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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL
OMB Number: 3235-0123
Expires: February 28, 2010
Estimated average burden
hours per response... 12.00

ANNUAL AUDITED REPORT
FORM X-17A-5
PART III

SEC FILE NUMBER
8-25976

FACING PAGE
Information Required of Brokers and Dealers Pursuant to Section 17 of the
Securities Exchange Act of 1934 and Rule 17a-5 Thereunder

REPORT FOR THE PERIOD BEGINNING 01/01/2008 AND ENDING 12/31/2008
MM/DD/YY MM/DD/YY

A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER: KDC MERGER ARBITRAGE FUND, LP

OFFICIAL USE ONLY
FIRM I.D. NO.

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

900 THIRD AVENUE - SUITE 1000

NEW YORK NY 10022
(City) (State) (Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT
Glen M Friedman 212-350-0262
(Area Code - Telephone Number)

B. ACCOUNTANT IDENTIFICATION

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report*

PricewaterhouseCoopers, LLP

300 Madison Avenue New York NY 10017
(Address) (City) (State) (Zip Code)

SEC Mail Processing
Section

MAR 02 2009
Washington, DC
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CHECK ONE:

- Certified Public Accountant
- Public Accountant
- Accountant not resident in United States or any of its possessions.

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*Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis for the exemption. See Section 240.17a-5(e)(2)

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OATH OR AFFIRMATION

I, Glen M. Friedman, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of KDC Merger Arbitrage Fund, LP, as of December 31, 2008, are true and correct. I further swear (or affirm) that neither the company nor any partner, proprietor, principal officer or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

No Exceptions

Signature

Chief Financial Officer

Title

Notary Public

Aristeo Thanos
Notary Public, State of New York
No. 01TH6132246
Qualified in Westchester County
Commission Expires: Aug 22, 2009

This report ** contains (check all applicable boxes):

- (a) Facing Page.
- (b) Statement of Financial Condition.
- (c) Statement of Income (Loss).
- (d) Statement of Changes in Financial Condition.
- (e) Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietors' Capital.
- (f) Statement of Changes in Liabilities Subordinated to Claims of Creditors.
- (g) Computation of Net Capital.
- (h) Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3.
- (i) Information Relating to the Possession or Control Requirements Under Rule 15c3-3.
- (j) A Reconciliation, including appropriate explanation of the Computation of Net Capital Under Rule 15c3-1 and the Computation for Determination of the Reserve Requirements Under Exhibit A of Rule 15c3-3.
- (k) A Reconciliation between the audited and unaudited Statements of Financial Condition with respect to methods of consolidation.
- (l) An Oath or Affirmation.
- (m) A copy of the SIPC Supplemental Report.
- (n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.

**For conditions of confidential treatment of certain portions of this filing, see section 240.17a-5(e)(3).

**KDC Merger Arbitrage
Fund, LP**

**Consolidated Statement of Financial Condition
December 31, 2008**

KDC Merger Arbitrage Fund, LP
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December 31, 2008

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Report of Independent Auditors

To the Partners of KDC Merger Arbitrage Fund, LP

In our opinion, the accompanying consolidated statement of financial condition, including the consolidated condensed schedule of investments, presents fairly, in all material respects, the financial position of KDC Merger Arbitrage Fund, LP and its subsidiary at December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. This financial statement is the responsibility of the General Partner. Our responsibility is to express an opinion on this financial statement based on our audit. We conducted our audit of this financial statement in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement, assessing the accounting principles used and significant estimates made by the General Partner, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.


February 25, 2009

KDC Merger Arbitrage Fund, LP
Consolidated Statement of Financial Condition
December 31, 2008

(Expressed in U.S. Dollars)

Assets

Cash and cash equivalents		\$	6,974,698
Investments owned, at fair value (cost \$233,206,617)			
Investments owned	\$	200,288,001	
Investments owned, held by clearing broker		<u>8,198,359</u>	
			208,486,360
Receivable from brokers, dealers and clearing organizations			1,236,850,768
Dividends receivable			337,165
Furniture and equipment, at cost, net of accumulated depreciation of \$1,818,042			286,046
Other assets			<u>444,986</u>
Total assets		\$	<u>1,453,380,023</u>

Liabilities and Partners' Capital

Liabilities

Bank loans		\$	10,000
investments sold, but not yet purchased, at fair value (proceeds \$215,460,866)			176,993,080
Payable to brokers, dealers and clearing organizations			1,162,409,370
Dividends payable			343,422
Unrealized loss on contracts for differences, at fair value			11,105
Unincorporated business tax payable			325,000
Withdrawals payable			7,415,721
Other liabilities			<u>6,301,597</u>
Total liabilities			<u>1,353,809,295</u>
Partners' capital			<u>99,570,728</u>
Total liabilities and partners' capital		\$	<u>1,453,380,023</u>

The accompanying notes are an integral part of this consolidated financial statement.

