by increases in capitalized customer acquisition costs are signing bonus payments of $4.6 million and $4.2 million, respectively, in the first quarters of 2005 and 2004. In the first quarter of 2005 and 2004, we reduced the accrued buyout liability by making buyout payments of $3.3 million and $0.7 million, respectively.

Cash Flow from Investing Activities. Net cash used in investing activities was $2.4 million for the three months ended March 31, 2005, compared to $1.1 million for the three months ended March 31, 2004. During each period, most of the cash used in investing activities was used to fund capital expenditures. Total capital expenditures for the three months ended March 31, 2005 were $2.1 million, an increase of $1.0

million from the $1.1 million invested in the three months ended March 31, 2004. These expenditures were primarily related to continued building of our technology infrastructure, primarily for hardware and software needed for the expansion of HPS Exchange and our own back-end processing system. We anticipate that these expenditures may increase as we further develop our technology. In addition, we have invested a portion of the cash balances held at our subsidiary, Heartland Payroll Company, in securities that are classified on our balance sheet as investments. We invest in federal, federal agency and corporate debt obligations with maturities of up to four years and no less than a single-A rating.

Cash Flow from Financing Activities. Net cash used in financing activities was $0.5 million for the three months ended March 31, 2005, compared to $2.0 million for the three months ended March 31, 2004. During the three months ended March 31, 2005 and 2004, we paid down financing arrangements and borrowings in the amounts of $0.5 million and $0.9 million, respectively, including in January 2004 we made the final payment of $250,000 on a note issued in a 2002 acquisition. On January 8, 2004, a warrant holder elected to exercise their put, and we redeemed half of the holder s warrants, or 168,906 shares, at the deemed fair value of $6.25 per share. The exercise price of the warrants was $.005 per warrant and net consideration paid by us was $1.1 million. The remaining warrants to purchase 168,904 shares of our common stock expire on July 25, 2006, and the holder can exercise their fair value put at any time.

Credit Facilities. On August 28, 2002, we signed a loan and security agreement with KeyBank National Association for two loan instruments, which was amended on November 6, 2003, June 23, 2004, and May 26, 2005. The agreement was amended twice to reflect changes we have made in our accounting policies. The loan and security agreement contains covenants requiring an operating cash flow to total fixed charges ratio of not less than 1.2 to 1, and a measure of total funded debt to EBITDA of less than 2 to 1. The first instrument is a revolver advance facility, which is to be used solely to fund the buyouts of future residual commissions from former Relationship Managers or Independent Sales Organizations. We may draw down on the revolver up to an aggregate unpaid principal amount of $3.5 million. As of March 31, 2005, $2.1 million was outstanding under the revolver. The entire principal balance plus all accrued interest and fees are due on May 31, 2005 (subsequently extended to August 31, 2005) or on demand if we are in default. The second instrument is a purpose and ability line of credit totaling $3.0 million, which is payable on demand. As of March 31 2005, we had $784,000 of outstanding indebtedness under this line of credit. Borrowings under the two lines of credit bear interest at the prime rate, which was 5.75% at March 31, 2005 and are secured by a lien on our assets. They contain customary covenants, including the provision of financial reports, maintenance of insurance, payment of taxes and provision of notice of any default, and events of default, including failure to pay principal or interest, cross-default, and insolvency covenants. We are currently in compliance with all covenants, and have been since the instruments were established.

On May 26, 2005, we entered into an amendment to our loan and security agreement with KeyBank National Association, which extended the scheduled maturity date from May 31, 2005 to August 31, 2005. We are in the process of reassessing its credit facilities.

Contractual Obligations. The Visa and MasterCard associations generally allow chargebacks up to four months after the later of the date the transaction is processed or the delivery of the product or service to the cardholder. As the majority of our transactions involve the delivery of the product or service at the time of the transaction, a good estimate of our exposure to chargebacks is the last four months processing volume on our portfolio, which was $9.4 billion and $9.0 billion for the four months ended March 31, 2005 and December 31, 2004, respectively. However, for the four months ended March 31, 2005 and December 31, 2004, we were presented with $5.5 million and $5.6 million, respectively, of chargebacks by issuing banks. In the three months ended March 31, 2005 and the year ended December 31, 2004, we incurred merchant credit losses of $300,000 and $940,000, respectively, on total dollar volume processed of $6.9 billion and $25.0 billion, respectively. These credit losses are included in cost of services in our consolidated statements of operations.

The following table reflects our significant contractual obligations as of March 31, 2005:

Contractual Obligations	Total	Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years
	Payments Due by Period (in thousands)				
Processing providers	$ 10,896	$ 7,089	$ 2,727	$ 1,080	$
Financing arrangement (expected payments, including interest)	10,265	2,598	4,123	2,837	707
Telecommunications providers	5,783	2,610	3,173		
Office and equipment leases	6,647	1,315	2,885	1,497	950
Revolver advance	2,069	2,069			
Line of credit	784	784			
	$ 36,444	$ 16,465	$ 12,908	$ 5,414	$ 1,657

In addition, we record a payable to KeyBank each month in conjunction with our monthly processing activities. This amount was $45.5 million as of March 31, 2005. This amount is repaid on the first business day of the following month out of the fees collected from our merchants.

Legal and Regulatory Considerations

In the ordinary course of our business, we are party to various legal actions, which we believe are incidental to the operation of our business. We believe that the outcome of the proceedings to which we are currently a party will not have a material adverse effect on our financial position, results of operations or cash flows.

Quantitative and Qualitative Disclosures About Market Risk

Our primary market risk exposure is to changes in interest rates. During each month, KeyBank advances interchange fees to most of our merchants so that during the month we build up a significant payable to KeyBank, bearing interest at the prime rate. At March 31, 2005, our payable to KeyBank was approximately $45.5 million. This advance is repaid on the first business day of the following month out of fee collections from our merchants. During the quarter ended March 31, 2005 the average daily balance of that loan was approximately $21.6 million and was directly related to our processing volume. We also had outstanding $2.9 million in other loans at March 31, 2005, which also bear interest at the prime rate. A hypothetical 100 basis point change in short-term interest rates would result in a change of approximately $245,000 in annual pre-tax income.

While the bulk of our cash and cash-equivalents are held in checking accounts or money market funds, we do hold certain fixed-income investments with maturities of up to three years. At March 31, 2005, a hypothetical 100 basis point increase in short-term interest rates would result in an increase of approximately $12,000 in annual pre-tax income from money market fund holdings, but a decrease in the value of fixed-rate investments of approximately $18,000. A hypothetical 100 basis point decrease in short-term interest rates would result in a decrease of approximately $12,000 in annual pre-tax income from money market funds, but an increase in the value of fixed-rate instruments of approximately $18,000.

We do not hold or engage in the trading of derivative financial, commodity or foreign exchange instruments. All of our business is conducted in U.S. dollars.

Office Facilities

Our principal executive offices are located in approximately 5,000 square feet of leased office space on Hulfish Street in Princeton, New Jersey. This lease expires on September 30, 2007. We also lease approximately 10,000 square feet of office space in Cleveland, Ohio under a lease that expires on June 30, 2009, 5,000 square feet in Scottsdale, Arizona under a lease that expires on October 31, 2006, 50,000 square feet in Jeffersonville, Indiana under a lease that expires on April 30, 2009, and 10,000 square feet in Frisco, Texas under a lease that expires on October 31, 2008. In September 2004, we leased approximately 9,300 square feet of office space on Nassau Street in Princeton under a lease that expires in 2013. We believe that these facilities are adequate for our current operations and, if necessary, can be replaced with little disruption to our company. Each of these leases, other than the original Princeton lease (Hulfish Street) and the Frisco lease, is renewable.

Recent Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29. SFAS No. 153 addresses the measurement of exchanges of nonmonetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. We do not believe adoption of Statement 153 will have a material effect on our consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123 revised). This statement revises SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. The most significant change resulting from this statement is the requirement for public companies to expense employee share-based payments under fair value as originally introduced in SFAS No. 123.

SFAS No. 123 revised is effective, as amended on April 21, 2005 by the Securities and Exchange Commission, beginning with the first interim or annual reporting period of the registrant s first fiscal year beginning on or after June 15, 2005. We will adopt this statement when effective, and continue to assess its impact.

In July 2005, the FASB issued an exposure draft of a proposed Interpretation*, Accounting for Uncertain Tax Positions an interpretation of FASB Statement No. 109.* This proposed Interpretation would clarify the accounting for uncertain tax positions in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* An enterprise would be required to recognize, in its financial statements, the best estimate of the impact of a tax position, if that tax position is probable of being sustained if audited by a tax authority based solely on the technical merits of the position. Individual tax positions that fail to meet the Interpretation s recognition threshold would result in either (a) a reduction in the deferred tax asset or an increase in a deferred tax liability or (b) an increase in a liability for income taxes payable or the reduction of an income tax refund receivable. The proposed Interpretation would be effective as of the end of the first annual period ending on or after December 15, 2005. We do not believe the adoption of this proposed Interpretation will have a material effect on our consolidated financial position, results of operations or cash flows.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

See Management s Discussion and Analysis of Financial Condition and Results of Operations Quantitative and Qualitative Disclosures About Market Risk.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of the Company s management, including its Chief Executive Officer (CEO) and Chief Financial Officer (CFO), the Company evaluated the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)). Based upon that evaluation, the CEO and CFO concluded that, as of the end of the period covered by this report, the Company s disclosure controls and procedures have been designed and are being operated in a manner that provides reasonable assurance that the information required to be disclosed by the Company in reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms.

Any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system will be met. In addition, the design of any control system is based, in part, upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there is only reasonable assurance that the Company s controls will succeed in achieving their goals under all potential future conditions.

Changes in Internal Controls

During the period covered by this report, there has been no change in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In the normal course of our business, we are involved in lawsuits, claims, audits and investigations, including any arising out of services or products provided by or to our operations, personal injury claims and employment disputes, the outcome of which, in the opinion of management, will not have a material adverse effect on our financial position, cash flows or results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following is a summary of our sales of our securities during the past five years involving sales of our securities that were not registered under the Securities Act of 1933, as amended:

On September 30, 2000, we entered into an agreement and plan of merger with Triad, L.L.C., a New Jersey limited liability company, pursuant to which Triad was merged into us upon the filing of certificates of merger with the states of Delaware and New Jersey on October 3, 2000 and October 2, 2000, respectively. Each outstanding membership interest of Triad was converted into 2,000 shares of our common stock. Carr Holdings, L.L.C., a New Jersey limited liability company owned and managed by Robert O. Carr, our Chairman and Chief Executive Officer, and Jill Carr, Mr. Carr s wife, held 5,200 membership interests of Triad which were converted into 10,400,000 shares of our common stock upon the effectiveness of the merger of Triad into us. These 10,400,000 shares include the 508,000 shares of common stock sold to Greenhill Capital Partners, L.P. and its affiliated investment funds and LLR Equity Partners, L.P. and its affiliated investment fund in March 2003, November 2004 and May 2005. The issuance of common stock in connection with the Triad merger was exempt from registration pursuant to Section 4(2) of the Securities Act. The following individuals and entity also received the amount of our common stock set forth next to their name in exchange for their Triad membership interests in the merger:

Name	**Number of Shares of Common Stock Received in Merger**
Donnie E. Lassiter	2,000,000
Alan M. Atkins	1,000,000
Barry E. Welsch	300,000
Rayanne E. Welsch	300,000
B. Terrell Limited Partnership	150,000
Donald L. Nighswonger and Susan K. Nighswonger	75,000
Wes Williams	50,000
Jeff Nichols and Corrie Nichols, Jointly	50,000
Sanford Brown	50,000
Denise A. Miller	25,000
Joan M. Herman	25,000

On July 26, 2001, we issued a warrant to BHC Interim Funding, L.P. for 337,810 shares of our common stock at an exercise price of $0.005 per share as consideration for a loan made to us of $4,760,000. The issuance of the warrant was exempt from registration pursuant to Section 4(2) of the Securities Act.

On October 11, 2001, we sold 7,619,048 shares of Series A Convertible Participating Preferred Stock, par value $0.01, and six warrants for 1,000,000 shares of our common stock at an exercise price of $5.25 per share to the following investors for an aggregate purchase price of $40,000,002:

Investor	Number of Series A Preferred Shares Purchased	Purchase Price	Number of Shares of Common Stock Purchasable Upon Exercise of Warrants	Purchase Price for Warrants	Aggregate Purchase Price
Greenhill Capital Partners, L.P.	2,915,472	$ 14,732,245	382,656	$ 573,983	$ 15,306,228
Greenhill Capital Partners (Cayman), L.P.	486,683	$ 2,459,270	63,877	$ 95,816	$ 2,555,086
Greenhill Capital Partners (Executives), L.P.	470,800	$ 2,379,012	61,792	$ 92,688	$ 2,471,700
Greenhill Capital, L.P.	888,950	$ 4,491,975	116,675	$ 175,013	$ 4,666,988
LLR Equity Partners, L.P.	2,593,900	$ 13,107,301	340,449	$ 510,674	$ 13,617,975
LLR Equity Partners Parallel, L.P.	263,243	$ 1,330,199	34,551	$ 51,826	$ 1,382,025
Total	7,619,048	$ 38,500,002	1,000,000	$ 1,500,000	$ 40,000,002

The issuance of the Series A Senior Convertible Participating Preferred Stock was exempt from registration pursuant to Section 4(2) of the Securities Act. On September 28, 2004, we redeemed all the six warrants by paying the holders net consideration of $5.25 million.

On March 31, 2002, we issued 263,744 shares of our common stock to Welsch Financial Merchant Services, Inc. and, in April 2003, we issued Welsch an additional 266,666 shares of our common stock valued at $3.745 per share. The issuance of the common stock to Welsch was exempt from registration pursuant to Section 4(2) of the Securities Act.

On December 19, 2003, we sold 90,000 shares of our common stock at $6.25 per shares to the California Restaurant Association, a California non-profit corporation. The shares issued by us to the California Restaurant Association were redeemed by us from other stockholders. Such issuance was exempt from registration pursuant to Section 4(2) of the Securities Act.

