

Item 1 – Cover Page

Nantahala Capital Management, LLC

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June 6, 2011

This Brochure provides information about the qualifications and business practices of Nantahala Capital Management, LLC (“Nantahala” or the “Firm”). If you have any questions about the contents of this Brochure, please contact us at 203-909-6430 or [paul@nantahalapartners.com](mailto:paul@nantahalapartners.com). The information in this Brochure has not been approved or verified by the United States Securities and Exchange Commission (“SEC”) or by any state securities authority.

Nantahala is a registered investment adviser with the SEC. Registration of an Investment Adviser does not imply any level of skill or training. The oral and written communications of an Investment Adviser provide you with information based on which you determine to hire or retain an Investment Adviser.

Additional information about Nantahala also is available on the SEC’s website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

## **Item 2 – Material Changes**

On July 28, 2010, the United State Securities and Exchange Commission published “Amendments to Form ADV” which amends the disclosure document that we provide to clients as required by SEC Rules. This Brochure dated June 6, 2011 is a new document prepared according to the new requirements and rules (the “Rules”). As such, this document is materially different in structure and requires certain new information that the previous version of Form ADV brochures did not require.

In the future, this Item will discuss only specific material changes that are made to the Brochure and provide clients with a summary of such changes. We will also reference the date of our last annual update of our Brochure.

Pursuant to the new Rules, we will ensure that you receive a summary of any material changes to this and subsequent Brochures within 120 days of the close of our business’ fiscal year. We may further provide other ongoing disclosure information about material changes as necessary.

We will further provide you with a new Brochure as necessary based on changes or new information, at any time, without charge. Currently, our Brochure may be requested by contacting Paul Rehm at (203)-909-6430 or [paul@nantahalapartners.com](mailto:paul@nantahalapartners.com).

Additional information about Nantahala is also available via the SEC’s web site [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov). The SEC’s web site also provides information about any persons affiliated with Nantahala who are registered, or are required to be registered, as investment adviser representatives of Nantahala.

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## **Item 4 – Advisory Business**

**A.** Nantahala Capital Management, LLC, a Massachusetts limited liability company (“Nantahala” or the “Firm”), is the investment manager to the Clients, as defined below. Nantahala was organized in May 2004. Wilmot B. Harkey and Daniel J. Mack are the principal owners and Managing Members of Nantahala.

**B.** Nantahala provides investment advice and management to privately placed investment funds including limited partnerships (the “Partnerships”) and non-U.S. companies of which Nantahala is the investment manager (the “Offshore Funds,” jointly with the Partnerships, the “Funds”). The Offshore Funds intend to pursue their investment activities by investing all or a portion of their assets in the Partnerships in a mini-master structure. Nantahala’s clients also include separately managed accounts (“Separate Accounts”), primarily for funds of funds and endowments. The Funds and Separate Accounts are jointly referred to herein as “Clients.”

Nantahala’s investment objective is to seek superior and consistent risk-adjusted returns. Nantahala focuses on investments in smaller capitalization equity, fixed-income and equity-derivative securities. Nantahala will, however, invest in other asset classes of securities as opportunities arise. Nantahala intends to achieve its objectives through value-oriented securities selection and disciplined risk management.

The Clients are offering interests (the “Interest(s)”) to certain qualified investors as described in response to Item 7, below (such investors or prospective limited partners are referred to herein as “Investors”).

**C.** Advisory services are tailored to achieve the Clients’ investment objectives. Generally, Nantahala has the authority to select which and how many securities and other instruments to buy or sell without consultation with the Clients or their Investors.

**D.** Nantahala does not participate in wrap-fee programs.

**E.** Nantahala manages the assets of the Clients. As of April 30, 2011, Nantahala manages \$197,000,000 in assets on a discretionary basis. The Firm manages no assets on a non-discretionary basis.

## **Item 5 – Fees and Compensation**

### **Management Fee.**

The compensation payable to Nantahala is negotiable and varies among its Clients. However, the range of compensation is generally as follows:

- *The Partnerships.* From the Partnerships, Nantahala typically receives a monthly or quarterly asset-based management fee calculated as a percentage of each Investor’s

capital account, payable monthly in advance, or quarterly, in arrears, depending on the specific Partnership.

- *The Offshore Funds.* From the Offshore Funds, Nantahala typically receives a monthly asset-based management fee calculated as a percentage of net asset value of each class of shares, payable monthly in advance.
- *Separate Accounts.* From Separate Accounts, Nantahala generally receives fees similar to those paid by the Funds.