KDC Merger Arbitrage Fund, LP
Consolidated Condensed Schedule of Investments
December 31, 2008

(Expressed in U.S. Dollars)

Shares, No. of Contracts or Principal Amount	Description	Fair Value	Percent of Partners' Capital
Investments Owned			
Common Stocks			
United States			
Banks			
329,670	JPMorgan Chase & Co.	\$ 10,394,495	10.44 %
	Other	2,744,144	2.76 %
Biomedical			
67,100	Genentech, Inc.	5,563,261	5.59 %
	Chemicals, Diversified	4,312,942	4.33 %
	Financial Services	2,624,820	2.64 %
	Food and Food Services	4,509,841	4.53 %
	Insurance	3,659,921	3.68 %
Medical/Pharmaceutical			
333,000	AmerisourceBergen Corp.	11,874,780	11.93 %
563,402	Johnson & Johnson	33,708,341	33.85 %
	Other	8,405,851	8.44 %
Multimedia			
	Oil Exploration and Production		
1,078,000	Chevron Corporation	79,739,660	80.08 %
	Optical Recognition Equipment	71,563	0.07 %
	Other	19,956	0.02 %
	Telecommunications Service and Equipment	3,883,613	3.90 %
Tobacco			
101,600	UST Inc.	7,049,008	7.08 %
	Total United States (cost \$165,061,048)	<u>180,798,220</u>	<u>181.59 %</u>
France			
	Telecommunications Service and Equipment (cost \$28,124,047)	803,273	0.81 %
Germany			
	Telecommunications Service and Equipment		
646,138	Deutsche Telekom AG (cost \$9,304,396)	9,885,912	9.93 %
United Kingdom			
	Computer Software and Computer Services	1,204,140	1.21 %
	Telecommunications Service and Equipment		
753,375	Vodafone Group Plc	15,398,985	15.46 %
	Total United Kingdom (cost \$30,450,619)	<u>16,603,125</u>	<u>16.67 %</u>
	Total common stocks (cost \$232,940,110)	<u>208,090,530</u>	<u>209.00 %</u>

The accompanying notes are an integral part of this consolidated financial statement.

KDC Merger Arbitrage Fund, LP
Consolidated Condensed Schedule of Investments
December 31, 2008

Shares, No. of Contracts or Principal Amount	Description	Fair Value	Percent of Partners' Capital
	Warrants and Rights		
	United States		
	Other (cost \$0)	\$ 63,660	0.06 %
	Germany		
	Medical/Pharmaceutical (cost \$0)	8,750	0.01 %
	Total warrants and rights (cost \$0)	<u>72,410</u>	<u>0.07 %</u>
	Exchange Traded Equity Options		
	United States		
	Biomedical		
400	Put/DNA 75 Exp 1/17/2009	33,000	0.03 %
	Chemicals, Diversified	<u>290,420</u>	<u>0.29 %</u>
	Total exchange traded equity options (cost \$266,507)	<u>323,420</u>	<u>0.32 %</u>
	Total investments owned (cost \$233,206,617)	<u>\$ 208,486,360</u>	<u>209.39 %</u>

The accompanying notes are an integral part of this consolidated financial statement.