As of March 31, 2005, we have granted stock options to purchase 9,261,002 shares of our common stock, with exercise prices ranging from $3.00 to $9.80 per share, to current and former officers, directors and employees. The option grants were exempt from registration pursuant to Rule 701 promulgated under the Securities Act.

With respect to each transaction listed above, no general solicitation was made by either the Registrant or any person acting on its behalf; the securities sold are subject to transfer restrictions, and the certificates for the shares contained an appropriate legend stating such securities have not been registered under the Securities Act and may not be offered or sold absent registration or pursuant to an exemption therefrom. No underwriters were involved in connection with the sales of securities referred to in this Item 2.

Item 3. Defaults Upon Senior Securities

Not applicable.

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

Not applicable.

Item 5. Other Information

None

Item 6. Exhibits

Exhibit Number		Description
3.1(a)		Amended and Restated Certificate of Incorporation of Heartland Payment Systems, Inc.
3.1(b)		Certificate of Amendment to Certificate of Designations, Preferences and Rights of Series A Senior Convertible Participating Preferred Stock (Incorporated by reference to Exhibit 3.1 to the Registrant s Registration Statement on Form S-1, File No. 333-118073)
3.1(c)		Certificate of Amendment to Certificate of Designations, Preferences and Rights of Series A Senior Convertible Participating Preferred Stock (Incorporated by reference to Exhibit 3.2 to the Registrant s Registration Statement on Form S-1, File No. 333-118073)
3.2		Amended and Restated By-Laws of Heartland Payment Systems, Inc.
31.1		Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2		Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1		Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2		Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Reports on Form 8-K none

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: July 28, 2005

HEARTLAND PAYMENT SYSTEMS, INC.
(Registrant)

By: /s/ Robert O. Carr
Robert O. Carr
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Robert H.B. Baldwin, Jr.
Robert H.B. Baldwin, Jr.
Chief Financial Officer
(Principal Financial Officer)

EXHIBIT INDEX

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nbsp;of the Securities Exchange Act of 1934, as amended.

(2) The term Family of Investment Companies includes two or more, registered funds that share the same investment adviser or principal underwriter and hold themselves out to investors as related companies for purposes of investment and investor services. Currently the registered funds that comprise the Fund Complex are identical to those that comprise the Family of Investment Companies.

Set forth in the table below is the amount of interests beneficially owned by each Independent Director, nominee for election as an Independent Director or his or her family member, as applicable, in a person that may be deemed to be controlled by Mario J. Gabelli and/or affiliates and in that event would be deemed to be under common control with the Fund s Adviser.

Name of Independent Director/Nominee	Name of Owner and Relationships to Director/Nominee	Company	Title of Class	Value of Interests	Percent of Class[3]
Anthony J. Colavita	Same	The LGL Group, Inc.	Common Stock	$ 7,004[1]	*
Frank J. Fahrenkopf, Jr.	Same	Gabelli Associates Limited II E	Membership Interests	$ 1,049,959[2]	2.1%
Kuni Nakamura	Same	The LGL Group, Inc.	Common Stock	$ 9,114[1]	*
Anthony R. Pustorino	Same	The LGL Group, Inc.	Common Stock	$ 46,633[1]	*

Werner J. Roeder	Same	Gabelli Associates Fund II	Membership Interests	$ 498,926[2]	*
Salvatore J. Zizza	Same	Gabelli Associates Fund	Membership Interests	$ 2,642,128[2]	1.3%

(1) This information has been furnished as of December 31, 2012.
(2) This information has been furnished as of March 31, 2013.
(3) An asterisk indicates that the ownership amount constitutes less than 1% of the total interests outstanding.

Remuneration of Directors and Officers

The Fund pays each Independent Director an annual retainer of $6,000 plus $500 for each Board meeting attended and each Independent Director is reimbursed by the Fund for any out-of-pocket expenses incurred in attending meetings. All Board committee members receive $1,000 per meeting attended, the Audit Committee Chairman receives an annual fee of $3,000, the Nominating Committee Chairman, and the lead Independent Director each receive an annual fee of $2,000. A Director may receive a single meeting fee, allocated among the participating funds, for participation in certain meetings on behalf of multiple funds. The aggregate remuneration (excluding out-of-pocket expenses) paid by the Fund to such Directors during the fiscal year ended December 31, 2012 amounted to $76,390. During the fiscal year ended December 31, 2012, the Directors of the Fund met four times, all of which were regular quarterly Board meetings. Each Director then serving in such capacity attended at least 75% of the meetings of Directors and of any Committee of which he is a member.

Directors who are directors or employees of the Adviser or an affiliated company receive no compensation or expense reimbursement from the Fund.

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The following table sets forth certain information regarding the compensation of the Directors by the Fund and executive officers, if any, who were compensated by the Fund rather than the Investment Adviser, for the fiscal year ended December 31, 2012.

Compensation Table for the Fiscal Year Ended December 31, 2012

Name of Person and Position	Aggregate Compensation From the Fund	Aggregate Compensation From the Fund and Fund Complex Paid to Directors*
Interested Directors:		
Mario J. Gabelli Director and Chief Investment Officer	$ 0	$ 0
Independent Directors:		
Anthony J. Colavita Director	$ 11,521	$ 402,500(34)
James P. Conn Director	$ 10,038	$ 224,500(18)
Frank J. Fahrenkopf, Jr. Director	$ 7,500	$ 105,500(6)
Kuni Nakamura Director	$ 3,250	$ 129,625(12)
Anthony R. Pustorino Director	$ 13,045	$ 207,000(13)
Werner J. Roeder, MD Director	$ 11,536	$ 185,500(22)
Salvatore J. Zizza Director	$ 11,500	$ 328,500(28)

* Represents the total compensation paid to such persons during the year ended December 31, 2012 by investment companies (including the Fund) or portfolios that are considered part of the same fund complex as the Fund because they have common or affiliated investment advisers.

Investment Management

The Investment Adviser is a New York limited liability company which serves as an investment adviser to sixteen open-end and ten closed-end registered management investment companies and a Luxembourg SICAV with combined aggregate net assets in excess of $20.5 billion as of December 31, 2012. The Investment Adviser is a registered investment adviser under the Investment Advisers Act of 1940, as amended. Mr. Mario J. Gabelli may be deemed a controlling person of the Investment Adviser on the basis of his controlling interest in GBL, the parent company of the Investment Adviser. The Investment Adviser has several affiliates that provide investment advisory services: GAMCO, a wholly owned subsidiary of GBL, acts as investment adviser for individuals, pension trusts, profit-sharing trusts and endowments, and as sub-adviser to certain third party investment funds, which include registered investment companies, and had assets under management of approximately of $15.0 billion as of December 31, 2012. Teton Advisors, Inc., an affiliate of the Investment Adviser with assets under management of approximately $1.3 billion as of December 31, 2012, acts as investment adviser to The TETON Westwood Funds and separately managed accounts; Gabelli Securities, Inc., a majority owned subsidiary of GBL, acts as investment adviser to certain alternative investment products, consisting primarily of risk arbitrage and merchant banking limited partnerships and offshore companies, with assets

under management of approximately $920 million as of December 31, 2012; and Gabelli Fixed Income LLC, an indirect wholly owned subsidiary of GBL, acts as investment adviser for separate accounts having assets under management of approximately $60 million as of December 31, 2012. Teton Advisors, Inc. was spun off by GBL in March 2009 and is an affiliate of GBL by virtue of Mr. Gabelli s ownership of GGCP, Inc., the principal shareholder of Teton Advisors, Inc. as of December 31, 2012.

The Investment Adviser will provide a continuous investment program for the portfolios of the Fund and oversee the administration of all aspects of the Fund s business and affairs. The Investment Adviser has sole investment discretion for the assets of the Fund under the supervision of the Fund s Board and in accordance with the Fund s stated policies. The Investment Adviser will select investments for the Fund and will place purchase and sale orders on behalf of the Fund.

Investment Advisory Agreement

Affiliates of the Investment Adviser may, in the ordinary course of their business, acquire for their own account or for the accounts of their advisory clients, significant (and possibly controlling) positions in the securities of companies that may also be suitable for investment by the Fund. The securities in which the Fund might invest may thereby be limited to some extent. For instance, many companies in the past several years have adopted so-called poison pill or other defensive measures designed to discourage or prevent the completion of non-negotiated offers for control of the company. Such defensive measures may have the effect of limiting the shares of the company that might otherwise be acquired by the Fund if the affiliates of the Investment Adviser or their advisory accounts have or acquire a significant position in the same securities. However, the Investment Adviser does not believe that the investment activities of its affiliates will have a material adverse effect upon each the Fund in seeking to achieve its investment objectives. Securities purchased or sold pursuant to contemporaneous orders entered on behalf of the investment company accounts of the Investment Adviser or the advisory accounts managed by its affiliates for their unaffiliated clients are allocated pursuant to principles believed to be fair and not disadvantageous to any such accounts. In addition, all such orders are accorded priority of execution over orders entered on behalf of accounts in which the Investment Adviser or its affiliates have a substantial pecuniary interest. The Investment Adviser may on occasion give advice or take action with respect to other clients that differs from the actions taken with respect to the Fund. The Fund may invest in the securities of companies that are investment management clients of GAMCO Asset Management Inc. In addition, portfolio companies or their officers or directors may be minority shareholders of the Investment Adviser or its affiliates.

Under the terms of the Advisory Agreement, the Investment Adviser manages the portfolio of the Fund in accordance with its stated investment objectives and policies, makes investment decisions for the Fund, places orders to purchase and sell securities on behalf of the Fund and manages its other business and affairs, all subject to the supervision and direction of the Fund s Board. In addition, under the Advisory Agreement, the Investment Adviser oversees the administration of all aspects of the Fund s business and affairs and provides, or arranges for others to provide, at the Investment Adviser s expense, certain enumerated services, including maintaining the Fund s books and records, preparing reports to the Fund s shareholders and supervising the calculation of the net asset value of its shares. All expenses of computing the net asset value of the Fund, including any equipment or services obtained solely for the purpose of pricing shares or valuing its investment portfolio, will be an expense of the Fund under its Advisory Agreement unless the Investment Adviser voluntarily assumes responsibility for such expense. During fiscal year 2012, the Fund paid or accrued $45,000 to the Investment Adviser in connection with the cost of computing the Fund s net asset value.

The Advisory Agreement combines investment advisory and administrative responsibilities in one agreement. For services rendered by the Investment Adviser on behalf of the Fund under the Advisory Agreement, the Fund pays the Investment Adviser a fee computed weekly and paid monthly, equal on an annual basis to 1.00% of the Fund s average weekly net assets including the liquidation value of preferred stock. The fee paid by the Fund may be higher when leverage in the form of preferred stock is utilized, giving the Investment Adviser an incentive to utilize such leverage. However, the Investment Adviser has agreed to reduce the management fee on the incremental assets attributable to the preferred stock during the fiscal year if the total return of the net asset value of the common stock of the Fund, including distributions and advisory fees subject to reduction for that year, does not exceed the stated dividend rate or corresponding swap rate of each particular series of preferred stock for the period. In other words, if the effective cost of the leverage for any series of preferred stock exceeds the total return (based on net asset value) on the Fund s common stock, the Investment Adviser will reduce that portion of its management fee on

the incremental assets attributable to the leverage for that series of preferred stock to mitigate the negative impact of the leverage on the common shareholder s total return. The Investment Adviser currently intends that the voluntary advisory fee waiver will remain in effect for as long as the 6.00% Series B Cumulative Preferred Stock and Series C Auction Rate Cumulative Preferred Stock are outstanding. This fee waiver will not apply to any preferred stock issued from this offering. The Investment Adviser, however, reserves the right to modify or terminate the voluntary advisory fee waiver at any time. The Fund s total return on the net asset value of the common stock is monitored on a monthly basis to assess whether the total return on the net asset value of the common stock exceeds the stated dividend rate or corresponding swap rate of each particular series of preferred stock for the period. The test to confirm the accrual of the management fee on the assets attributable to each particular series of preferred stock is annual. The Fund will accrue for the management fee on these assets during the fiscal year if it appears probable that the Fund will incur the management fee on those additional assets.

The Advisory Agreement provides that in the absence of willful misfeasance, bad faith, gross negligence, or reckless disregard for its obligations and duties thereunder, the Investment Adviser is not liable for any error or judgment or mistake of law or for any loss suffered by the Fund. As part of the Advisory Agreement, the Fund has agreed that the name Gabelli is the Investment Adviser s property, and that in the event the Investment Adviser ceases to act as an investment adviser to the Fund, the Fund will change its name to one not including Gabelli.

Pursuant to its terms, the Advisory Agreement will remain in effect with respect to the Fund until the second anniversary of shareholder approval of such Agreement, and from year to year thereafter if approved annually (i) by the Fund s Board or by the holders of a majority of its outstanding voting securities and (ii) by a majority of the directors who are not interested persons (as defined in the 1940 Act) of any party to the Advisory Agreement, by vote cast in person at a meeting called for the purpose of voting on such approval. The Advisory Agreement was initially approved by the Board at a meeting held on April 6, 1994, and was approved most recently by the Board on May 16, 2012. The Advisory Agreement terminates automatically on its assignment and may be terminated without penalty on sixty days written notice at the option of either party thereto or by a vote of a majority (as defined in the 1940 Act) of the Fund s outstanding shares.

A discussion regarding the basis of the Board s approval of the Advisory Agreement for the Fund is available in the semiannual report to shareholders for the six months ended June 30, 2012.

For each of the fiscal years ended December 31, 2012, 2011, and 2010, the Fund paid for advisory and administrative services rendered to the Fund, and the Investment Adviser waived fees and/or reimbursed expenses of the Fund under the Advisory Agreement as follows:

	Fees Paid (After Waivers)	Reductions	Reimbursements
December 31, 2012	$ 1,764,236	None	None
December 31, 2011	$ 1,406,795	None	None
December 31, 2010	$ 1,470,029	None	None

Portfolio Managers Information

Other Accounts Managed

The information below lists other accounts for which each portfolio manager was primarily responsible for the day-to-day management during the year ended December 31, 2012, for Messrs. Gabelli, Haverty and Marangi.