**Expenses.** The Funds bear their own expenses (and, through their investment in a master Fund, their *pro rata* portions of the expenses of the master Fund), including, but not limited to, investment related expenses such as the Funds' pro-rata share of the brokerage commissions, clearing and settlement charges, interest and commitment fees on debit balances or borrowings, borrowing charges on securities sold short, interest on margin accounts and other indebtedness, custodial fees, bank service fees, withholding and transfer fees, taxes, systems and technology expenses, corporate licensing fees, legal and auditing expenses, accounting, fund administration, outsourced risk management advisory and software, outsourced compliance advisor(s), third-party research fees and other research expenses (including news and quotations services), investment related consultants whether research related or not, investment related travel costs, expenses incurred with respect to the preparation, duplication and distribution to Investors and prospective Investors of the Funds' offering documents and marketing collateral, annual reports and other financial information, any other services or service provider expenses deemed necessary by Nantahala on behalf of the Funds.

Generally, expenses for Separate Accounts are similar to those paid by the Funds.

Nantahala's fees are exclusive of brokerage commissions, transaction fees, and other related costs and expenses which shall be incurred by the Clients. Such charges, fees and commissions are exclusive of and in addition to Nantahala's management fee, and Nantahala shall not receive any portion of these commissions, fees, and costs.

The management fees, incentive allocations (see Item 6, below) and expenses are deducted from Client assets with respect to the Funds and billed to Clients in the case of Separate Accounts. Nantahala will pro rate the management fee for Interests held for less than a full month or quarter, as applicable. Prepaid but unearned fees are refunded to the Clients and/or Investors, as the case may be.

Item 12 further describes the factors that Nantahala considers in selecting or recommending broker-dealers for Client transactions and determining the reasonableness of their compensation (*e.g.*, commissions).

## Item 6 – Performance-Based Fees and Side-By-Side Management

In addition to the management fees described in response to Item 5, Nantahala also receives a performance-based incentive allocation. The incentive allocation is negotiable and varies among Clients. However, the range of compensation is generally as follows:

- *The Partnerships.* Nantahala generally receives an incentive allocation equal to a percentage of the net income allocated to each Investor for the year, but only to the extent net income allocated to that Investor exceeds any cumulative losses that were allocated to that Investor for earlier periods and that have not been recovered (a “high water mark”). This special allocation is typically made at the end of each calendar year.
- *The Offshore Funds.* Nantahala generally receives an incentive allocation equal to a percentage of the realized and unrealized profits for each series of shares generally for each calendar year, calculated and paid annually in a manner similar to the special allocation described above for the Partnerships.
- *Separate Accounts.* From Separate Accounts, Nantahala generally receives fees similar to those paid by the Partnerships and Offshore Funds.

**The foregoing responses to Items 5 and 6 represent Nantahala’s basic compensation arrangements. The management fees and incentive allocation described above are structured to comply with Rule 205-3 under the Investment Advisers Act of 1940. Fees and other compensation are negotiable in certain circumstances and arrangements with any particular Investor may vary. Although the Firm believes its fees are competitive, lower fees for comparable services may be available from other investment advisers.**

## Item 7 – Types of Clients

Nantahala provides investment advice and management to the Partnerships, Offshore Funds and Separate Accounts. Separate Account clients may include funds of funds and endowments.

Nantahala may in the future provide the same or similar services to other privately placed investment funds and/or separately managed accounts.

Prospective Investors in the Funds must meet eligibility criteria as set forth below, and are subject to certain withdrawal requirements and limitations. Prospective Investors are encouraged to thoroughly review the Funds’ offering documents and any other materials provided by Nantahala, which set forth all of the terms in detail. Though the Clients generally pursue the same strategy, offering terms may differ. Terms for Separate Accounts are generally similar to the Funds, but can be negotiated on a case by case basis and may differ from those of the Funds.

- *The Partnerships.* Depending on the Fund, Interests are offered to “accredited investors” (as defined in Regulation D under the Securities Act of 1933) and to “qualified purchasers” (as defined in Section 2(a)(51) of the U.S. Investment Company Act of 1940, as amended). The minimum initial investment is \$1,000,000, and the minimum additional investment is \$250,000, subject to waiver at the discretion of Nantahala.
- *The Offshore Funds.* Shares are offered to non-U.S. persons and a limited number of U.S. persons who are: “qualified purchasers,” “accredited investors”, and exempt from U.S. federal income taxation. The minimum initial investment is \$1,000,000 and the minimum additional investment is \$250,000. Nantahala reserves the right to waive or to increase or decrease these minimum subscription amounts in its discretion, subject to a minimum investment of \$100,000, or such other minimum as may be required by Cayman Islands regulation.
- *Separate Accounts.* Generally, similar terms will apply to Separate Accounts, though Investors in such separate accounts may negotiate terms that differ or are more favorable than those for the Funds.

## **Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss**

Investing in securities involves risk of loss that Clients and their Investors should be prepared to bear. Please refer to the Funds’ offering documents for a more detailed discussion of Nantahala’s investment strategy and related risks.