KDC Merger Arbitrage Fund, LP
Consolidated Condensed Schedule of Investments
December 31, 2008

Shares, No. of Contracts or Principal Amount	Description	Fair Value	Percent of Partners' Capital
Investments Sold, but Not Yet Purchased			
Common Stocks			
United States			
Banks			
(329,700)	JPMorgan Chase & Co.	\$ (10,395,441)	(10.44)%
	Other	(5,478,678)	(5.50)%
	Food and Food Services	(4,508,493)	(4.53)%
Medical/Pharmaceutical			
(333,000)	AmerisourceBergen Corp.	(11,874,780)	(11.93)%
(563,402)	Johnson & Johnson	(33,708,342)	(33.85)%
	Other	(435,047)	(0.44)%
Multimedia			
		(2,236,224)	(2.25)%
Oil Exploration and Production			
(1,078,028)	Chevron Corporation	(79,741,731)	(80.08)%
	Telecommunications Service and Equipment	(2,674,785)	(2.69)%
	Total United States (proceeds \$142,446,846)	<u>(151,053,521)</u>	<u>(151.71)%</u>
Germany			
(645,987)	Telecommunications Service and Equipment Deutsche Telekom AG (proceeds \$10,211,846)	(9,883,601)	(9.93)%
France			
	Telecommunications Service and Equipment (proceeds \$28,925,958)	(221,295)	(0.22)%
United Kingdom			
	Multimedia	(435,678)	(0.44)%
	Telecommunications Service and Equipment		
(753,375)	Vodafone Group Plc	(15,398,985)	(15.46)%
	Total United Kingdom (proceeds \$33,876,216)	<u>(15,834,663)</u>	<u>(15.90)%</u>
	Total investments sold, but not yet purchased (proceeds \$215,460,866)	<u>\$ (176,993,080)</u>	<u>(177.76)%</u>
Contracts for Differences			
United Kingdom			
	Multimedia	\$ (11,105)	(0.10)%
	Total contracts for differences	<u>\$ (11,105)</u>	<u>(0.10)%</u>

Note: Approximately \$173.3 million of investments owned and investments sold, but not yet purchased, are identical investments.

The accompanying notes are an integral part of this consolidated financial statement.

KDC Merger Arbitrage Fund, LP

Notes to Consolidated Statement of Financial Condition

December 31, 2008

1. Organization and Activities

KDC Merger Arbitrage Fund, LP (the "Partnership"), a Delaware limited partnership formed on March 12, 1981, is registered as a broker-dealer under Federal and New York State securities laws and as an investment adviser under the Investment Advisers Act of 1940. The Partnership engages primarily in risk arbitrage investing (i.e., investing in the securities of public companies which are the subjects of announced mergers), the related trading of securities and options, and securities lending.

Kellner DiLeo & Co., LLC is the General Partner of the Partnership.

2. Significant Accounting Policies

Basis of Presentation

The Partnership's records are maintained on the accrual basis of accounting and conform to accounting principles generally accepted in the United States of America.

Basis of Consolidation

The consolidated financial statements include the accounts of the Partnership and its wholly owned subsidiary KDC (UK) Limited. The Partnership and its subsidiary are collectively referred to hereinafter as the Partnership. All material intercompany balances and transactions have been eliminated in consolidation.

Cash and Cash Equivalents

Cash and cash equivalents include U.S. and foreign cash held on deposit and short-term investments with original maturities of three months or less. These balances are held at two commercial banks and, at times, may exceed FDIC insurable limits.

Investment Transactions

Financial instruments, including options, are recorded at fair value. Purchases and sales of financial instruments are recorded on a trade-date basis. Dividends on investments owned and on investments sold, but not yet purchased, are recognized on the ex-dividend date.

Investments which are listed on a national securities exchange are valued by the Partnership at their last sale price on the date of valuation, or, if no sales occurred on that date, at the mean "bid" and "asked" prices on that date. Investments for which quotations are not readily available or whose quotes are deemed to be inappropriate by the General Partner, are valued at estimated fair value as determined in good faith by the General Partner, based on, among other things, the type of investment or underlying investment, marketability (or absence thereof), cost and quotations from outside brokers. The fair value of financial instruments determined by the General Partner is based upon available information and is not necessarily indicative of an amount that the Partnership could realize in a current transaction. Because of the inherent uncertainty of valuation for these investments, the estimated fair value may not necessarily represent amounts that might be ultimately realized, since such amounts depend on future circumstances, and the difference could be material.

Securities Lending Activities

Securities borrowed and securities loaned are carried at the amount of cash collateral advanced or received. The Partnership monitors the market value of securities borrowed and loaned on a daily basis with additional collateral obtained or refunded as necessary.

KDC Merger Arbitrage Fund, LP

Notes to Consolidated Statement of Financial Condition

December 31, 2008

Foreign Currency Translation

The accounts of the Partnership are maintained in U.S. dollars. Assets and liabilities denominated in non-U.S. dollar currencies are translated into U.S. dollar equivalents using year-end spot foreign currency exchange rates.