Name of Portfolio Managers	Type of Accounts	Total # of Accounts Managed	Total Assets	# of Accounts Managed with Advisory Fee Based on Performance	Total Assets With Advisory Fee Based on Performance
Mario J. Gabelli	Registered Investment Companies:	26	$ 19.0B	7	$ 4.3B
	Other Pooled Investment Vehicles:	15	$ 542.5M	13	$ 534.6M
	Other Accounts:	1,869	$ 14.7B	19	$ 1.6B
Lawrence J. Haverty, Jr.	Registered Investment Companies:	0	$ 0	0	$ 0
	Other Pooled Investment Vehicles:	0	$ 0	0	$ 0
	Other Accounts:	7	$ 6.0M	0	$ 0
Christopher J. Marangi	Registered Investment Companies:	5	$ 5.6B	1	$ 1.9B
	Other Pooled Investment Vehicles:	0	$ 0	0	$ 0
	Other Accounts:	187	$ 538.6M	2	$ 73.1M

Potential Conflicts of Interest

Actual or apparent conflicts of interest may arise when the portfolio managers also have day-to-day management responsibilities with respect to one or more other accounts. These potential conflicts include:

Allocation of Limited Time and Attention. Because the portfolio managers may manage more than one account, they may not be able to formulate as complete a strategy or identify equally attractive investment opportunities for each of those accounts as if they were to devote substantially more attention to the management of only one account.

Allocation of Limited Investment Opportunities. If the portfolio managers identify an investment opportunity that may be suitable for multiple accounts, the Fund may not be able to take full advantage of that opportunity because the opportunity may need to be allocated among these accounts or other accounts managed primarily by other portfolio managers of the Investment Adviser and its affiliates.

Pursuit of Differing Strategies. At times, the portfolio managers may determine that an investment opportunity may be appropriate for only some of the accounts for which they exercise investment responsibility, or may decide that certain of these accounts should take differing positions with respect to a particular security. In these cases, the portfolio managers may execute differing or opposite transactions for one or more accounts which may affect the market price of the security or the execution of the transactions, or both, to the detriment of one or more other accounts.

Selection of Broker/Dealers. A portfolio manager may be able to select or influence the selection of the brokers and dealers that are used to execute securities transactions for the Fund or accounts that they supervise. In addition to providing execution of trades, some brokers and dealers provide portfolio managers with brokerage and research services which may result in the payment of higher brokerage fees than might otherwise be available. These services may be more beneficial to certain funds or accounts of the Adviser and its affiliates than to others. Although the payment of brokerage commissions is subject to the requirement that the Investment Adviser determine in good faith that the commissions are reasonable in relation to the value of the brokerage and research services provided to the Fund, a portfolio manager s decision as to the selection of brokers and dealers could yield disproportionate costs and benefits among the Fund or other accounts that the Investment Adviser and its affiliates manage. In addition, with respect to certain types of accounts (such as pooled investment vehicles and other accounts managed for organizations and individuals), the Investment Adviser may be limited by the client concerning the selection of brokers or may be instructed to direct trades to particular brokers. In these cases, the Investment Adviser or its affiliates may place separate, non-simultaneous transactions in the same security for the Fund and another account that may temporarily affect the market price of the security or the execution of the transaction, or both, to the detriment of the Fund or the other accounts.

Variation in Compensation. A conflict of interest may arise where the financial or other benefits available to a portfolio manager differ among the accounts that they manage. If the structure of the Investment Adviser s management fee or the portfolio manager s compensation differs among accounts (such as where certain accounts pay higher management fees or performance based management fees), the portfolio managers may be motivated to favor certain accounts over others. The portfolio managers also may be motivated to favor accounts in which they have investment interests or in which the Investment Adviser or its affiliates have investment interests. Similarly, the desire to maintain assets under management or to enhance a portfolio manager s performance record or to derive other rewards, financial or otherwise, could influence the portfolio managers in affording preferential treatment to those accounts that could most significantly benefit the portfolio managers.

The Investment Adviser and the Fund have adopted compliance policies and procedures that are designed to address the various conflicts of interest that may arise for the Investment Adviser and its staff members. However, there is no guarantee that such policies and procedures will be able to detect and address every situation in which an actual or potential conflict may arise.

Portfolio Manager Compensation

Mr. Gabelli receives incentive based variable compensation based on a percentage of net revenues received by the Investment Adviser for managing the Fund. Net revenues are determined by deducting from gross investment management fees the firm s expenses (other than Mr. Gabelli s compensation) allocable to the Fund. Five closed-end registered investment companies (including the Fund) managed by Mr. Gabelli have arrangements whereby the Investment Adviser will only receive its investment advisory fee attributable to the liquidation value of outstanding preferred stock (and Mr. Gabelli would only receive his percentage of such advisory fee) if certain performance levels are met. Additionally, he receives similar incentive based variable compensation for managing other accounts within the firm and its affiliates. This method of compensation is based on the premise that superior long-term performance in managing a portfolio should be rewarded with higher compensation as a result of growth of assets through appreciation and net investment activity. The level of compensation is not determined with specific reference to the performance of any account against any specific benchmark. One of the other registered investment companies managed by Mr. Gabelli has a performance (fulcrum) fee arrangement for which his compensation is adjusted up or down based on the performance of the investment company relative to an index. Mr. Gabelli manages other accounts with performance fees. Compensation for managing these accounts has two components. One component is based on a percentage of net revenues to the investment adviser for managing the account. The second component is based on absolute performance of the account, with respect to which a percentage of such performance fee is paid to Mr. Gabelli. As an executive officer of the Investment Adviser s parent company, GBL, Mr. Gabelli also receives ten percent (10%) of the net operating profits of the parent company. He receives no base salary, no annual bonus, and no stock options.

The compensation of the other portfolio managers for the Fund is reviewed annually and structured to enable the Investment Adviser to attract and retain highly qualified professionals in a competitive environment. The portfolio managers receive a compensation package that includes a minimum draw or base salary, equity based incentive compensation via awards of stock options or restricted stock awards, and incentive based variable compensation based on a percentage of net revenue received by the Investment Adviser for managing a fund to the extent that the amount exceeds a minimum level of compensation. Net revenues are determined by deducting from gross investment management fees certain of the firm s expenses (other than the respective portfolio manager s compensation) allocable to the respective fund (the incentive based variable compensation for managing other accounts is also based on a percentage of net revenues to the Investment Adviser for managing the account). This method of compensation is based on the premise that superior long-term performance in managing a portfolio should be rewarded with higher compensation as a result of growth of assets through appreciation and net investment activity. The level of equity based incentive and incentive based variable compensation is based on an evaluation by the Investment Adviser s parent, GBL, of quantitative and qualitative performance evaluation criteria. This evaluation takes into account, in a broad sense, the performance of the accounts managed by the portfolio manager, but the level of compensation is not determined with specific reference to the performance of any account against any specific benchmark. Generally, greater consideration is given to the performance of larger accounts and to longer term performance over smaller accounts and short-term performance.

Ownership of Shares in the Fund

As reported to the Fund, the information in the following table reflects beneficial ownership by the portfolio managers of shares as of December 31, 2012:

Name of Portfolio Manager	Dollar Range of Equity Securities in the Fund*(1)
Mario J. Gabelli	G
Lawrence J. Haverty	E
Christopher J. Marangi	B

* Key to Dollar Ranges
A. None
B. $1 $10,000
C. $10,001 $50,000
D. $50,001 $100,000
E. $100,001 $500,000
F. $500,001 $1,000,000
G. over $1,000,000
(1) Beneficial Ownership is determined in accordance with Rule 16a-1(a)(2) promulgated under the 1934 Act.

Portfolio Holdings Information

Employees of the Investment Adviser and its affiliates will often have access to information concerning the portfolio holdings of the Fund. The Fund and the Investment Adviser have adopted policies and procedures that require all employees to safeguard proprietary information of the Fund, which includes information relating to the Fund s portfolio holdings as well as portfolio trading activity of the Investment Adviser with respect to the Fund (collectively, Portfolio Holdings Information). In addition, the Fund and the Investment Adviser have adopted policies and procedures providing that Portfolio Holdings Information may not be disclosed except to the extent that it is (a) made available to the general public by posting on the Fund s website or filed as a part of a required filing on Form N-Q or N-CSR or (b) provided to a third party for legitimate business purposes or regulatory purposes, that has agreed to keep such data confidential under forms approved by the Investment Adviser s legal department or outside counsel, as described below. The Investment Adviser will examine each situation under (b) with a view to determine that release of the information is in the best interest of the Fund and its shareholders and, if a potential conflict between the Investment Adviser s interests and the Fund s interests arises, to have such conflict resolved by the Chief Compliance Officer or the independent Board. These policies further provide that no officer of the Fund or employee of the Investment Adviser shall communicate with the media about the Fund without obtaining the advance consent of the Chief Executive Officer, Chief Operating Officer, or General Counsel of the Investment Adviser.

Under the foregoing policies, the Fund currently may disclose Portfolio Holdings Information in the circumstances outlined below. Disclosure generally may be either on a monthly or quarterly basis with no time lag in some cases and with a time lag of up to sixty days in other cases (with the exception of proxy voting services which require a regular download of data):

(1) To regulatory authorities in response to requests for such information and with the approval of the Chief Compliance Officer of the Fund;

(2) To mutual fund rating and statistical agencies and to persons performing similar functions where there is a legitimate business purpose for such disclosure and such entity has agreed to keep such data confidential at least until it has been made public by the Investment Adviser;

(3) To service providers of the Fund, as necessary for the performance of their services to the Fund and to the Board; the Fund s anticipated service providers are its administrator, transfer agent, custodian, independent registered public accounting firm, and legal

counsel;

(4) To firms providing proxy voting and other proxy services, provided such entity has agreed to keep such data confidential until at least it has been made public by the Investment Adviser;

(5) To certain broker-dealers, investment advisers, and other financial intermediaries for purposes of their performing due diligence on the Fund and not for dissemination of this information to their clients or use of this information to conduct trading for their clients. Disclosure of Portfolio Holdings Information in these circumstances requires the broker, dealer, investment adviser, or financial intermediary to agree to keep such information confidential and is further subject to prior approval of the Chief Compliance Officer of the Fund and to reporting to the Board at the next quarterly meeting; and

(6) To consultants for purposes of performing analysis of the Fund, which analysis (but not the Portfolio Holdings Information) may be used by the consultant with its clients or disseminated to the public, provided that such entity shall have agreed to keep such information confidential until at least it has been made public by the Investment Adviser.

Disclosures made pursuant to a confidentiality agreement are subject to periodic confirmation by the Chief Compliance Officer of the Fund that the recipient has utilized such information solely in accordance with the terms of the agreement. Neither the Fund nor the Investment Adviser, nor any of the Investment Adviser s affiliates will accept on behalf of itself, its affiliates, or the Fund any compensation or other consideration in connection with the disclosure of portfolio holdings of the Fund. The Board will review such arrangements annually with the Fund s Chief Compliance Officer.

AUCTIONS FOR AUCTION RATE PREFERRED STOCK

The Fund s Series C Auction Rate Preferred are a type of preferred stock that pays dividends that vary over time. Since February 2008, the auctions have failed and have continued to fail. Failure means that more shares of the preferred stock are offered for sale in the auction that there are bids to buy shares. During this period while auctions have continued to fail, holders of the Fund s Series C Auction Rate Preferred have received dividends at a maximum rate determined by reference to short term rates, rather than at a price set by auction. If auctions were to resume functioning, they would operate in accordance with the procedures described below.

Summary of Auction Procedures

The following is a brief summary of the auction procedures for preferred shares that are auction rate preferred stock. These auction procedures are complicated, and there are exceptions to these procedures. Many of the terms in this section have a special meaning. Accordingly, this description does not purport to be complete and is qualified, in its entirety, by reference to the Fund s Charter, including the provisions of the Articles Supplementary establishing any series of auction rate preferred stock.

The auctions determine the dividend rate for auction rate preferred stock, but each dividend rate will not be higher than the maximum rate. If you own auction rate preferred stock, you may instruct your broker-dealer to enter one of three kinds of orders in the auction with respect to your stock: sell, bid, and hold.

If you enter a sell order, you indicate that you want to sell auction rate preferred stock at their liquidation preference per share, no matter what the next dividend period s rate will be.

If you enter a bid (or hold at a rate) order, which must specify a dividend rate, you indicate that you want to sell auction rate preferred stock only if the next dividend period s rate is less than the rate you specify.

If you enter a hold order you indicate that you want to continue to own auction rate preferred stock, no matter what the next dividend period s rate will be.

You may enter different types of orders for different portions of your auction rate preferred stock. You may also enter an order to buy additional auction rate preferred stock. All orders must be for whole shares of stock. All orders you submit are irrevocable. There is a fixed number of auction rate preferred stock, and the dividend rate likely will vary from auction to auction depending on the number of bidders, the number of shares the bidders seek to buy, the

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rating of the auction rate preferred stock and general economic conditions including current interest rates. If you own auction rate preferred stock and submit a bid for them higher than the then-maximum rate, your bid will be treated as a sell order. If you do not enter an order, the broker-dealer will assume that you want to continue to hold auction rate preferred stock, but if you fail to submit an order and the dividend period is longer than 28 days, the broker-dealer will treat your failure to submit a bid as a sell order.

If you do not then own auction rate preferred stock, or want to buy more shares, you may instruct a broker-dealer to enter a bid order to buy shares in an auction at the liquidation preference per share at or above the dividend rate you specify. If your bid for shares you do not own specifies a rate higher than the then-maximum rate, your bid will not be considered.

Broker-dealers will submit orders from existing and potential holders of auction rate preferred stock to the auction agent. Neither the Fund nor the auction agent will be responsible for a broker-dealer s failure to submit orders from existing or potential holders of auction rate preferred stock. A broker-dealer s failure to submit orders for auction rate preferred stock held by it or its customers will be treated in the same manner as a holder s failure to submit an order to the broker-dealer. A broker-dealer may submit orders to the auction agent for its own account. The Fund may not submit an order in any auction.