### **METHODS OF ANALYSIS**

The investment objective of Nantahala is to provide Clients with superior risk-adjusted returns on their capital. There can be no assurance that the Clients will achieve this objective or that substantial losses will not be incurred.

Nantahala practices research intensive, fundamental security selection and bases its investment decisions on internally generated research and research obtained from outside sources. Nantahala may take long and short positions in a wide range of public and private equity and debt securities and derivatives, including, but not limited to, listed equities, when-issued equities, bonds, listed put or call options, OTC derivatives, loans, and other instruments in implementing its strategies and, in certain cases, these positions are leveraged, either through outright borrowings or through leverage embedded in derivatives acquired by the Clients.

Nantahala focuses on intrinsic value by identifying securities which are mispriced relative to the real economic value they represent, and on the expected timing for the mispricing to be corrected by market forces. Nantahala generally invests in securities it believes are

substantially mispriced and are likely to revalue in the short- to medium-term. With a process that focuses on not only the long-term value of a security but also the reasons a security might be mispriced, Nantahala strives to further reduce risk by attempting to avoid situations where long-term value may never be realized.

Nantahala's approach to assessing a particular security's risk characteristics divides risk into two types: 1) the specific risks of the security; and 2) the general risks associated with the security's asset class or sector. Nantahala manages the first type of risk by appropriately allocating capital, meaning the riskier a security appears to be, the smaller a portion of capital can be allocated to it. The second type of risk is managed by taking opposing positions to neutralize general exposures Nantahala does not wish to take. For example, if the General Partner favors a particular retailer over others but does not want to be exposed to the general risk of the retail sector, then Nantahala will take positions against other retailers so that the net exposure to the overall retail sector is neutralized. Generally, Nantahala seeks to build a portfolio from a bottoms-up basis that minimizes systemic risk in the portfolio.

From a top-down basis, Nantahala's portfolio risk management philosophy is designed to protect the portfolio from large and difficult to predict moves in markets and individual securities via 1) balancing systemic risks, 2) large margins of safety, 3) medium diversification, 4) long optionality and 5) no or very modest use of leverage.

## **INVESTMENT STRATEGY**

Nantahala will pursue investment opportunities in a variety of asset classes, investing solely for profit, while employing a variety of hedging methodologies in an attempt to hedge risks associated the Clients' portfolios. Without limiting the nature of the securities or the nature of the strategies in which the Clients may invest, the following represent some of the strategies the Nantahala will deploy including:

**Undervalued Equity Securities.** Nantahala looks at four elements in determining whether a security is undervalued: 1) the value of the business; 2) the value of the security; 3) the price of the security; and 4) the relationship between value and price. Nantahala seeks to make an investment at a price that will reflect a "margin of safety," a discount to estimated value that compensates the Client sufficiently for the risks inherent in the security.

**Overvalued Equity Securities.** Many of the points made in the section on undervalued equities pertain here except with the opposite objective of attempting to profit from price declines by selling short overvalued securities. Reasons for establishing a short position on a security may include, but are not limited to: little or no revenue growth, a perilous financial condition, questionable management, evidence of accounting irregularities, or a poor competitive position. Shorting a security often involves additional risks of "buy-in", which is the forced closure of the short position by the prime broker in order to return the borrowed security, and the unlimited loss potential of a short position due to the lack of a theoretical ceiling value.



**Risk Arbitrage.** Nantahala may employ risk arbitrage in assessing the probability that an announced transaction will be completed, the timing of such a transaction, and the risk that the terms of the transaction will change. The transaction may be a merger, tender offer, sale, liquidation, spin-off, exchange offer or other form of asset conversion. The assessment of probability, risk, valuation, and timing requires analysis of business, financial, regulatory, and legal issues specific to each transaction. A risk arbitrage investment may involve long or short positions, or a combination of the two.

**High-Yield Securities.** Economic cycles and changes in interest rates, in addition to issuer-specific developments, sometimes produce attractive opportunities to purchase high-yield securities. These securities include debt and preferred stock rated below investment grade. Many of these companies are highly leveraged and have complex capital structures. The securities of such issuers may present investment opportunities due to limited research coverage, a greater than average sensitivity to overall market movements, and the analytical challenges involved in determining the fair value of such securities.

**Financially Distressed Issuers.** Nantahala may from time to time purchase debt securities of issuers experiencing financial distress present opportunities since the market often fails to value accurately the issuer's securities or to assess the likely effect of future events. Debt investments may take the form of the purchase of bank loans, equipment leases, trade payables and traded debt or preferred stock of companies which may undergo Chapter 11 bankruptcy proceedings, financial reorganizations, exchange offers, liquidations, and other extraordinary transactions. The Clients may also invest in equity securities of such companies.