Fixed Assets

Depreciation of furniture and equipment is computed by using the straight-line method over the estimated useful lives of the related assets (generally seven years). Computer equipment is depreciated over five years. Communications equipment is depreciated over ten years.

Withdrawals Payable

The Partnership recognizes withdrawals pursuant to FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity, as effected by FASB Staff Position No. FAS 150-3. Withdrawals are recognized as liabilities, net of incentive allocation, when the amount requested in the withdrawal notice becomes fixed. This generally may occur either at the time of the receipt of the notice, or on the last day of a fiscal period, depending on the nature of the request. As a result, withdrawals paid after the end of the year, but based upon year-end capital balances are reflected as withdrawals payable at December 31, 2008. Withdrawal notices received for which the dollar amount is not fixed remains in capital until the amount is determined. Withdrawals payable are treated as capital for purposes of allocations of gains and losses pursuant to the Partnership's governing documents.

Income Taxes

As a partnership, the Partnership itself is not subject to U.S. Federal income taxes; each Partner is individually liable for income taxes, if any, on its share of the Partnership's net taxable income. Interest, dividends and other income realized by the Partnership from non-U.S. sources and capital gains realized on the sale of the securities of non-U.S. issuers may be subject to withholding and other taxes levied by the jurisdiction in which the income is sourced.

Certain activities of the Partnership have caused the Partnership to be subject to New York City Unincorporated Business Tax at a rate of 4% of adjusted net taxable income.

Clearing Agreement

The Partnership clears certain of its investments through a clearing broker on a fully disclosed basis. Pursuant to the terms of the agreement between the Partnership and the clearing broker, the clearing broker has the right to charge the Partnership for losses that result from a counterparty's failure to fulfill its contractual obligations. As the right to charge the Partnership has no maximum amount and applies to all trades executed through the clearing broker, the Partnership believes that there is no determinable amount assignable to this right. At December 31, 2008, the Partnership has recorded no liabilities with regard to this right.

In addition, the Partnership has the right to pursue collection or performance from the counterparties who do not perform their contractual obligations. The Partnership monitors the credit standings of the clearing broker and all counterparties with which it conducts business.

Use of Estimates and Indemnifications

The preparation of consolidated 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 and liabilities and disclosure of contingent assets and liabilities at the date of this consolidated financial statement. Actual results could differ from those estimates.

KDC Merger Arbitrage Fund, LP
Notes to Consolidated Statement of Financial Condition
December 31, 2008

In the normal course of business, the Partnership enters into contracts that contain a variety of representations and warranties and which provide general indemnifications. The Partnership's maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against the Partnership that have not yet occurred. However, based on experience, the Partnership expects the risk of loss to be remote.

Accounting Developments

The Partnership's General Partner elected during the year ended December 31, 2007 to defer the adoption of Financial Accounting Standards Board ("FASB") Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 ("FIN 48") in accordance with FIN 48-2, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises ("FSP 48-2"). FSP 48-2 allowed the Partnership to defer the adoption of FIN 48 until annual periods beginning after December 15, 2007.

On December 30, 2008, the FASB issued FIN 48-3, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises ("FSP 48-3"), which once again deferred the effective date of FIN 48. Under FSP 48-3, in the absence of early adoption, FIN 48 will become effective for the Partnership at December 31, 2009. The General Partner has elected to take advantage of this deferral and will continue to accrue for liabilities relating to uncertain tax positions only when such liabilities are probable and reasonably estimatable. The General Partner is currently evaluating the impact of the effect of implementing this guidance.

FIN 48 requires the General Partner to determine whether a tax position of the Partnership is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement which could result in the Partnership recording a tax liability that would reduce partners' capital. FIN 48 must be applied to all existing tax positions upon initial adoption and the cumulative effect, if any, is to be reported as an adjustment to the beginning balance of partners' capital upon adoption.

In March 2008, Statement of Financial Accounting Standards ("SFAS") No. 161, "Disclosures about Derivative Instruments and Hedging Activities" ("FAS 161") was issued and is effective for fiscal years and interim periods beginning after November 15, 2008. FAS 161 requires enhanced disclosures about a partnership's derivative and hedging activities. The General Partner is currently evaluating the impact the adoption of FAS 161 will have on the Partnership's financial statement disclosures.