After each auction for the auction rate preferred stock, the auction agent will pay to each broker-dealer, from funds provided by the Fund, a service charge equal to, in the case shares of any auction immediately preceding a dividend period of less than 365 days, the product of (i) a fraction, the numerator of which is the number of days in such dividend period and the denominator of which is 365, times (ii) 1/4 of 1%, times (iii) the liquidation preference per share, times (iv) the aggregate number of auction rate preferred shares placed by such broker-dealer at such auction or, in the case of any auction immediately preceding a dividend period of one year or longer, a percentage of the purchase price of the auction rate preferred shares placed by the broker-dealer at the auction agreed to by the Fund and the broker-dealers.

If the number of shares of auction rate preferred stock subject to bid orders by potential holders with a dividend rate equal to or lower than the then-maximum rate is at least equal to the number of shares of auction rate preferred stock subject to sell orders, then the dividend rate for the next dividend period will be the lowest rate submitted which, taking into account that rate and all lower rates submitted in order from existing and potential holders, would result in existing and potential holders owning all the auction rate preferred stock available for purchase in the auction.

If the number of auction rate preferred stock subject to bid orders by potential holders with a dividend rate equal to or lower than the then-maximum rate is less than the number of auction rate preferred stock subject to sell orders, then the auction is considered to be a failed auction, and the dividend rate will be the maximum rate. In that event, existing holders that have submitted sell orders (or are treated as having submitted sell orders) may not be able to sell any or all of the auction rate preferred stock offered for sale than there are buyers for those shares.

If broker-dealers submit or are deemed to submit hold orders for all outstanding auction rate preferred stock, the auction is considered an all hold auction and the dividend rate for the next dividend period will be the all hold rate, which is 80% of the AA Financial Composite Commercial Paper Rate, as determined in accordance with procedures set forth in the Articles Supplementary establishing the auction rate preferred stock.

The auction procedures include a pro rata allocation of auction rate preferred stock for purchase and sale. This allocation process may result in an existing holder continuing to hold or selling, or a potential holder buying, fewer shares than the number of shares of auction rate preferred stock in its order. If this happens, broker-dealers will be required to make appropriate pro rata allocations among their respective customers.

Settlement of purchases and sales will be made on the next business day (which also is a dividend payment date) after the auction date through DTC. Purchasers will pay for their auction rate preferred stock through broker-dealers in same-day funds to DTC against delivery to the broker-dealers. DTC will make payment to the sellers broker-dealers in accordance with its normal procedures, which require broker-dealers to make payment against delivery in same-day funds. As used in this SAI, a business day is a day on which the NYSE is open for trading, and which is not a Saturday, Sunday, or any other day on which banks in New York City are authorized or obligated by law to close.

The first auction for a series of auction rate preferred stock will be held on the date specified in the Prospectus Supplement for such series, which will be the business day preceding the dividend payment date for the initial dividend period. Thereafter, except during special dividend periods, auctions for such series auction rate preferred stock normally will be held within the frequency specified in the Prospectus Supplement for such series, and each subsequent dividend period for such series auction rate preferred stock normally will begin on the following day.

If an auction is not held because an unforeseen event or unforeseen events cause a day that otherwise would have been an auction date not to be a business day, then the length of the then-current dividend period will be extended by seven days (or a multiple thereof if necessary because of such unforeseen event or events), the applicable rate for such period will be the applicable rate for the then-current dividend period so extended and the dividend payment date for such dividend period will be the first business day immediately succeeding the end of such period.

The following is a simplified example of how a typical auction works. Assume that the Fund has 1,000 outstanding shares of auction rate preferred stock and three current holders. The three current holders and three potential holders submit orders through broker-dealers at the auction.

Current Holder A	Owns 500 shares, wants to sell all 500 shares if auction rate is less than 4.6%	Bid order at 4.6% rate for all 500 shares
Current Holder B	Owns 300 shares, wants to hold	Hold order will take the auction rate
Current Holder C	Owns 200 shares, wants to sell all 200 shares if auction rate is less than 4.4%	Bid order at 4.4% rate for all 200 shares
Potential Holder D	Wants to buy 200 shares	Places order to buy at or above 4.5%
Potential Holder E	Wants to buy 300 shares	Places order to buy at or above 4.4%
Potential Holder F	Wants to buy 200 shares	Places order to buy at or above 4.6%

The lowest dividend rate that will result in all 1,000 shares of auction rate preferred stock continuing to be held is 4.5% (the offer by D). Therefore, the dividend rate will be 4.5%. Current holders B and C will continue to own their shares. Current holder A will sell its shares because A s dividend rate bid was higher than the dividend rate: Potential holder D will buy 200 shares and potential holder E will buy 300 shares because their bid rates were at or below the dividend rate. Potential holder F will not buy any shares because its bid rate was above the dividend rate.

Secondary Market Trading and Transfer of Auction Rate Preferred Stock

The underwriters shall not be required to make a market in the auction rate preferred stock. The broker-dealers (including the underwriters) may maintain a secondary trading market for outside of auctions, but they are not required to do so. There can be no assurance that a secondary trading market for the auction rate preferred stock will develop or, if it does develop, that it will provide owners with liquidity of investment. The auction rate preferred stock will not be registered on any stock exchange. Investors who purchase auction rate preferred stock in an auction for a special dividend period should note that because the dividend rate on such shares will be fixed for the length of that dividend period, the value of such shares may fluctuate in response to the changes in interest rates and may be more or less than their original cost if sold on the open market in advance of the next auction thereof, depending on market conditions.

You may sell, transfer, or otherwise dispose of the auction rate preferred stock in the auction process only in whole shares and only pursuant to a bid or sell order placed with the auction agent in accordance with the auction procedures, to the Fund or its affiliates or to or through a broker-dealer that has been selected by the Fund or to such other persons as may be permitted by the Fund. However, if you hold your auction rate preferred stock in the name of a broker-dealer, a sale or transfer of your auction rate preferred stock to that broker dealer, or to another customer of that broker-dealer, will not be considered a sale or transfer for purposes of the foregoing if the shares remain in the name of the broker-dealer immediately after your transaction. In addition, in the case of all transfers other than

through an auction, the broker-dealer (or other person, if the Fund permits) receiving the transfer must advise the auction agent of the transfer. These procedures would not limit a holder s ability to sell its auction rate preferred stock in a secondary market transaction.

Due to recent market turmoil most auction rate preferred stock, including our Series C Auction Rate Preferred, has been unable to hold successful auctions and holders of such stock have suffered reduced liquidity. If the number of Series C Auction Rate Preferred subject to bid orders by potential holders is less than the number of Series C Auction Rate Preferred subject to sell orders, then the auction is considered to be a failed auction, and the dividend rate will be the maximum rate. In that event, holders that have submitted sell orders may not be able to sell any or all of Series C Auction Rate Preferred for which they have submitted sell orders. The current maximum rate is 175% of the AA Financial Composite Commercial Paper Rate on the date of such auction. These failed auctions have been an industry wide problem and may continue to occur in the future. Any current or potential holder of auction rate preferred stock faces the risk that auctions will continue to fail, or will fail again at some point in the future, and that he or she may not be able to sell his or her stock through the auction process.

PORTFOLIO TRANSACTIONS

Subject to policies established by the Board, the Investment Adviser is responsible for placing purchase and sale orders and the allocation of brokerage on behalf of the Fund. Transactions in equity securities are in most cases effected on U.S. stock exchanges and involve the payment of negotiated brokerage commissions. In general, there may be no stated commission in the case of securities traded in over-the-counter markets, but the prices of those securities may include undisclosed commissions or mark-ups. Principal transactions are not entered into with affiliates of the Fund. However, G.research may execute transactions in the over-the-counter markets on an agency basis and receive a stated commission therefrom. To the extent consistent with applicable provisions of the 1940 Act and the rules and exemptions adopted by the SEC thereunder, as well as other regulatory requirements, the Fund s Board has determined that portfolio transactions may be executed through G.research and its broker-dealer affiliates if, in the judgment of the Investment Adviser, the use of those broker-dealers is likely to result in price and execution at least as favorable as those of other qualified broker-dealers, and if, in particular transactions, the affiliated broker-dealers charge the Fund a rate consistent with that charged to comparable unaffiliated customers in similar transactions. The Fund has no obligations to deal with any broker or group of brokers in executing transactions in portfolio securities. In executing transactions, the Investment Adviser seeks to obtain the best price and execution for the Fund, taking into account such factors as price, size of order, difficulty of execution, and operational facilities of the firm involved and the firm s risk in positioning a block of securities. While the Investment Adviser generally seeks reasonably competitive commission rates, the Fund does not necessarily pay the lowest commission available.

Subject to obtaining the best price and execution, brokers who provide supplemental research, market, and statistical information, or other services (*e.g.*, wire services) to the Investment Adviser or its affiliates may receive orders for transactions by the Fund. The term research, market, and statistical information includes advice as to the value of securities, and advisability of investing in, purchasing or selling securities, and the availability of securities or purchasers or sellers of securities, and furnishing analyses and reports concerning issues, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts. Information so received will be in addition to and not in lieu of the services required to be performed by the Investment Adviser under the Advisory Agreement, and the expenses of the Investment Adviser will not necessarily be reduced as a result of the receipt of such supplemental information. Such information may be useful to the Investment Adviser and its affiliates in providing services to clients other than the Fund, and not all such information is used by the Investment Adviser in connection with the Fund. Conversely, such information provided to the Investment Adviser and its affiliates by brokers and dealers through whom other clients of the Investment Adviser and its affiliates effect securities transactions may be useful to the Investment Adviser in providing services to the Fund.

Although investment decisions for the Fund are made independently from those of the other accounts managed by the Investment Adviser and its affiliates, investments of the kind made by the Fund may also be made for those other accounts. When the same securities are purchased for or sold by the Fund and any of such other accounts, it is the policy of the Investment Adviser and its affiliates to allocate such purchases and sales in a manner deemed fair and equitable over time to all of the accounts, including the Fund.

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For the fiscal years ended December 31, 2010, 2011 and 2012, the Fund paid a total of $47,477, $40,105, and $28,540 respectively, in brokerage commissions, of which G.research and its affiliates received, $28,929, $19,705, and $15,825 respectively. The amount received by G.research and its affiliates from the Fund in respect of brokerage commissions for the fiscal year ended December 31, 2012 represented approximately 55% of the aggregate dollar amount of brokerage commissions paid by the Fund for such period and approximately 29% of the aggregate dollar amount of transactions by the Fund for such period.

REPURCHASE OF COMMON STOCK

The Fund is a closed-end, non-diversified, management investment company and as such its shareholders do not, and will not, have the right to redeem their stock. The Fund, however, may repurchase its common stock from time to time as and when it deems such a repurchase advisable. Such repurchases will be made when the Fund s common stock is trading at a discount of 5% (or such other percentage as the Board may determine from time to time) or more from net asset value. Pursuant to the 1940 Act, the Fund may repurchase its common stock on a securities exchange (provided that the Fund has informed its shareholders within the preceding six months of its intention to repurchase such stock) or as otherwise permitted in accordance with Rule 23c-1 under the 1940 Act. Under that Rule, certain conditions must be met regarding, among other things, distribution of net income for the preceding fiscal year, status of the seller, price paid, brokerage commissions, prior notice to shareholders of an intention to purchase stock and purchasing in a manner and on a basis that does not discriminate unfairly against the other shareholders through their interest in the Fund.

When the Fund repurchases its common stock for a price below net asset value, the net asset value of the common stock that remains outstanding will be enhanced, but this does not necessarily mean that the market price of the outstanding common stock will be affected, either positively or negatively.

Shares repurchased are retired.

PORTFOLIO TURNOVER

The portfolio turnover rates of the Fund for the fiscal years ending December 31, 2012 and December 31, 2011 were 7.9% and 14.4%, respectively. The portfolio turnover rate is calculated by dividing the lesser of an investment company s annual sales or purchases of portfolio securities by the monthly average value of securities in its portfolio during the year, excluding portfolio securities the maturities of which at the time of acquisition were one year or less. A high rate of portfolio turnover involves correspondingly greater brokerage commission expense than a lower rate, which expense must be borne by the Fund and its shareholders, as applicable. A higher rate of portfolio turnover may also result in taxable gains being passed to shareholders.

TAXATION

The following discussion is a brief summary of certain U.S. federal income tax considerations affecting the Fund and its shareholders. This discussion reflects applicable tax laws of the United States as of the date of this SAI, which tax laws may be changed or subject to new interpretations by the courts or the Internal Revenue Service (the IRS) retroactively or prospectively. No attempt is made to present a detailed explanation of all U.S. federal, state, local and foreign tax concerns affecting the Fund and its shareholders (including shareholders owning a large position in the Fund), and the discussions set forth herein do not constitute tax advice. Investors are urged to consult their own tax advisers to determine the tax consequences to them of investing in the Fund.

Taxation of the Fund

The Fund has qualified and intends to continue to qualify, as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986, as amended (the Code) (a RIC). Accordingly, the Fund will, among other things, (i) derive in each taxable year at least 90% of its gross income from (a) dividends, interest (including tax-exempt interest), payments with respect to certain securities loans, and gains from the sale or other disposition of stock, securities or foreign currencies, or other income (including but not limited to gain from options, futures and forward contracts) derived with respect to its business of investing in such stock, securities or currencies and (b) net income derived from interests in certain publicly traded partnerships that are treated as partnerships for U.S. federal income tax purposes and that derive less than 90% of their gross income from the items described in (a) above (each

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a Qualified Publicly Traded Partnership); and (ii) diversify its holdings so that, at the end of each quarter of each taxable year (a) at least 50% of the value of its total assets is represented by cash and cash items, U.S. government securities, the securities of other regulated investment companies and other securities, with such other securities limited, in respect of any one issuer, to an amount not greater than 5% of the value of the Fund s total assets and not more than 10% of the outstanding voting securities of such issuer and (b) not more than 25% of the value of the Fund s total assets is invested in the securities of (I) any one issuer (other than U.S. government securities and the securities of other RICs), (II) any two or more issuers in which the Fund owns more than 20% or more of the voting stock and that are determined to be engaged in the same business or similar or related trades or businesses or (III) any one or more Qualified Publicly Traded Partnerships.

The investments of the Fund in partnerships, including Qualified Publicly Traded Partnerships, may result in the Fund being subject to state, local, or foreign income, and franchise or withholding tax liabilities.