**Capital Structure Arbitrage.** The Clients will also engage in modified capital structure arbitrage which consists of the purchase of securities of an issuer coupled with the sale of other securities of the same issuer to take advantage of attractive price disparities and/or otherwise to hedge certain of its exposure given that particular issuer's financial situation. Nantahala will seek to evaluate the terms and structure of an issuer's debt and equity securities relative to each other and to the issuer's business risk as well as an expected revaluation event. Nantahala will generally seek capital structure arbitrage situations in which a revaluation catalyst is anticipated in the short to medium term. In addition, the Clients may be net long or net short.

**Leverage.** The Clients have the power to borrow and may do so when deemed appropriate by Nantahala, including enhancing the Clients' return and meeting redemptions that would otherwise result in the premature liquidation of investments.

**Long and Short Positions.** Generally, the majority of the Clients' investments will be "long" positions in which the Clients own securities for capital appreciation and/or income. The Clients' long positions may be "hedged" by various methods in order to protect against broad market declines. When market valuation conditions dictate, or when Nantahala anticipates a decline in the price of a security, it may sell "short" an index of securities or the securities of a particular issuer. Selling short involves borrowing and selling securities

which the Clients do not own. Short sales may be used for profit or as a hedging device to control risk.

**Control Positions.** From time to time, a Client may purchase a large enough position in a company to have some influence, friendly or unfriendly, on the management and/or board of directors of that company. The Client may propose shareholder resolutions at the company's annual meeting, hire proxy solicitation firms to oppose company sponsored resolutions, nominate one or more persons (whether affiliated with Nantahala or not) to the board of directors, or otherwise attempt to influence the company's direction.

**Foreign Securities.** Nantahala will monitor investment opportunities in capital markets outside of the United States, as well as in foreign securities traded in domestic markets. Investment decisions will be based upon criteria similar to those employed in U.S. markets with additional consideration being given to currency risk and the host country's political, regulatory and tax environment. Nantahala will hedge potential foreign currency risk where appropriate.

**Risk Management and Diversification.** Nantahala's commitment to risk management is significant and it will employ a disciplined approach to managing risk. Nantahala focuses on security selection in an attempt to mitigate risk. Although Clients will have no fixed diversification requirements, Nantahala seeks to mitigate security selection risk by hedging, position and industry size limits, loss limit strategies and other risk management considerations.

Although Clients will generally not make speculative investments in "macro" instruments, such as foreign currencies, physical commodities or sovereign fixed-income securities, Clients may invest its excess funds in short-term investments, including U.S. Government securities, money market funds, commercial paper, certificates of deposit and bankers' acceptances. At times, Clients may maintain higher levels of cash and cash equivalents than are necessary to meet short-term cash needs, and may invest in longer-term debt instruments. Clients may also utilize foreign currency instruments but will limit its use to the hedging of foreign currency exposures resulting from their investment in the securities of non-U.S. companies.

Nantahala is not limited with respect to the types of investment strategies it may employ, the markets or instruments in which it may invest or the percentage of its capital that may be invested in a single security. Clients may also enter into joint venture arrangements, co-invest with third parties or otherwise participate in pooled investment vehicles with others. Depending on conditions and trends in securities markets and the economy generally, Nantahala may pursue other objectives or employ other techniques it considers appropriate and in the best interests of the Clients.

## **INVESTMENT AND TRADING RISKS**

**Risks Associated with Investments in Distressed Securities.** Nantahala invests in "below investment grade" securities and obligations of domestic and non-U.S. issuers in

weak financial condition, experiencing poor operating results, having substantial capital needs or negative net worth, facing special competitive or product obsolescence problems, including companies involved in bankruptcy or other reorganization and liquidation proceedings. Some of these securities may not be publicly traded, and it therefore may be difficult to obtain information as to the true condition of such issuers. Additionally, in certain periods, there may be little or no liquidity in markets for these securities. Such investments also may be affected adversely by laws relating to, among other things, fraudulent transfers and other voidable transfers or payments, lender liability and the bankruptcy court's power to disallow, reduce, subordinate or disenfranchise particular claims.

**Bank Loans.** Nantahala's investment program may include investments in significant amounts of bank loans and participations. These obligations are subject to unique risks, including: (i) the possible invalidation of an investment transaction as a fraudulent conveyance under relevant creditors' rights laws; (ii) so-called lender-liability claims by the issuer of the obligations; (iii) environmental liabilities that may arise with respect to collateral securing the obligations; and (iv) limitations on the ability of the Clients to directly enforce their rights with respect to participations.