3. Receivable from and Payable to Brokers, Dealers and Clearing Organizations

Amounts receivable from and payable to brokers, dealers and clearing organizations at December 31, 2008 consist of the following:

Securities borrowed	\$ 1,209,175,683
Other amounts due from brokers, dealers and clearing organizations	<u>27,675,085</u>
Total receivable	<u>\$ 1,236,850,768</u>
Securities loaned	\$ 1,146,138,356
Other amounts payable to brokers, dealers and clearing organizations	<u>16,271,014</u>
Total payable	<u>\$ 1,162,409,370</u>

KDC Merger Arbitrage Fund, LP
Notes to Consolidated Statement of Financial Condition
December 31, 2008

4. Investments Owned and Investments Sold, but Not Yet Purchased

Under FAS 140, investments owned which can be resold or re-hypothecated by the holder have been reclassified on the Consolidated Statement of Financial Condition to investments owned and held by clearing broker.

Investments sold, but not yet purchased, represent obligations of the Partnership to deliver specified investments at the contracted prices and thereby create a liability to repurchase the investments in the market at prevailing prices. Accordingly, these transactions result in off-balance sheet market risk, as the Partnership's ultimate obligation to satisfy investments sold, but not yet purchased, may exceed the amount recognized in the consolidated financial statement.

The Partnership has loaned to brokers and dealers, securities having a market value of \$1,112,383,883. In addition, the Partnership has borrowed from brokers and dealers, securities having a market value of \$1,177,639,140.

5. Bank Loans

Bank loans at December 31, 2008 consist of demand loans of \$10,000, which bear interest at a rate of 2.25%. Such loans are fully collateralized by certain of the Partnership's marketable securities which are valued at \$703,500 on December 31, 2008.

6. Financial Instruments

The Partnership enters into transactions in derivative financial instruments with varying degrees of off-balance sheet risk as part of its normal proprietary trading activities and in order to reduce its exposure to market risk in connection with these activities. The values of these instruments are a function of the underlying securities values and volatilities and interest rates. These transactions include the purchases and sales of equity option contracts. A buyer of an option has the right to purchase (in the case of a call option) or sell (in the case of a put option) a specified quantity of a specific financial instrument at a specified price prior to or on a specified expiration date. A writer of an option is exposed to the risk of loss if the market price of the underlying financial instrument declines (in the case of a put option) or increases (in the case of a call option). A writer of a call option can never profit by more than the premium paid by the buyer, but can lose an unlimited amount.

The Partnership may enter into contracts for differences ("CFD") as part of its investment strategies. A CFD is an agreement between two parties to exchange the difference between the opening price and the closing price of an underlying security, at the close of the contract, multiplied by the number of shares specified within the contract. Such transactions are stated at fair value and are subject to margin and collateral requirements as stipulated by the counterparty. Net unrealized gains are reported as an asset and net unrealized losses are reported as a liability on the Consolidated Statement of Financial Condition.

KDC Merger Arbitrage Fund, LP
Notes to Consolidated Statement of Financial Condition
December 31, 2008

A summary of the fair value of the Partnership's derivative financial instruments is as follows:

	Fair Value as of December 31, 2008	
	Long	Short
Equity options	\$ 323,420	\$ -
Contracts for differences	\$ -	\$ (11,105)
Warrants and Rights	\$ 72,410	\$ -

The majority of the Partnership's transactions relate to trading in quoted securities on national securities exchanges with a diverse group of corporate and institutional counterparties. The securities loaned and securities borrowed transactions are collateralized and executed with major domestic and international brokers and dealers. The Partnership's exposure to credit risk associated with the nonperformance of these counterparties in fulfilling their contractual obligations for such transactions can be directly impacted by a volatile trading market which may impair the counterparties' ability to satisfy their obligations to the Partnership. Securities loaned and securities borrowed transactions are entered into to facilitate the trading operations and as part of a conduit business. Exposure is monitored on a daily basis, with additional collateral obtained or refunded as necessary.

7. Fair Value Measurement

SFAS No. 157 "Fair Value Measurements" ("FAS 157") establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under FAS 157 are as follows:

- Level 1 Inputs that reflect unadjusted quoted prices in active markets for identical assets or liabilities that the Partnership has the ability to access at the measurement date;
- Level 2 Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly, including inputs in markets that are not considered to be active;
- Level 3 Inputs that are unobservable.