As a RIC, the Fund generally is not or will not be, as the case may be, subject to U.S. federal income tax on income and gains that it distributes each taxable year to shareholders, if it distributes at least 90% of the sum of the Fund s (i) investment company taxable income (which includes, among other items, dividends, interest and the excess of any net short-term capital gain over net long-term capital loss and other taxable income, other than any net long-term capital gain, reduced by deductible expenses) determined without regard to the deduction for dividends paid and (ii) its net tax-exempt interest (the excess of its gross tax-exempt interest over certain disallowed deductions). The Fund intends to distribute at least annually substantially all of such income.

Amounts not distributed on a timely basis in accordance with a calendar year distribution requirement are subject to a nondeductible 4% excise tax at the Fund level. To avoid the tax, the Fund must distribute during each calendar year an amount at least equal to the sum of (i) 98% of its ordinary income (not taking into account any capital gain or loss) for the calendar year, (ii) 98.2% of its capital gain in excess of its capital loss (adjusted for certain ordinary losses) for a one-year period generally ending on October 31 of the calendar year (unless an election is made to use the fund s fiscal year), and (iii) certain undistributed amounts from previous years on which a fund paid no federal income tax. While the Fund intends to distribute any income and capital gain in the manner necessary to minimize imposition of the 4% excise tax, there can be no assurance that sufficient amounts of the Fund s taxable income and capital gain will be distributed to avoid entirely the imposition of the tax. In that event, the Fund will be liable for the tax only on the amount by which it does not meet the foregoing distribution requirement.

A distribution will be treated as paid during the calendar year if it is paid during the calendar year or declared by the Fund in October, November or December of the year, payable to shareholders of record on a date during such a month and paid by the Fund during January of the following year. Any such distributions paid during January of the following year will be deemed to be received no later than December 31 of the year the distributions are declared, rather than when the distributions are received.

If the Fund were unable to satisfy the 90% distribution requirement or otherwise were to fail to qualify as a RIC in any year, it would be taxed in the same manner as an ordinary corporation and distributions to the Fund s shareholders would not be deductible by the Fund in computing its taxable income. To qualify again to be taxed as a RIC in a subsequent year, the Fund would be required to distribute to its shareholders its earnings and profits attributable to non-RIC years. In addition, if the Fund failed to qualify as a RIC for a period greater than two taxable years, then the Fund would be required to elect to recognize and pay tax on any net built-in gain (the excess of aggregate gain, including items of income, over aggregate loss that would have been realized if the Fund had been liquidated) or, alternatively, be subject to taxation on such built-in gain recognized for a period of ten years, in order to qualify as a RIC in a subsequent year.

Gain or loss on the sales of securities by the Fund will generally be long-term capital gain or loss if the securities have been held by the Fund for more than one year. Gain or loss on the sale of securities held for one year or less will be short-term capital gain or loss.

Foreign currency gain or loss on non-U.S. dollar-denominated securities and on any non-U.S. dollar-denominated futures contracts, options and forward contracts that are not section 1256 contracts (as defined below) generally will be treated as ordinary income and loss.

Investments by the Fund in certain passive foreign investment companies (PFICs), as defined in the Code, could subject the Fund to federal income tax (including interest charges) on certain distributions or dispositions with respect to those investments which cannot be eliminated by making distributions to shareholders. Elections may be available to the Fund to mitigate the effect of this tax provided that the PFIC complies with certain reporting requirements, but such elections generally accelerate the recognition of income without the receipt of cash. Dividends paid by PFICs will not qualify for the reduced tax rates discussed below under Taxation of Shareholders.

The Fund may invest in debt obligations purchased at a discount with the result that the Fund may be required to accrue income for U.S. federal income tax purposes before amounts due under the obligations are paid. The Fund may also invest in securities rated in the medium to lower rating categories of nationally recognized rating organizations, and in unrated securities (high yield securities). A portion of the interest payments on such high yield securities may be treated as dividends for certain U.S. federal income tax purposes.

As a result of investing in stock of PFICs or securities purchased at a discount or any other investment that produces income that is not matched by a corresponding cash distribution to the Fund, the Fund could be required to include in current income, income it has not yet received. Any such income would be treated as income earned by the Fund and therefore would be subject to the distribution requirements of the Code. This might prevent the Fund from distributing 90% of its investment company taxable income as is required in order to avoid Fund-level federal income taxation on all of its income, or might prevent the Fund from distributing enough ordinary income and capital gain net income to avoid completely the imposition of the excise tax. To avoid this result, the Fund may be required to borrow money or dispose of securities to be able to make distributions to its shareholders.

If the Fund does not meet the asset coverage requirements of the 1940 Act and the Articles Supplementary, the Fund will be required to suspend distributions to the holders of common stock until the asset coverage is restored. Such a suspension of distributions might prevent the Fund from distributing 90% of its investment company taxable income as is required in order to avoid fund-level federal income taxation on all of its income, or might prevent the fund from distributing enough income and capital gain net income to avoid completely imposition of the excise tax.

Certain of the Fund s investment practices are subject to special and complex U.S. federal income tax provisions that may, among other things, (i) disallow, suspend or otherwise limit the allowance of certain losses or deductions, (ii) convert lower taxed long-term capital gains into higher taxed short-term capital gains or ordinary income, (iii) convert ordinary loss or a deduction into capital loss (the deductibility of which is more limited), (iv) cause a fund to recognize income or gain without a corresponding receipt of cash, (v) adversely affect the time as to when a purchase or sale of stock or securities is deemed to occur, (vi) adversely alter the characterization of certain complex financial transactions and (vii) produce income that will not qualify as good income for purposes of the 90% annual gross income requirement described above. The Fund will monitor its transactions and may make certain tax elections to mitigate the effect of these rules and prevent disqualification of the fund as a regulated investment company.

Foreign Taxes

Since the Fund may invest in foreign securities, income from such securities may be subject to non-U.S. taxes. The Fund expects to invest less than 35% of its total assets in foreign securities. As long as the Fund continues to invest less than 35% of its assets in foreign securities it will not be eligible to elect to pass-through to shareholders of a fund the ability to use the foreign tax deduction or foreign tax credit for foreign taxes paid with respect to qualifying taxes.

Taxation of Shareholders

The Fund will determine either to distribute or to retain for reinvestment all or part of its net capital gain. If any such gain is retained, the Fund will be subject to a tax of 35% of such amount. In that event, the Fund expects to designate the retained amount as undistributed capital gain in a notice to its shareholders, each of whom (i) will be required to include in income for tax purposes as long-term capital gain its share of such undistributed amounts, (ii) will be entitled to credit its proportionate share of the tax paid by the Fund against its federal income tax liability and to claim refunds to the extent that the credit exceeds such liability and (iii) will increase its basis in its shares of the Fund by an amount equal to 65% of the amount of undistributed capital gain included in such shareholder s gross income.

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Distributions paid by the Fund from its investment company taxable income, which includes net short-term capital gain, generally are taxable as ordinary income to the extent of the Fund s earnings and profits.

Such distributions, if reported by the Fund, may, however, qualify (provided holding period and other requirements are met by the Fund and its shareholders) (i) for the dividends received deduction available to corporations, but only to the extent that the Fund s income consists of dividend income from U.S. corporations and (ii) for taxable years beginning on or before December 31, 2012, as qualified dividend income eligible for the reduced maximum federal tax rate to individuals of generally 15% (currently 0% for individuals in lower tax brackets) to the extent that the Fund receives qualified dividend income. Qualified dividend income is, in general, dividend income from taxable domestic corporations and certain qualified foreign corporations (*e.g.*, generally, foreign corporations incorporated in a possession of the United States or in certain countries with a qualifying comprehensive tax treaty with the United States, or whose shares with respect to which such dividend is paid is readily tradable on an established securities market in the United States). A qualified foreign corporation does not include a foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a PFIC. If the Fund engages in certain securities lending transactions, the amount received by the Fund that is the equivalent of the dividends paid by the issuer on the securities loaned will not be eligible for qualified dividend income treatment. Distributions of net capital gain reported as capital gain distributions, if any, are taxable to shareholders at rates applicable to long-term capital gain, whether paid in cash or in shares, and regardless of how long the shareholder has held the Fund s shares. Capital gain distributions are not eligible for the dividends received deduction. The maximum federal tax rate on net long-term capital gain of individuals is currently 20%. Unrecaptured Section 1250 gain distributions, if any, will be subject to a 25% tax. Distributions in excess of the Fund s earnings and profits will first reduce the adjusted tax basis of a holder s shares and, after such adjusted tax basis is reduced to zero, will constitute capital gain to such holder (assuming the shares are held as a capital asset). Investment company taxable income (other than qualified dividend income) will currently be taxed at a maximum rate of 35%. For corporate taxpayers, both investment company taxable income and net capital gain are taxed at a maximum rate of 35%.

If an individual receives a dividend that is eligible for qualified dividend income treatment, and such dividend constitutes an extraordinary dividend, any loss on the sale or exchange of shares in respect of which the extraordinary dividend was paid, then the loss will be long-term capital loss to the extent of such extraordinary dividend. An extraordinary dividend for this purpose is generally a dividend (i) in an amount greater than or equal to 5% of the taxpayer s tax basis (or trading value) in a share of stock, aggregating dividends with ex-dividend dates within an 85-day period or (ii) in an amount greater than 20% of the taxpayer s tax basis (or trading value) in a share of stock, aggregating dividends with ex-dividend dates within a 365-day period.

The IRS currently requires that a registered investment company that has two or more classes of stock allocate to each such class proportionate amounts of each type of its income (such as ordinary income, capital gains, dividends qualifying for the dividends received deduction (DRD) and qualified dividend income) based upon the percentage of total dividends paid out of current or accumulated earnings and profits to each class for the tax year. Accordingly, the Fund intends each year to allocate capital gain dividends, dividends qualifying for the DRD and dividends that constitute qualified dividend income, if any, between its common stock and preferred stock in proportion to the total dividends paid out of current or accumulated earnings and profits to each class with respect to such tax year. Distributions in excess of the Fund s current and accumulated earnings and profits, if any, however, will not be allocated proportionately among the common stock and preferred stock. Since the Fund s current and accumulated earnings and profits will first be used to pay dividends on its preferred stock, distributions in excess of such earnings and profits, if any, will be made disproportionately to holders of common stock.

Shareholders may be entitled to offset their capital gain distributions (but not distributions eligible for qualified dividend income treatment) with capital loss. There are a number of statutory provisions affecting when capital loss may be offset against capital gain, and limiting the use of loss from certain investments and activities. Accordingly, shareholders with capital loss are urged to consult their tax advisers.

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The price of stock purchased at any time may reflect the amount of a forthcoming distribution. Those purchasing stock just prior to a distribution will receive a distribution which will be taxable to them even though it represents in part a return of invested capital.

Certain types of income received by the Fund from real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), taxable mortgage pools or other investments may cause the Fund to designate some or all of its distributions as excess inclusion income. To Fund shareholders such excess inclusion income may (1) constitute taxable income, as unrelated business taxable income (UBTI) for those shareholders who would otherwise be tax-exempt such as individual retirement accounts, 401(k) accounts, Keogh plans, pension plans and certain charitable entities; (2) not be offset by other taxable deductions for tax purposes; (3) not be eligible for reduced U.S. withholding for non-U.S. shareholders even from tax treaty countries; and (4) cause the Fund to be subject to tax if certain disqualified organizations as defined by the Code are fund shareholders.

Upon a sale, exchange, redemption or other disposition of stock, a shareholder will generally realize a taxable gain or loss equal to the difference between the amount of cash and the fair market value of other property received and the shareholder s adjusted tax basis in the stock. Such gain or loss will be treated as long-term capital gain or loss if the shares have been held for more than one year. Any loss realized on a sale or exchange will be disallowed to the extent the shares disposed of are replaced by substantially identical shares within a 61-day period beginning 30 days before and ending 30 days after the date that the shares are disposed of. In such a case, the basis of the shares acquired will be adjusted to reflect the disallowed loss.

Any loss realized by a shareholder on the sale of Fund shares held by the shareholder for six months or less will be treated for tax purposes as a long-term capital loss to the extent of any capital gain distributions received by the shareholder (or amounts credited to the shareholder as an undistributed capital gain) with respect to such shares.

Ordinary income distributions and capital gain distributions also may be subject to state and local taxes. Shareholders are urged to consult their own tax advisers regarding specific questions about federal (including the application of the alternative minimum tax rules), state, local or foreign tax consequences to them of investing in the Fund.

Shareholders will receive, if appropriate, various written notices after the close of each of the Fund s taxable years regarding the U.S. federal income tax status of certain dividends, distributions and deemed distributions that were paid (or that are treated as having been paid) by the Fund to its shareholders during the preceding taxable year.

Dividends paid or distributions made by the Fund to shareholders who are non-resident aliens or foreign entities (foreign investors) are generally subject to withholding tax at a 30% rate or a reduced rate specified by an applicable income tax treaty to the extent derived from investment income and short-term capital gains. In order to obtain a reduced rate of withholding, a foreign investor will be required to provide an IRS Form W-8BEN certifying its entitlement to benefits under a treaty. The withholding tax does not apply to regular dividends paid or distributions made to a foreign investor who provides a Form W-8ECI, certifying that the dividends or distributions are effectively connected with the foreign investor s conduct of a trade or business within the United States. Instead, the effectively connected dividends or distributions will be subject to regular U.S. income tax as if the foreign investor were a U.S. shareholder. A non-U.S. corporation receiving effectively connected dividends or distributions may also be subject to additional branch profits tax imposed at a rate of 30% (or lower treaty rate). A foreign investor who fails to provide an IRS Form W-8BEN or other applicable form may be subject to backup withholding at the appropriate rate.

In general, United States federal withholding tax will not apply to any gain or income realized by a foreign investor in respect of any distributions of net long-term capital gains over net short-term capital losses, exempt-interest dividends, or upon the sale or other disposition of shares of the Fund.