**Bankruptcy Claims.** Nantahala may invest in bankruptcy claims which are amounts owed to creditors of companies in financial difficulty. Bankruptcy claims are illiquid and generally do not pay interest and there can be no guarantee that the debtor will ever be able to satisfy the obligation on the bankruptcy claim. The markets in bankruptcy claims are not generally regulated by U.S. federal securities laws or the SEC. Because bankruptcy claims are frequently unsecured, holders of such claims may have a lower priority in terms of payment than certain other creditors in a bankruptcy proceeding. In addition, under certain circumstances, payments and distributions may be reclaimed if any such payment is later determined to have been a fraudulent conveyance or a preferential payment.

**Risks Associated with Bankruptcy Cases.** Many of the events within a bankruptcy case are adversarial and often beyond the control of the creditors. While creditors generally are afforded an opportunity to object to significant actions, there can be no assurance that a bankruptcy court would not approve actions that may be contrary to the interests of the Clients. In some cases, the company may not be able to reorganize and may be required to liquidate assets. Such investments can result in a total loss of principal. Investment in the debt of financially distressed companies domiciled outside the United States involves additional risks. Bankruptcy law and process may differ substantially from that in the United States, resulting in greater uncertainty as to the rights of creditors, the enforceability of such rights, reorganization timing and the classification, seniority and treatment of claims. In certain developing countries, although bankruptcy laws have been enacted, the process for reorganization remains highly uncertain. Nantahala, on behalf of the Clients, may elect to serve, directly or through an affiliate, on creditors' committees, equity holders' committees or other groups to ensure preservation or enhancement of the Clients' position as creditors or equity holders. In addition, a portion of the Clients' assets will be invested in securities and loans with limited liquidity. If the Clients are represented

by Nantahala on a committee or group, they may be restricted or prohibited under applicable law from disposing of its investments in such company while it continues to be represented on such committee or group.

**Loans of Portfolio Securities.** Nantahala may lend the Clients' portfolio securities. In the event of the bankruptcy of the other party to a securities loan there could be delays in recovering the securities lent. To the extent that the value of the securities the Clients lent has increased, the Clients could experience a loss if such securities are not recovered.

**Non-Performing Nature of Debt.** It is anticipated that certain debt instruments purchased by Nantahala for the Clients will be non-performing and possibly in default. Furthermore, the obligor or relevant guarantor may also be in bankruptcy or liquidation. There can be no assurance as to the amount and timing of payments, if any, with respect to the loans.

**Convertible Securities.** Convertible securities are bonds, debentures, notes, preferred stocks or other securities that may be converted into or exchanged for a specified amount of common stock of the same or different issuer within a particular period of time at a specified price or formula. A convertible security entitles its holder to receive interest that is generally paid or accrued on debt or a dividend that is paid or accrued on preferred stock until the convertible security matures or is redeemed, converted or exchanged. A convertible security may be subject to redemption at the option of the issuer at a price established in the convertible security's governing instrument. If a convertible security held by the Clients is called for redemption, the Clients will be required to permit the issuer to redeem the security, convert it into the underlying common stock or sell it to a third-party. Any of these actions could have an adverse effect on the Clients' ability to achieve their investment objective.

**Commodities and Derivative Investments.** The prices of commodities contracts and derivative instruments, including futures and options, are highly volatile. Payments made pursuant to swap agreements may also be highly volatile. Price movements of commodities, futures and options contracts and payments pursuant to swap agreements are influenced by, among other things, interest rates, changing supply and demand relationships, trade, fiscal, monetary and exchange control programs and policies of governments, and national and international political and economic events and policies.

**Highly Volatile Markets.** The prices of financial instruments in which Nantahala may invest can be highly volatile. Price movements of forward and other derivative contracts in which the Clients' assets may be invested are influenced by, among other things, interest rates, changing supply and demand relationships, trade, fiscal, monetary and exchange control programs and policies of governments, and national and international political and economic events and policies. The Clients are subject to the risk of failure of any of the exchanges on which their positions trade or of its clearinghouses.

**Use of Leverage and Financing.** Nantahala may leverage the Clients' capital because the use of leverage may enable the Clients to achieve a higher rate of return. Accordingly,

Nantahala may pledge Clients' securities in order to borrow additional funds for investment purposes. Any event which adversely affects the value of an investment by the Clients would be magnified to the extent the Clients are leveraged. The cumulative effect of the use of leverage by the Clients in a market that moves adversely to the Clients' investments could result in a substantial loss to the Clients which would be greater than if the Clients were not leveraged.

**Hedging Transactions.** Nantahala is not required to attempt to hedge portfolio positions of Clients and, for various reasons, may determine not to do so. Furthermore, Nantahala may not anticipate a particular risk so as to hedge against it. While Nantahala may enter into hedging transactions to seek to reduce risk, such transactions may result in a poorer overall performance for the Clients than if it had not engaged in any such hedging transactions. For a variety of reasons, Nantahala may not seek to establish a perfect correlation between such hedging instruments and the portfolio holdings being hedged. Such imperfect correlation may prevent the Clients from achieving the intended hedge or expose the Clients to risk of loss.