Inputs are used in applying the various valuation techniques and broadly refer to the assumptions that market participants use to make valuation decisions, including assumptions about risk. Inputs may include price information, volatility statistics, specific and broad credit data, liquidity statistics, and other factors. A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. However, the determination of what constitutes "observable" requires significant judgment by the General Partner. The General Partner considers observable data to be that market data which is readily available, regularly distributed or updated, reliable and verifiable, not proprietary, and provided by independent sources that are actively involved in the relevant market. The categorization of a financial instrument within the hierarchy is based upon the pricing transparency of the instrument and does not necessarily correspond to the General Partner's perceived risk of that instrument.

KDC Merger Arbitrage Fund, LP
Notes to Consolidated Statement of Financial Condition
December 31, 2008

Investments whose values are based on quoted market prices in active markets, and are therefore classified within level 1, include active listed equities and listed equity options. The General Partner does not adjust the quoted price for such instruments, even in situations where the Partnership holds a large position and a sale could reasonably impact the quoted price.

Investments that trade in markets that are not considered to be active, but are valued based on quoted market prices, dealer quotations or alternative pricing sources supported by observable inputs are classified within level 2. These include contracts for differences which have inputs which can generally be corroborated by market data. As level 2 investments are not traded in active markets and/or are subject to transfer restrictions, valuations may be adjusted to reflect illiquidity and/or non-transferability, which are generally based on available market information.

Investments classified within level 3 have significant unobservable inputs, as they trade infrequently or not at all. Level 3 instruments include warrants on non public entities and securities which are non-transferable. When observable prices are not available for these securities, the General Partner uses one or more valuation techniques (e.g., the market approach or the income approach) for which sufficient and reliable data is available. Within level 3, the use of the market approach generally consists of using comparable market transactions, while the use of the income approach generally consists of the net present value of estimated future cash flows, adjusted as appropriate for liquidity, credit, market and/or other risk factors.

The inputs used by the General Partner in estimating the value of level 3 investments include the original transaction price, recent transactions in the same or similar instruments, completed or pending third-party transactions in the underlying investment or comparable issuers, subsequent rounds of financing, recapitalizations and other transactions across the capital structure, offerings in the equity or debt capital markets, and changes in financial ratios or cash flows. Level 3 investments may also be adjusted to reflect illiquidity and/or non-transferability, with the amount of such discount estimated by the General Partner in the absence of market information. The fair value measurement of level 3 investments does not include transaction costs that may have been capitalized as part of the security's cost basis. Assumptions used by the General Partner due to the lack of observable inputs may significantly impact the resulting fair value and therefore the Partnership's results of operations.

The following table presents the financial instruments carried on the Consolidated Statement of Financial Condition by caption and by level within the valuation hierarchy as of December 31, 2008.

Assets at Fair Value as of December 31, 2008				
	Level 1	Level 2	Level 3	Total
Investments owned, at fair value	\$ 208,402,744	\$ -	\$ 83,616	\$ 208,486,360

Liabilities at Fair Value as of December 31, 2008				
	Level 1	Level 2	Level 3	Total
Investments sold, but not yet purchased, at fair value	\$ (176,993,080)	\$ -	\$ -	\$ (176,993,080)
Unrealized loss on contracts for differences, at fair value	-	(11,105)	-	(11,105)
Total	\$ (176,993,080)	\$ (11,105)	\$ -	\$ (177,004,185)

KDC Merger Arbitrage Fund, LP
Notes to Consolidated Statement of Financial Condition
December 31, 2008

The following table includes a rollforward of the amounts for the year ended December 31, 2008 for financial instruments classified within level 3. The classification of a financial instrument within level 3 is based upon the significance of the unobservable inputs to the overall fair value measurement.

	Fair Value Measurements using Level 3 Inputs
Investments owned	
Balance at December 31, 2007	\$ 211,926
Net purchases and sales	274
Net change in unrealized loss	(128,584)
Balance at December 31, 2008	<u>\$ 83,616</u>

Net change in unrealized loss relates to those financial instruments held by the Partnership at December 31, 2008.