Recent Legislation

Recently enacted legislation (known as the Foreign Account Tax Compliance Act, or FACTA) will require certain increased certification requirements and information reporting related to U.S. accounts or U.S. ownership of our shares through certain foreign financial institutions and other non-U.S. entities. In the event of noncompliance with the revised requirements, withholding at a rate of 30% on dividends in respect of, and gross proceeds from the sale of, our common stock held by or through such foreign

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entities would be imposed. Non-U.S. persons that are otherwise eligible for an exemption from, or a reduction of, U.S. withholding tax with respect to such dividends and sale proceeds would be required to seek a refund from the Internal Revenue Service to obtain the benefit of such exemption or reduction. Prospective investors should consult with their tax advisers regarding the possible implications of these rules on their investment in our common stock.

Backup Withholding

The Fund may be required to withhold U.S. federal income tax on all taxable distributions and redemption proceeds payable to non-corporate shareholders who fail to provide the Fund with their correct taxpayer identification number or to make required certifications, or who have been notified by the IRS that they are subject to backup withholding. Backup withholding is not an additional tax. Any amounts withheld may be refunded or credited against such shareholder s U.S. federal income tax liability, if any, provided that the required information is furnished to the IRS.

The foregoing is a general and abbreviated summary of the applicable provisions of the Code and Treasury regulations presently in effect. For the complete provisions, reference should be made to the pertinent Code sections and the Treasury regulations promulgated thereunder. The Code and the Treasury regulations are subject to change by legislative, judicial, or administrative action, either prospectively or retroactively. Persons considering an investment in shares of the Fund should consult their own tax advisers regarding the purchase, ownership and disposition of shares of the Fund.

BENEFICIAL OWNERS

The following table sets forth the beneficial ownership of each person (including any group) known to the Fund to be deemed the beneficial owner of more than 5% of the outstanding shares of common stock of the Fund as of December 31, 2012:

Name and Address of Beneficial Owner(s)	Title of Class	Amount of Shares and Nature of Ownership	Percent of Class
Lazard Asset Management LLC 30 Rockefeller Plaza New York, NY 10112	Common	2,177,327 (beneficial)	12.08%
First Trust Portfolios LP Suite 400 120 East Liberty Drive Wheaton IL 60187	Common	1,661,068 (beneficial)	9.21%
Mario J. Gabelli and affiliates One Corporate Center Rye, N.Y. 10580-1422	Common	967,815 (beneficial)*	5.37%

* Comprised of 468,837 shares of Common Stock owned directly by Mr. Gabelli, 14,776 Shares of Common Stock owned by a family partnership for which Mr. Gabelli serves as general partner, 21,815 Shares of Common Stock owned by GPJ Retirement Partners, LLC., and 462,387 shares of Common Stock owned by GAMCO Investors, Inc. or its affiliates. Mr. Gabelli disclaims beneficial ownership of the Shares held by discretionary accounts and by the entities named except to the extent of his interest in such entities.

As of December 31, 2012, there were no persons known to the Fund to be beneficial owners of more than 5% of the Fund s outstanding shares of Preferred Stock.

As of December 31, 2012 the Directors and Officers of the Fund as a group beneficially owned approximately 5.60% of the outstanding shares of the Fund s common stock and less than 1% of the outstanding shares of the Fund s Preferred Stock.

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GENERAL INFORMATION

Book-Entry-Only Issuance

The Depository Trust Company (DTC) will act as securities depository for the securities offered pursuant to the Prospectus. The information in this section concerning DTC and DTC s book entry system is based upon information obtained from DTC. The securities offered hereby initially will be issued only as fully registered securities registered in the name of Cede & Co. (as nominee for DTC). One or more fully registered global security certificates initially will be issued, representing in the aggregate the total number of securities, and deposited with DTC.

DTC is a limited purpose trust company organized under the New York Banking Law, a banking organization within the meaning of the New York Banking Law, a member of the Federal Reserve System, a clearing corporation within the meaning of the New York Uniform Commercial Code, and a clearing agency registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds securities that its participants deposit with DTC. DTC also facilitates the settlement among participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book entry changes in participants accounts, thereby eliminating the need for physical movement of securities certificates. Direct DTC participants include securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. Access to the DTC system is also available to others such as securities brokers and dealers, banks, and trust companies that clear through or maintain a custodial relationship with a direct participant, either directly or indirectly through other entities.

Purchases of securities within the DTC system must be made by or through direct participants, which will receive a credit for the securities on DTC s records. The ownership interest of each actual purchaser of a security, a beneficial owner, is in turn to be recorded on the direct or indirect participants records. Beneficial owners will not receive written confirmation from DTC of their purchases, but beneficial owners are expected to receive written confirmations providing details of the transactions, as well as periodic statements of their holdings, from the direct or indirect participants through which the beneficial owners purchased securities. Transfers of ownership interests in securities are to be accomplished by entries made on the books of participants acting on behalf of beneficial owners. Beneficial owners will not receive certificates representing their ownership interests in securities, except as provided herein.

DTC has no knowledge of the actual beneficial owners of the securities being offered pursuant to the prospectus; DTC s records reflect only the identity of the direct participants to whose accounts such securities are credited, which may or may not be the beneficial owners. The participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to direct participants, by direct participants to indirect participants, and by direct participants and indirect participants to beneficial owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Payments on the securities will be made to DTC. DTC s practice is to credit direct participants accounts on the relevant payment date in accordance with their respective holdings shown on DTC s records unless DTC has reason to believe that it will not receive payments on such payment date. Payments by participants to beneficial owners will be governed by standing instructions and customary practices and will be the responsibility of such participant and not of DTC or the Fund, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of distributions to DTC is the responsibility of the Fund, disbursement of such payments to direct participants is the responsibility of DTC, and disbursement of such payments to the beneficial owners is the responsibility of direct and indirect participants. Furthermore each beneficial owner must rely on the procedures of DTC to exercise any rights under the securities.

DTC may discontinue providing its services as securities depository with respect to the securities at any time by giving reasonable notice to the Fund. Under such circumstances, in the event that a successor securities depository is not obtained, certificates representing the securities will be printed and delivered.

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Proxy Voting Procedures

The Fund has adopted the proxy voting procedures of the Investment Adviser and has directed the Investment Adviser to vote all proxies relating to the Fund s voting securities in accordance with such procedures. A copy of the Fund s proxy voting policies and procedures is attached as Appendix A.

Information regarding how the Fund voted proxies relating to portfolio securities during the most recent twelve-month period ended June 30 is available without charge, upon request, by calling (800) 422-3554 or on the SEC s website at http://www.sec.gov.

Code of Ethics

The Fund and the Investment Adviser have adopted a code of ethics (the Code of Ethics) under Rule 17j-1 under the 1940 Act. The Code of Ethics permits personnel, subject to the Code of Ethics and its restrictive provisions, to invest in securities, including securities that may be purchased or held by the Fund. The Code of Ethics can be reviewed and copied at the SEC s Public Reference Room in Washington, D.C. Information on the operations of the Reference Room may be obtained by calling the SEC at 202-551-8090. The Code of Ethics is also available on the EDGAR database on the SEC s Internet web site at http://www.sec.gov. Copies of the Code of Ethics may also be obtained, after paying a duplicating fee, by electronic request at the following e-mail address: publicinfo@sec.gov, or by writing the SEC s Public Reference Room, Washington, D.C. 20549-0102.

Financial Statements

The audited financial statements included in the annual report to the Fund s shareholders for the year ended December 31, 2012, together with the report of PricewaterhouseCoopers LLP are incorporated herein by reference to the Fund s annual report. All other portions of the annual report are not incorporated herein by reference and are not part of the registration statement.

Custodian, Transfer Agent, Auction Agent, and Dividend Disbursing Agent

State Street Bank and Trust Company, located at 1776 Heritage Drive, North Quincy, Massachusetts 02171, serves as the custodian of the Fund s assets pursuant to a custody agreement. Under the custody agreement, the Custodian holds the Fund s assets in compliance with the 1940 Act. For its services, the Custodian receives a monthly fee based upon the average weekly value of the total assets of the Fund, plus certain charges for securities transactions.

Computershare Trust Company, N.A., located at 250 Royall Street, Canton, Massachusetts 02021, serves as the Fund s dividend disbursing agent, as agent under the Fund s automatic dividend reinvestment and voluntary cash purchase plans and as transfer agent and registrar for shares of common stock of the Fund.

Computershare Trust Company, N.A. also serves as the transfer agent, registrar, dividend paying agent, and redemption agent with respect to the Series B Preferred.

The Bank of New York Mellon, located at 101 Barclay Street, New York, NY 10014, serves as the Fund s auction agent, transfer agent, registrar, dividend paying agent and redemption agent with respect to the Series C Auction Rate Preferred.

Independent Registered Public Accounting Firm

PricewaterhouseCoopers LLP serves as the Independent Registered Public Accounting Firm of the Fund and audits the financial statements of the Fund. PricewaterhouseCoopers LLP is located at 300 Madison Avenue, New York, New York 10017.

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APPENDIX A

The Voting of Proxies on Behalf of Clients

Rules 204(4)-2 and 204-2 under the Investment Advisers Act of 1940 and Rule 30b1-4 under the Investment Company Act of 1940 require investment advisers to adopt written policies and procedures governing the voting of proxies on behalf of their clients.

These procedures will be used by GAMCO Asset Management Inc., Gabelli Funds, LLC, Gabelli Securities, Inc., and Teton Advisors, Inc. (collectively, the Advisers) to determine how to vote proxies relating to portfolio securities held by their clients, including the procedures that the Advisers use when a vote presents a conflict between the interests of the shareholders of an investment company managed by one of the Advisers, on the one hand, and those of the Advisers; the principal underwriter; or any affiliated person of the investment company, the Advisers, or the principal underwriter. These procedures will not apply where the Advisers do not have voting discretion or where the Advisers have agreed to with a client to vote the client s proxies in accordance with specific guidelines or procedures supplied by the client (to the extent permitted by ERISA).

I. Proxy Voting Committee

The Proxy Voting Committee was originally formed in April 1989 for the purpose of formulating guidelines and reviewing proxy statements within the parameters set by the substantive proxy voting guidelines originally published in 1988 and updated periodically, a copy of which are appended as Exhibit A. The Committee will include representatives of Research, Administration, Legal, and the Advisers. Additional or replacement members of the Committee will be nominated by the Chairman and voted upon by the entire Committee.

Meetings are held on an as needed basis to form views on the manner in which the Advisers should vote proxies on behalf of their clients.

In general, the Director of Proxy Voting Services, using the Proxy Guidelines, recommendations of Institutional Shareholder Corporate Governance Service (ISS), other third-party services and the analysts of G.research, Inc. (G.research), will determine how to vote on each issue. For non-controversial matters, the Director of Proxy Voting Services may vote the proxy if the vote is: (1) consistent with the recommendations of the issuer s Board of Directors and not contrary to the Proxy Guidelines; (2) consistent with the recommendations of the issuer s Board of Directors and is a non-controversial issue not covered by the Proxy Guidelines; or (3) the vote is contrary to the recommendations of the Board of Directors but is consistent with the Proxy Guidelines. In those instances, the Director of Proxy Voting Services or the Chairman of the Committee may sign and date the proxy statement indicating how each issue will be voted.

All matters identified by the Chairman of the Committee, the Director of Proxy Voting Services or the Legal Department as controversial, taking into account the recommendations of ISS or other third party services and the analysts of G.research, will be presented to the Proxy Voting Committee. If the Chairman of the Committee, the Director of Proxy Voting Services or the Legal Department has identified the matter as one that (1) is controversial; (2) would benefit from deliberation by the Proxy Voting Committee; or (3) may give rise to a conflict of interest between the Advisers and their clients, the Chairman of the Committee will initially determine what vote to recommend that the Advisers should cast and the matter will go before the Committee.

A. Conflicts of Interest.

The Advisers have implemented these proxy voting procedures in order to prevent conflicts of interest from influencing their proxy voting decisions. By following the Proxy Guidelines, as well as the recommendations of ISS, other third-party services and the analysts of G.research the Advisers are able to avoid, wherever possible, the influence of potential conflicts of interest. Nevertheless, circumstances may arise in which one or more of the Advisers are faced with a conflict of interest or the appearance of a conflict of interest in connection with its vote. In general, a conflict of interest may arise when an Adviser knowingly does business with an issuer, and may appear to have a material conflict between its own interests and the interests of the shareholders of an investment company managed by one of the Advisers regarding how the proxy is to be voted. A conflict also may exist when an Adviser has actual knowledge of a material business arrangement between an issuer and an affiliate of the Adviser.

In practical terms, a conflict of interest may arise, for example, when a proxy is voted for a company that is a client of one of the Advisers, such as GAMCO Asset Management Inc. A conflict also may arise when a client of one of the Advisers has made a shareholder proposal in a proxy to be voted upon by one or more of the Advisers. The Director of Proxy Voting Services, together with the Legal Department, will scrutinize all proxies for these or other situations that may give rise to a conflict of interest with respect to the voting of proxies.

B. Operation of Proxy Voting Committee

For matters submitted to the Committee, each member of the Committee will receive, prior to the meeting, a copy of the proxy statement, any relevant third party research, a summary of any views provided by the Chief Investment Officer and any recommendations by G.research analysts. The Chief Investment Officer or the G.research analysts may be invited to present their viewpoints. If the

Director of Proxy Voting Services or the Legal Department believe that the matter before the committee is one with respect to which a conflict of interest may exist between the Advisers and their clients, counsel will provide an opinion to the Committee concerning the conflict. If the matter is one in which the interests of the clients of one or more of the Advisers may diverge, counsel will so advise and the Committee may make different recommendations as to different clients. For any matters where the recommendation may trigger appraisal rights, counsel will provide an opinion concerning the likely risks and merits of such an appraisal action.

Each matter submitted to the Committee will be determined by the vote of a majority of the members present at the meeting. Should the vote concerning one or more recommendations be tied in a vote of the Committee, the Chairman of the Committee will cast the deciding vote. The Committee will notify the proxy department of its decisions and the proxies will be voted accordingly.

Although the Proxy Guidelines express the normal preferences for the voting of any shares not covered by a contrary investment guideline provided by the client, the Committee is not bound by the preferences set forth in the Proxy Guidelines and will review each matter on its own merits. Written minutes of all Proxy Voting Committee meetings will be maintained. The Advisers subscribe to ISS, which supplies current information on companies, matters being voted on, regulations, trends in proxy voting and information on corporate governance issues.