**Derivatives and Hedging.** Nantahala may invest and trade in a variety of derivative instruments, both to hedge the Clients' portfolios and for profit. Derivatives are financial instruments or arrangements in which the risk and return are related to changes in the value of other assets, reference rates or indices. The Clients' ability to profit or avoid risk through investment or trading in derivatives will depend on Nantahala's ability to anticipate changes in the underlying assets, reference rates or indices.

**Short Selling.** Short selling involves selling securities which are not owned and borrowing them for delivery to the purchaser, with an obligation to replace the borrowed securities at a later date. Short selling allows the investor to profit from declines in market prices to the extent such decline exceeds the transaction costs and the costs of borrowing the securities. A short sale creates the risk of a theoretically unlimited loss, in that the price of the underlying security could theoretically increase without limit, thus increasing the cost to the Clients of buying those securities to cover the short position. There also can be no assurance that the securities necessary to cover a short position are available for purchase at or near prices quoted in the market. Purchasing securities to close out the short position can itself cause the price of the securities to rise further, thereby exacerbating the loss.

**Forward Trading.** Forward contracts and options thereon, unlike futures contracts, are not traded on exchanges and are not standardized; rather banks and dealers act as principals in these markets, negotiating each transaction on an individual basis. Forward and "cash" trading is substantially unregulated; there is no limitation on daily price movements and speculative position limits are not applicable. There have been periods during which certain participants in these markets have refused to quote prices for certain currencies or commodities or have quoted prices with an unusually wide spread between the price at which they were prepared to buy and that at which they were prepared to sell. Disruptions can occur in any market traded by Nantahala due to unusually high trading volume, political intervention or other factors. The imposition of controls by governmental

authorities might also limit such forward (and futures) trading to less than that which Nantahala would otherwise recommend, to the possible detriment of the Clients. Market illiquidity or disruption could result in major losses to the Clients.

**Limited Diversification.** Nantahala's investments are primarily focused geographically in North American countries. Furthermore, broad diversification of investments in number or by industry or geography is not a primary investment objective of Nantahala. At any given time, it is therefore possible that Nantahala may select investments that are concentrated in a limited number or types of investments. This limited diversity could expose the Clients to losses disproportionate to market movements in general if there are disproportionately greater adverse price movements in those investments.

**Non-U.S. Securities.** Investments in securities of non-U.S. issuers (including non-U.S. governments) pose a range of potential risks which could include expropriation, confiscatory taxation, imposition of withholding or other taxes on dividends, interest, capital gains or other income, political or social instability, illiquidity, price volatility and market manipulation. In addition, less information may be available regarding securities of non-U.S. issuers, and non-U.S. issuers may not be subject to accounting, auditing and financial reporting standards and requirements comparable to or as uniform as those of U.S. issuers.

**Emerging Markets.** In addition to the risks associated with investments outside of the United States, investments in emerging markets (i.e., the developing countries) may involve additional risks. Emerging markets generally are not as efficient as those in developed countries. In some cases, a market for the security may not exist locally, and transactions will need to be made on a neighboring exchange. Volume and liquidity levels in emerging markets are lower than in developed countries and little or no market may exist for the securities. Clients may be subject to a number of additional risks, including inadequate investor protection, contradictory legislation, incomplete, unclear and changing laws, ignorance or breaches of regulations on the part of other market participants, lack of established or effective avenues for legal redress, lack of standard practices and confidentiality customs characteristic of developed markets, and lack of enforcement of existing regulations.

**Litigation.** Reorganizations can be contentious and adversarial. It is by no means unusual for participants to use the threat of, as well as actual, litigation as a negotiating technique. Nantahala anticipates that the Clients and perhaps certain of their larger Investors may be named as defendants in civil proceedings. The expense of defending against claims by third parties and paying any amounts pursuant to settlements or judgments would generally be borne by the Clients.

**Fraud.** Of paramount concern in lending is the possibility of material misrepresentation or omission on the part of the borrower. Such inaccuracy or incompleteness may adversely affect the valuation of the collateral underlying the loans or may adversely affect the ability of the Clients to perfect or effectuate a lien on the collateral securing the loan. Nantahala

will rely upon the accuracy and completeness of representations made by borrowers to the extent reasonable, but cannot guarantee such accuracy or completeness.

**Illiquid Investments.** Nantahala may invest in securities, bank debt and other claims, and other assets, which are subject to legal or other restrictions on transfer or for which no liquid market exists. The market prices, if any, for such investments tend to be volatile and may not be readily ascertainable, and Nantahala may not be able to sell them when it desires to do so or to realize what it perceives to be their fair value in the event of a sale.