8. Commitments and Contingencies

The Partnership is obligated under lease commitments for its office space, which expire by December 31, 2009. The leases contain provisions for operating and tax escalations based on increased costs by the lessor. The minimum rental commitments under these leases at December 31, 2008 are as follows:

2009	<u>\$ 530,443</u>
	<u>\$ 530,443</u>

At December 31, 2008, the Partnership is contingently liable for letters of credit aggregating \$1,029,500, none of which are collateralized by any of the Partnership's marketable securities. Such letters of credit are primarily used to satisfy margin deposits at clearing organizations. In addition, at December 31, 2008, the Partnership had \$24,015,042 of investments owned, which have been deposited as collateral with a clearing organization to satisfy margin deposits.

9. Related Party Transactions

In the normal course of business, the Partnership pays certain expenses on behalf of its affiliated entities. The timing and payment of these amounts periodically causes payables and receivables between the Partnership and the affiliated entities.

The Partnership served as the investment advisor to an affiliated entity. The Partnership received a management fee at the rate of 1.5% per annum, payable in arrears, based on the net asset value of the limited partner accounts of such affiliated entity. This affiliated entity ceased operations at December 31, 2008.

The Partnership also provides administrative services to certain affiliated entities. The Partnership is reimbursed for all expenses incurred in connection with the provision of services to such affiliated entities. As stipulated in the Partnership's service agreement, the Partnership receives a monthly fee based upon the net assets of the affiliated entities.

At December 31, 2008, approximately \$30.4 million of limited partners' capital is owned or controlled by members or affiliates of the General Partner. Of this amount, approximately \$28.2 million relates to an

KDC Merger Arbitrage Fund, LP
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investment by a partnership organized and managed by the General Partner, where substantially all the limited partners are unaffiliated investors.

Other assets at December 31, 2008 include receivables from affiliated entities and management and administrative fees receivable totaling approximately \$292,000. Other liabilities at December 31, 2008 include a payable to a member of the General Partner of approximately \$232,000 and payables to affiliated entities of approximately \$91,000.

Withdrawals payable as of December 31, 2008 include \$495,800 payable to the General Partner.

10. Subsequent Events

In January 2009, the Partnership created a new type of limited partner interest ("Class B Interest") for investors who want to participate in profits derived from the securities lending business separate and apart from the Partnership's merger arbitrage business. Class B Interests will only be issued to an affiliated fund, KDC Alpha Securities Fund, LP ("KDC Alpha"). All of the limited partner interests in the Partnership prior to January 2009 have been deemed Class A Interests.

As of the report date, the Partnership received in 2009 approximately \$24.3 million of contributions from its partners, the majority of which were from KDC Alpha.

11. Net Capital Requirements

The Partnership is subject to the Securities and Exchange Commission's Uniform Net Capital Rule (Rule 15c3-1 or "the Rule"), which requires the maintenance of minimum net capital. The Partnership has elected to use the alternative method permitted by the Rule, which requires that it maintain minimum net capital, as defined, of \$250,000. The Partnership has net capital of \$95,624,264 at December 31, 2008, which exceeds requirements by \$95,374,264.

Anticipated partners' capital withdrawals of approximately \$14.6 million are expected within the six months following December 31, 2008.

The Partnership claims exemption under the exemptive provisions of the Securities and Exchange Commission's Rule 15c3-3 pursuant to paragraph (k)(2)(i), since it maintains no customer accounts.

**Report of Independent Auditors on
Internal Control Required By SEC Rule 17a-5**

To the Partners of KDC Merger Arbitrage Fund, LP:

In planning and performing our audit of the consolidated financial statements of KDC Merger Arbitrage Fund, LP (the "Partnership") as of and for the year ended December 31, 2008, in accordance with auditing standards generally accepted in the United States of America, we considered the Partnership's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Partnership's internal control. Accordingly, we do not express an opinion on the effectiveness of the Partnership's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (the "SEC"), we have made a study of the practices and procedures followed by the Partnership, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g), in making the following:

1. The periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11);
2. The quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13; and
3. Determining compliance with the exemptive provisions of Rule 15c3-3.

Because the Partnership does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Partnership in any of the following:

1. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System; and
2. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.

The management of the Partnership is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph, and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Partnership has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first, second, and third paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined above.

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Partnership's practices and procedures were adequate at December 31, 2008 to meet the SEC's objectives.

This report is intended solely for the information and use of the Board of Directors, management, the SEC, Financial Industry Regulatory Authority, and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.



February 25, 2009