If the vote cast either by the analyst or as a result of the deliberations of the Proxy Voting Committee runs contrary to the recommendation of the Board of Directors of the issuer, the matter will be referred to legal counsel to determine whether an amendment to the most recently filed Schedule 13D is appropriate.

II. Social Issues and Other Client Guidelines

If a client has provided special instructions relating to the voting of proxies, they should be noted in the client s account file and forwarded to the proxy department. This is the responsibility of the investment professional or sales assistant for the client. In accordance with Department of Labor guidelines, the Advisers policy is to vote on behalf of ERISA accounts in the best interest of the plan participants with regard to social issues that carry an economic impact. Where an account is not governed by ERISA, the Advisers will vote shares held on behalf of the client in a manner consistent with any individual investment/voting guidelines provided by the client. Otherwise the Advisers will abstain with respect to those shares.

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III. Client Retention of Voting Rights

If a client chooses to retain the right to vote proxies or if there is any change in voting authority, the following should be notified by the investment professional or sales assistant for the client.

- Operations
- Proxy Department
- Investment professional assigned to the account

In the event that the Board of Directors (or a Committee thereof) of one or more of the investment companies managed by one of the Advisers has retained direct voting control over any security, the Proxy Voting Department will provide each Board Member (or Committee member) with a copy of the proxy statement together with any other relevant information including recommendations of ISS or other third-party services.

IV. Proxies of Certain Non-U.S. Issuers

Proxy voting in certain countries requires share-blocking. Shareholders wishing to vote their proxies must deposit their shares shortly before the date of the meeting with a designated depository. During the period in which the shares are held with a depository, shares that will be voted at the meeting cannot be sold until the meeting has taken place and the shares are returned to the clients custodian. Absent a compelling reason to the contrary, the Advisers believe that the benefit to the client of exercising the vote is outweighed by the cost of voting and therefore, the Advisers will not typically vote the securities of non-U.S. issuers that require share-blocking.

In addition, voting proxies of issuers in non-US markets may also give rise to a number of administrative issues to prevent the Advisers from voting such proxies. For example, the Advisers may receive the notices for shareholder meetings without adequate time to consider the proposals in the proxy or after the cut-off date for voting. Other markets require the Advisers to provide local agents with power of attorney prior to implementing their respective voting instructions on the proxy. Although it is the Advisers policies to vote the proxies for its clients for which they have proxy voting authority, in the case of issuers in non-US markets, we vote client proxies on a best efforts basis.

V. Voting Records

The Proxy Voting Department will retain a record of matters voted upon by the Advisers for their clients. The Advisers will supply information on how they voted a client s proxy upon request from the client.

The complete voting records for each registered investment company (the Fund) that is managed by the Advisers will be filed on Form N-PX for the twelve months ended June 30th, no later than August 31st of each year. A description of the

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Fund s proxy voting policies, procedures, and how the Fund voted proxies relating to portfolio securities is available without charge, upon request, by (i) calling 800-GABELLI (800-422-3554); (ii) writing to Gabelli Funds, LLC at One Corporate Center, Rye, NY 10580-1422; or (iii) visiting the SEC s website at www.sec.gov. Question should we post the proxy voting records for the funds on the website.

The Advisers proxy voting records will be retained in compliance with Rule 204-2 under the Investment Advisers Act.

VI. Voting Procedures

1. Custodian banks, outside brokerage firms and clearing firms are responsible for forwarding proxies directly to the Advisers.

Proxies are received in one of two forms:

- Shareholder Vote Instruction Forms (VIFs) - Issued by Broadridge Financial Solutions, Inc. (Broadridge). Broadridge is an outside service contracted by the various institutions to issue proxy materials.

- Proxy cards which may be voted directly.

2. Upon receipt of the proxy, the number of shares each form represents is logged into the proxy system, electronically or manually, according to security.

3. Upon receipt of instructions from the proxy committee (see Administrative), the votes are cast and recorded for each account on an individual basis.

Records have been maintained on the Proxy Edge system.

Proxy Edge records include:

Security Name and Cusip Number

Date and Type of Meeting (Annual, Special, Contest)

Client Name

Adviser or Fund Account Number

Directors Recommendation

How the Adviser voted for the client on item

4. VIFs are kept alphabetically by security. Records for the current proxy season are located in the Proxy Voting Department office. In preparation for the upcoming season, files are transferred to an offsite storage facility during January/February.

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5. If a proxy card or VIF is received too late to be voted in the conventional matter, every attempt is made to vote including:

When a solicitor has been retained, the solicitor is called. At the solicitor s direction, the proxy is faxed.

In some circumstances VIFs can be faxed to Broadridge up until the time of the meeting.

6. In the case of a proxy contest, records are maintained for each opposing entity.

7. Voting in Person

a) At times it may be necessary to vote the shares in person. In this case, a legal proxy is obtained in the following manner:

Banks and brokerage firms using the services at Broadridge:
Broadridge is notified that we wish to vote in person. Broadridge issues individual legal proxies and sends them back via email or overnight (or the Adviser can pay messenger charges). A lead-time of at least two weeks prior to the meeting is needed to do this. Alternatively, the procedures detailed below for banks not using Broadridge may be implemented.

Banks and brokerage firms issuing proxies directly:
The bank is called and/or faxed and a legal proxy is requested.

All legal proxies should appoint:

Representative of [Adviser name] with full power of substitution.

b) The legal proxies are given to the person attending the meeting along with the limited power of attorney.

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Exhibit A

Proxy Guidelines

PROXY VOTING GUIDELINES

General Policy Statement

It is the policy of GAMCO Investors, Inc, and its affiliated advisers (collectively the Advisers) to vote in the best economic interests of our clients. As we state in our Magna Carta of Shareholders Rights, established in May 1988, we are neither *for* nor *against* management. We are for shareholders.

At our first proxy committee meeting in 1989, it was decided that each proxy statement should be evaluated on its own merits within the framework first established by our Magna Carta of Shareholders Rights. The attached guidelines serve to enhance that broad framework.

We do not consider any issue routine. We take into consideration all of our research on the company, its directors, and their short and long-term goals for the company. In cases where issues that we generally do not approve of are combined with other issues, the negative aspects of the issues will be factored into the evaluation of the overall proposals but will not necessitate a vote in opposition to the overall proposals.

Board of Directors

We do not consider the election of the Board of Directors a routine issue. Each slate of directors is evaluated on a case-by-case basis.

Factors taken into consideration include:

- Historical responsiveness to shareholders

This may include such areas as:

  - Paying greenmail
  - Failure to adopt shareholder resolutions receiving a majority of shareholder votes

- Qualifications
- Nominating committee in place
- Number of outside directors on the board
- Attendance at meetings
- Overall performance

Selection of Auditors

In general, we support the Board of Directors recommendation for auditors.

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Blank Check Preferred Stock

We oppose the issuance of blank check preferred stock.

Blank check preferred stock allows the company to issue stock and establish dividends, voting rights, etc. without further shareholder approval.

Classified Board

A classified board is one where the directors are divided into classes with overlapping terms. A different class is elected at each annual meeting.

While a classified board promotes continuity of directors facilitating long range planning, we feel directors should be accountable to shareholders on an annual basis. We will look at this proposal on a case-by-case basis taking into consideration the board s historical responsiveness to the rights of shareholders.

Where a classified board is in place we will generally not support attempts to change to an annually elected board.

When an annually elected board is in place, we generally will not support attempts to classify the board.

Increase Authorized Common Stock

The request to increase the amount of outstanding shares is considered on a case-by-case basis.

Factors taken into consideration include:

- Future use of additional shares
  - Stock split
  - Stock option or other executive compensation plan
  - Finance growth of company/strengthen balance sheet
  - Aid in restructuring
  - Improve credit rating
  - Implement a poison pill or other takeover defense
- Amount of stock currently authorized but not yet issued or reserved for stock option plans
- Amount of additional stock to be authorized and its dilutive effect

We will support this proposal if a detailed and verifiable plan for the use of the additional shares is contained in the proxy statement.

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Confidential Ballot

We support the idea that a shareholder s identity and vote should be treated with confidentiality.

However, we look at this issue on a case-by-case basis.

In order to promote confidentiality in the voting process, we endorse the use of independent Inspectors of Election.

Cumulative Voting

In general, we support cumulative voting.

Cumulative voting is a process by which a shareholder may multiply the number of directors being elected by the number of shares held on record date and cast the total number for one candidate or allocate the voting among two or more candidates.

Where cumulative voting is in place, we will vote against any proposal to rescind this shareholder right.

Cumulative voting may result in a minority block of stock gaining representation on the board. When a proposal is made to institute cumulative voting, the proposal will be reviewed on a case-by-case basis. While we feel that each board member should represent all shareholders, cumulative voting provides minority shareholders an opportunity to have their views represented.

Director Liability and Indemnification

We support efforts to attract the best possible directors by limiting the liability and increasing the indemnification of directors, except in the case of insider dealing.

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Equal Access to the Proxy

The SEC s rules provide for shareholder resolutions. However, the resolutions are limited in scope and there is a 500 word limit on proponents written arguments. Management has no such limitations. While we support equal access to the proxy, we would look at such variables as length of time required to respond, percentage of ownership, etc.

Fair Price Provisions

Charter provisions requiring a bidder to pay all shareholders a fair price are intended to prevent two-tier tender offers that may be abusive. Typically, these provisions do not apply to board-approved transactions.

We support fair price provisions because we feel all shareholders should be entitled to receive the same benefits.

Reviewed on a case-by-case basis.

Golden Parachutes

Golden parachutes are severance payments to top executives who are terminated or demoted after a takeover.

We support any proposal that would assure management of its own welfare so that they may continue to make decisions in the best interest of the company and shareholders even if the decision results in them losing their job. We do not, however, support excessive golden parachutes. Therefore, each proposal will be decided on a case-by- case basis.

Note: Congress has imposed a tax on any parachute that is more than three times the executive s average annual compensation

Anti-Greenmail Proposals

We do not support greenmail. An offer extended to one shareholder should be extended to all shareholders equally across the board.

Limit Shareholders Rights to Call Special Meetings

We support the right of shareholders to call a special meeting.

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Consideration of Nonfinancial Effects of a Merger

This proposal releases the directors from only looking at the financial effects of a merger and allows them the opportunity to consider the merger s effects on employees, the community, and consumers.

As a fiduciary, we are obligated to vote in the best economic interests of our clients. In general, this proposal does not allow us to do that. Therefore, we generally cannot support this proposal.

Reviewed on a case-by-case basis.

Mergers, Buyouts, Spin-Offs, Restructurings

Each of the above is considered on a case-by-case basis. According to the Department of Labor, we are not required to vote for a proposal simply because the offering price is at a premium to the current market price. We may take into consideration the long term interests of the shareholders.

Military Issues

Shareholder proposals regarding military production must be evaluated on a purely economic set of criteria for our ERISA clients. As such, decisions will be made on a case-by-case basis.

In voting on this proposal for our non-ERISA clients, we will vote according to the client s direction when applicable. Where no direction has been given, we will vote in the best economic interests of our clients. It is not our duty to impose our social judgment on others.

Northern Ireland

Shareholder proposals requesting the signing of the MacBride principles for the purpose of countering the discrimination of Catholics in hiring practices must be evaluated on a purely economic set of criteria for our ERISA clients. As such, decisions will be made on a case-by-case basis.

In voting on this proposal for our non-ERISA clients, we will vote according to client direction when applicable. Where no direction has been given, we will vote in the best economic interests of our clients. It is not our duty to impose our social judgment on others.

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Opt Out of State Anti-Takeover Law

This shareholder proposal requests that a company opt out of the coverage of the state s takeover statutes. Example: Delaware law requires that a buyer must acquire at least 85% of the company s stock before the buyer can exercise control unless the board approves.

We consider this on a case-by-case basis. Our decision will be based on the following:

- State of Incorporation
- Management history of responsiveness to shareholders
- Other mitigating factors

Poison Pill

In general, we do not endorse poison pills.

In certain cases where management has a history of being responsive to the needs of shareholders and the stock is very liquid, we will reconsider this position.

Reincorporation

Generally, we support reincorporation for well-defined business reasons. We oppose reincorporation if proposed solely for the purpose of reincorporating in a state with more stringent anti-takeover statutes that may negatively impact the value of the stock.

Stock Incentive Plans

Director and Employee Stock incentive plans are an excellent way to attract, hold and motivate directors and employees. However, each incentive plan must be evaluated on its own merits, taking into consideration the following:

- Dilution of voting power or earnings per share by more than 10%.
- Kind of stock to be awarded, to whom, when and how much.
- Method of payment.
- Amount of stock already authorized but not yet issued under existing stock plans.
- The successful steps taken by management to maximize shareholder value.

Supermajority Vote Requirements

Supermajority vote requirements in a company s charter or bylaws require a level of voting approval in excess of a simple majority of the outstanding shares. In general, we oppose supermajority-voting requirements. Supermajority requirements often exceed the average level of

shareholder participation. We support proposals approvals by a simple majority of the shares voting.

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Limit Shareholders Right to Act by Written Consent

Written consent allows shareholders to initiate and carry on a shareholder action without having to wait until the next annual meeting or to call a special meeting. It permits action to be taken by the written consent of the same percentage of the shares that would be required to effect proposed action at a shareholder meeting.

Reviewed on a case-by-case basis.

Say on Pay and Say When on Pay

We will generally abstain from advisory votes on executive compensation (Say on Pay) and will also abstain from advisory votes on the frequency of voting on executive compensation (Say When on Pay). In those instances when we believe that it is in our clients best interest, we may cast a vote for or against executive compensation and/or the frequency of votes on executive compensation.