**Valuation.** Securities which Nantahala believes are fundamentally undervalued or overvalued may not ultimately be valued in the capital markets at prices and/or within the time frame Nantahala anticipates. In particular, purchasing securities at prices which Nantahala believes to be distressed or below fair value is no guarantee that the price of such securities will not decline even further. Similarly, securities deemed overvalued and sold short, may continue to appreciate further.

**Uncertain Exit Strategies.** Due to the illiquid nature of some of the positions which Nantahala may acquire for the Clients, as well as the uncertainties of the reorganization and active management process, Nantahala is unable to predict with confidence what the exit strategy will ultimately be for any given core position, or that one will definitely be available. Exit strategies which appear to be viable when an investment is initiated may be precluded by the time the investment is ready to be realized due to economic, legal, political or other factors.

**Counterparty Risk.** Some of the markets in which Nantahala may effect the Clients' transactions are "over-the-counter" or "interdealer" markets. The participants in such markets are typically not subject to credit evaluation and regulatory oversight as are members of "exchange-based" markets. This exposes the Clients to the risk that a counterparty will not settle a transaction in accordance with its terms and conditions because of a dispute over the terms of the contract (whether or not bona fide) or because of a credit or liquidity problem, thus causing the Clients to suffer a loss.

**Terrorist Action.** There is a risk of terrorist attacks on the United States and elsewhere causing significant loss of life and property damage and disruptions in global markets. Economic and diplomatic sanctions may be in place or imposed on certain states and military action may be commenced. The impact of such events is unclear, but could have a material effect on general economic conditions and market liquidity.

**The foregoing list of risk factors does not purport to be a complete enumeration or explanation of the risks involved in an investment with Nantahala. Prospective Investors should read the entire Brochure, including the potential conflicts of interest described in Item 11 as well the relevant Fund's offering documents, other materials that may be provided by Nantahala and consult with their own advisers before deciding to subscribe for Interests.**

## **Item 9 – Disciplinary Information**

Registered investment advisers are required to disclose all material facts regarding any legal or disciplinary events that would be material to your evaluation of Nantahala or the integrity of Nantahala’s management. Nantahala has no information applicable to this Item.

## **Item 10 – Other Financial Industry Activities and Affiliations**

Nantahala is the investment adviser to the Clients as described above. In addition, it is the general partner of the Partnerships, and sponsor of the Offshore Funds. The Partnerships and Offshore Funds are engaged in private offerings of Interests to certain qualified Investors, as described more fully in response to Item 7, above.

### **Conflicts of Interest.**

**Generally.** Nantahala does not have any clients other than the Funds and the Separate Accounts, although it may advise additional funds or other clients in the future. Nantahala does not expect to be engaged to advise clients as to the appropriateness of investing in the Funds or through any Separate Account, nor will it receive any compensation for doing so.

**Nantahala Conflicts of Interest.** Nantahala will use its best efforts in connection with the purposes and objectives of the Clients and will devote as much of its time and effort to the affairs of the Clients as they deem necessary and appropriate to accomplish the purposes of the Clients. Under the terms of the Clients’ governing documents, Nantahala and its directors, members, partners, shareholders, officers, employees, agents and affiliates (hereinafter referred to as the “Affiliated Parties”) may conduct any other business, including any business within the securities industry, whether or not such business is in competition with the Clients. Without limiting the generality of the foregoing, the Affiliated Parties may act as investment adviser or investment manager for others, may manage funds, separate accounts or capital for others and may serve as an officer, director, consultant, partner or stockholder of one or more investment funds, partnerships, securities firms or advisory firms. In this regard, it should be noted that Nantahala and the Affiliated Parties intend to act as the investment manager to an offshore fund with a substantially similar investment program and method of operation to that of the Clients, and Nantahala and the Affiliated Parties may, in the future, also serve as the general partner and Nantahala, respectively, for other private investment partnerships with a substantially similar investment program and method of operation to that of the Clients. Such other entities or accounts may have investment objectives or may implement investment strategies similar or different to those of the Clients. In addition, the Affiliated Parties may, through other investments, including other investment funds, have interests in investments which the Clients invest as well as interests in investments in which the Clients do not invest. As a result of the foregoing, the Affiliated Parties may have conflicts of interest in allocating their time and activity between the Clients and other entities, in



allocating investments among the Clients and other entities and in effecting transactions for the Clients and other entities, including ones in which the Affiliated Parties may have a greater financial interest.

**Investment Opportunities.** Neither Nantahala nor the Affiliated Parties is obligated to make any particular investment opportunity available to the Clients and may take advantage of any opportunity, either for other accounts Nantahala manages or for themselves.