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PART C

OTHER INFORMATION

ITEM 25. FINANCIAL STATEMENTS AND EXHIBITS

(1) Financial Statements(1)

(a) Statement of Assets and Liabilities

(b) Statement of Operations

(c) Statement of Changes in Net Assets

(d) Notes to Financial Statements

(e) Report of Independent Registered Public Accounting Firm

(2) Exhibits

(a) (i) Articles of Incorporation(2)

(ii) Articles Supplementary for the 7.92% Cumulative Preferred Stock(3)

(iii) Articles Supplementary for the 6.00% Series B Cumulative Preferred Stock (7)

(iv) Articles of Amendment to the Articles Supplementary Creating and Fixing the Rights of 6.00% Series B Cumulative Preferred Stock (10)

(v) Articles Supplementary for the Series C Auction Rate Cumulative Preferred Stock (7)

(vi) Articles of Amendment to the Articles Supplementary Creating and Fixing the Rights of Series C Auction Rate Preferred Stock(10)

(vii) Articles Supplementary for the election of Section 3-804(c) of the Maryland General Corporation Law(10)

(b) Amended and Restated By-Laws of Registrant(11)

(c) Not applicable

(d) (i) Specimen Stock Certificate:

(A) 7.92% Cumulative Preferred Stock (12)

(B) 6.00% Series B Cumulative Preferred Stock (7)

(C) Series C Auction Rate Cumulative Preferred Stock (7)

(e) Automatic Dividend Reinvestment and Voluntary Cash Purchase Plan of Registrant(5)

(f) Not applicable

(g) Investment Advisory Agreement between Registrant and Gabelli Funds, LLC(5)

(h) Form of Underwriting Agreement (14)

(i) Not applicable

(j) (i) Custodian Contract between Registrant and State Street Bank and Trust Company(4)

(ii) Amendment to Custodian Contract between Registrant and State Street Bank and Trust Company(5)

(iii) Custodian Fee Schedule between Registrant and State Street Bank and Trust Company(4)

(k) (i) Transfer Agency and Service Agreement among Registrant, Computershare Trust Company, N.A. and Computershare, Inc.(8)

(ii) Fee and Service Schedule for Stock Transfer Services between Registrant, Computershare Trust Company, N.A. and Computershare, Inc.(8)

(iii) Form of Auction Agency Agreement(7)

(iv) Form of Broker-Dealer Agreement(7)

(v) Form of DTC Agreement(7)

(l) (i) Consent of Paul Hastings LLP(9)

(ii) Opinion and Consent of Venable LLP(15)

(m) Not applicable

(n) Consent of Independent Registered Public Accounting Firm(9)

(o) Not applicable

(p) Not applicable

(q) Not Applicable

(r) Codes of Ethics of the Fund and the Adviser(5)

(s) Powers of Attorney(6)(13)(16)

(1) Incorporated by reference to the Registrant s annual report filed March 11, 2013 on Form N-CSR (File No. 811- 8476).

(2) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File Nos. 333-60407 and 811-8476, as filed with the Securities and Exchange Commission on June 20, 1995.

(3) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-60407 and 811-8476, as filed with the Securities and Exchange Commission on May 23, 1997.

(4) Incorporated by reference from Amendment No. 1 to the Registrant s Registration Statement on Form N-2, File Nos. 33-60407 and 811-8476, as filed with the Securities and Exchange Commission on August 7, 1995.

(5) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-33514 and 811-8476, as filed with the Securities and Exchange Commission on June 2, 2000.

(6) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-172191 and 811-8476, as filed with the Securities and Exchange Commission on March 21, 2011.

(7) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-102755 and 811-8476, as filed with the Securities and Exchange Commission on March 21, 2003.

(8) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-173800 and 811-8476, as filed with the Securities and Exchange Commission on April 29, 2011.

(9) Filed herewith.

(10) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-172191 and 811-8476, as filed with the Securities and Exchange Commission on February 11, 2011.

(11) Incorporated by reference from the Registrant s Current Report on Form 8-K, File. No. 811- 8476, as filed with the Securities and Exchange Commission on November 29, 2010.

(12) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-25487 and 811-8476, as filed with the Securities and Exchange Commission on April 18, 1997.

(13) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-102755 and 811-8476, as filed with the Securities and Exchange Commission on March 18, 2003.

(14) To be filed by amendment

(15) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-173800 and 811-8476, as filed with the Securities and Exchange Commission on June 23, 2011.

(16) Incorporated by reference from the Registrant s Registration Statement on Form N-2, File No. 333-173800 and 811-8476, as filed with the Securities and Exchange Commission on September 5, 2012.

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ITEM 26. Marketing Arrangements

The information contained under the heading Plan of Distribution on page [56] of the Prospectus is incorporated by reference, and any information concerning any underwriters will be contained in the accompanying Prospectus Supplement, if any.

ITEM 27. Other Expenses of Issuance and Distribution

The following table sets forth the estimated expenses to be incurred in connection with the offering described in this Registration Statement:

SEC registration fees	$ 38,580
New York Stock Exchange listing fee	$ 60,000
Rating Agency fees	$ 50,000
Printing expenses	$ 200,000
Accounting fees	$ 40,000
Legal fees	$ 400,000
Blue Sky fees	$ 0
Miscellaneous	$ 61,420
Total	$ 850,000

ITEM 28. Persons Controlled by or Under Common Control with Registrant

None.

ITEM 29. Number of Holders of Securities as of March 31, 2013

Title of Class	Number of Record Holders
Common Stock	4,458
6.00% Series B Cumulative Preferred Stock	3
Series C Auction Rate Cumulative Preferred Stock	1

ITEM 30. Indemnification

Subject to limitations imposed by the 1940 Act, the Registrant s charter limits the liability of the Registrant s directors and officers to the Registrant and its shareholders to the fullest extent permitted by Maryland law. Under Maryland law, Maryland corporations may limit their directors and officers liability for money damages to the corporation and its shareholders except to the extent (i) that it is proved that a director or officer actually received an improper benefit or profit in money, property or services, in which case such director or officer may be liable for the amount of the benefit or profit actually received or (ii) that a judgment or other final adjudication adverse to a director or officer is entered in a proceeding based on a finding that such director s or officer s action, or failure to act, was the result of active and deliberate dishonesty and was material to the cause of action adjudicated in the proceeding.

The Registrant s Bylaws require the indemnification of, and expenses to be advanced on behalf of, directors and officers, among others, to the fullest extent permitted by Maryland law, subject to the limitations imposed by the 1940 Act. Under Maryland law, a corporation may indemnify a present or former director or officer or any person, who while a director or officer of the corporation, serves or has served another entity as a director, officer, partner or trustee of such entity, against judgments, penalties, fines, settlements and reasonable expenses actually incurred by them in connection with any proceedings to which they may be made, or threatened to be made, a party by reason of their service in such capacity, unless it is proved that (i) the act or omission of the director or officer was material to the matter giving rise to the proceeding and (a) was committed in bad faith or (b) was the result of active and deliberate dishonesty, (ii) the director or officer actually received an improper personal benefit in money, property, or services or (iii) in the case of any criminal proceeding, the director or officer had reasonable cause to believe that

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the act or omission was unlawful. However, under Maryland law, a Maryland corporation may not indemnify for an adverse judgment in a suit by or in the right of the corporation or for a judgment of liability on the basis that personal benefit was improperly received, unless in either case a court orders indemnification and then only for expenses. Maryland law requires a corporation (unless its charter provides otherwise, which the Registrant s charter does not) to indemnify present and past directors and officers who are successful, on the merits or otherwise, in the defense of any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative, against reasonable expenses (including attorneys fees) incurred in connection with such proceeding. In addition, Maryland law permits a corporation to advance reasonable expenses to a director or officer upon the corporation s receipt of (a) a written affirmation by the director or officer of his or her good faith belief that he or she has bet the standard of conduct necessary for indemnification by the corporation and (b) a written undertaking by him or her on his or her behalf to repay the amount paid or reimbursed by the corporation if it shall ultimately be determined that the standard of conduct was not met. The Registrant s Bylaws also permit the indemnification and advance of expenses to the Registrant s employees and agents to the extent approved by the Board of Directors and permitted by Maryland law and the 1940 Act.

Insofar as indemnification for liability arising under the Securities Act of 1933, as amended (Securities Act), may be permitted to directors, officers and controlling persons of Registrant pursuant to the foregoing provisions, or otherwise, Registrant has been advised that, in the opinion of the Securities and Exchange Commission, such indemnification is against public policy as expressed in the Securities Act, and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by Registrant of expenses incurred or paid by a director, officer or controlling person of Registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, Registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act and will be governed by the final adjudication of such issue.

ITEM 31. Business and Other Connections of Investment Adviser

The Investment Adviser, a limited liability company organized under the laws of the State of New York, acts as investment adviser to the Registrant. The Registrant is fulfilling the requirement of this Item 31 to provide a list of the officers and directors of the Investment Adviser, together with information as to any other business, profession, vocation or employment of a substantial nature engaged in by the Investment Adviser or those officers and directors during the past two years, by incorporating by reference the information contained in the Form ADV of the Investment Adviser filed with the commission pursuant to the Investment Advisers Act of 1940 (Commission File No. 801-26202).

ITEM 32. Location of Accounts and Records

The accounts and records of the Registrant are maintained in part at the office of the Investment Adviser at One Corporate Center, Rye, New York 10580-1422, in part at the offices of the Custodian, State Street Bank and Trust Company, 1776 Heritage Drive North Quincy Massachusetts 02171 at the offices of the Fund s sub-administrator, BNY Mellon Investment Servicing (US) Inc., 760 Moore Road, King of Prussia, Pennsylvania 19406, and in part at the offices of Computershare Trust Company, N.A., 250 Royall Street, Canton, Massachusetts 02021.

ITEM 33. Management Services

Not applicable.

ITEM 34. Undertakings

1. Registrant undertakes to suspend the offering of shares until the prospectus is amended, if subsequent to the effective date of this registration statement, its net asset value declines more than ten percent from its net asset value as of the effective date of the registration statement or its net asset value increases to an amount greater than its net proceeds as stated in the prospectus.

2. Not applicable.

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3. Registrant undertakes to file a post-effective amendment if it intends to issue subscription rights to purchase its common shares. If the securities being registered are to be offered to existing shareholders pursuant to warrants or rights, and any securities not taken by shareholders are to be reoffered to the public, the Registrant undertakes to supplement the prospectus, after the expiration of the subscription period, to set forth the results of the subscription offer, the transactions by underwriters during the subscription period, the amount of unsubscribed securities to be purchased by underwriters, and the terms of any subsequent reoffering thereof. If any public offering by the underwriters of the securities being registered is to be made on terms differing from those set forth on the cover page of the prospectus, the Registrant further undertakes to file a post-effective amendment to set forth the terms of such offering.

4. Registrant undertakes:

(a) to file, during any period in which offers or sales are being made, a post-effective amendment to this Registration Statement:

(1) to include any prospectus required by Section 10(a)(3) of the Securities Act;

(2) to reflect in the prospectus any facts or events after the effective date of the Registration Statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the Registration Statement; and

(3) to include any material information with respect to the plan of distribution not previously disclosed in the Registration Statement or any material change to such information in the Registration Statement.

(b) that for the purpose of determining any liability under the Securities Act, each post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof;

(c) to remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering; and

(d) that, for the purpose of determining liability under the Securities Act to any purchaser, if the Registrant is subject to Rule 430C: Each prospectus filed pursuant to Rule 497(b), (c), (d) or (e) under the Securities Act as part of a registration statement relating to an offering, other than prospectuses filed in reliance on Rule 430A under the Securities Act shall be deemed to be part of and included in the registration statement as of the date it is first used after effectiveness.

Provided, however, that no statement made in a registration statement or prospectus that is part of the registration or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such first use, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such date of first use.

(e) that for the purpose of determining liability of the Registrant under the Securities Act to any purchaser in the initial distribution of securities:

The undersigned Registrant undertakes that in a primary offering of securities of the undersigned Registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned Registrant will be a seller to the purchaser and will be considered to offer or sell such securities to the purchaser:

(1) any preliminary prospectus or prospectus of the undersigned Registrant relating to the offering required to be filed pursuant to Rule 497 under the Securities Act.

(2) the portion of any advertisement pursuant to Rule 482 under the Securities Act relating to the offering containing material information about the undersigned Registrant or its securities provided by or on behalf of the undersigned Registrant; and

(3) any other communication that is an offer in the offering made by the undersigned Registrant to the purchaser.

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5. Registrant undertakes:

(a) that, for the purpose of determining any liability under the Securities Act the information omitted from the form of prospectus filed as part of the Registration Statement in reliance upon Rule 430A and contained in the form of prospectus filed by the Registrant pursuant to Rule 497(h) will be deemed to be a part of the Registration Statement as of the time it was declared effective.

(b) that, for the purpose of determining any liability under the Securities Act, each post-effective amendment that contains a form of prospectus will be deemed to be a new Registration Statement relating to the securities offered therein, and the offering of such securities at that time will be deemed to be the initial bona fide offering thereof.

6. Registrant undertakes to send by first class mail or other means designed to ensure equally prompt delivery, within two business days of receipt of a written or oral request, any Statement of Additional Information constituting Part B of this Registration Statement.

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SIGNATURES

Pursuant to the requirements of the Securities Act of 1933 and the Investment Company Act of 1940, the Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, in the City of Rye, State of New York, on the 11th day of June, 2013.

THE GABELLI MULTIMEDIA TRUST INC.

By: /s/ Bruce N. Alpert
Bruce N. Alpert

President

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed below by the following persons in the capacities set forth below on the 11th day of June, 2013.

Signature	Capacity	Date
*	Chairman, Director and Chief Investment Officer	
Mario J. Gabelli		
/s/ Bruce N. Alpert	President	June 11, 2013
Bruce N. Alpert		
/s/ Agnes Mullady	Treasurer and Secretary	June 11, 2013
Agnes Mullady		
*	Director	
Anthony J. Colavita		
*	Director	
James P. Conn		
*	Director	
Frank J. Fahrenkopf, Jr.		
/s/ Christopher J. Marangi	Director	June 11, 2013
Christopher J. Marangi		
*	Director	
Kuni Nakamura		
*	Director	

Anthony R. Pustorino		
*	Director	
Werner J. Roeder		
*	Director	
Salvatore J. Zizza		
/s/ Bruce N. Alpert	President	June 11, 2013
Bruce N. Alpert		
Attorney-in-Fact		

* Pursuant to Powers of Attorney

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Exhibit Index

Exhibit	Caption
(l)(i)	Consent of Paul Hastings LLP
(n)	Consent of Independent Registered Public Accounting Firm

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