**Allocations.** The Affiliated Parties may give advice or take action with respect to such other entities or accounts that differs from the advice given with respect to the Clients. To the extent a particular investment is suitable for both the Clients and other clients of the Affiliated Parties, such investments may be allocated between the Clients and the other clients in some manner that the Affiliated Parties determine is fair and equitable under the circumstances to all clients, including the Clients. When it is determined that it would be appropriate for the Clients and one or more other investment accounts managed by Nantahala or its affiliates to participate in an investment opportunity, Nantahala will seek to execute orders for all of the participating investment accounts, including the Clients, on an equitable basis, taking into account such factors as the relative amounts of capital available for new investments, relative exposure to short-term market trends, and the investment programs and portfolio positions of the Clients and the affiliated entities for which participation is appropriate. Orders may be combined for all such accounts, and if any order is not filled at the same price, they may be allocated on an average price basis. Similarly, if an order on behalf of more than one account cannot be fully executed under prevailing market conditions, securities may be allocated among the different accounts on a basis which Nantahala or its affiliates consider equitable.

**Calculation of NAV.** Nantahala has the responsibility for calculating the net asset value of capital accounts, upon which its management fee is based.

The foregoing description of conflicts of interest does not purport to be a complete list of potential conflicts. Other present and future activities of Nantahala and its affiliates may give rise to additional conflicts of interest. If a conflict of interest arises, Nantahala will attempt to resolve such conflicts in a fair and equitable manner.

## **Item 11 – Code of Ethics**

### **Code of Ethics.**

Nantahala has adopted a Code of Ethics (the “Code”) pursuant to Rule 204A-1 under the Investment Advisers Act of 1940, as amended. The Code governs the activities of each member, officer, director and employee of Nantahala (collectively, “Employees”). Nantahala holds its Employees to a high standard of integrity and business practices that reflects its fiduciary duty to the Client. In serving its Client, Nantahala strives to avoid conflicts of interest or the appearance of conflicts of interest in connection with the personal trading

activities of its Employees and Client securities transactions. When persons covered by the Code engage in personal securities transactions, they must adhere to the following general principles as well as to the Code's specific provisions: (a) at all times the interests of Client must be paramount; (b) personal transactions must be conducted consistent with the Code in manner that avoids any actual or potential conflict of interest; and (c) no inappropriate advantage should be taken of any position of trust and responsibility. Employees covered by the Code have certain trading restrictions and reporting obligations of their personal securities transactions. Each Employee is provided with a copy of the Code and must annually certify that they have received it and have complied with its provisions. In addition, any Employee who becomes aware of any potential violation of the Code is obligated to report the potential violation to the Chief Compliance Officer.

Although Nantahala's policies and procedures generally prohibit Affiliated Parties from trading in the same instruments that Nantahala buys or sells for Client Accounts, there may be limited circumstances in which Nantahala and/or the Affiliated Parties may also personally buy or sell the same instruments that Nantahala buys or sells for Client accounts, and it or they may own securities, or options on securities, of issuers whose securities are subsequently bought for Client accounts. Nantahala's policy as to such transactions is that neither Nantahala nor any of the Affiliated Parties are to benefit from price movements that may be caused by transactions for Client accounts or otherwise because of Nantahala's recommendations regarding a particular security.

Nantahala will make available a full copy of the Code upon request. A request may be made by calling Paul Rehm at (203)909-6430 or [paul@nantahalapartners.com](mailto:paul@nantahalapartners.com).

## **Item 12 – Brokerage Practices**

**Investment Discretion.** Generally, Nantahala has the authority to select which and how many securities and other instruments to buy or sell without consultation with any Clients or any Investors in the Clients.

**Brokerage, Generally.** In acquiring and disposing of investment positions, Nantahala generally has complete discretion to select the brokers, dealers, futures commission merchants, swap dealers and counterparties, counterparties to other transactions and investment positions, and other financial intermediaries ("Transacting Parties"). Nantahala may also cause securities to be bought from underwriters in public offerings at prices that include compensation to the underwriters. Nantahala has complete discretion in negotiating the prices for investment positions and the amounts and nature of transaction-related compensation, if any, the Clients will pay.

**Selection Criteria, Generally.** In choosing Transacting Parties, Nantahala is not required to consider or focus on any particular criteria. However, Nantahala seeks "best execution" of the securities transactions of the Clients. What constitutes "best execution" and determining how to achieve it are inherently uncertain. In evaluating whether a

Transacting Party will provide best execution, Nantahala considers a range of factors. These include, among others, historical net prices (after markups, markdowns or other transaction-related compensation) on other transactions; the execution, clearance and settlement and error correction capabilities of the Transacting Party generally and in connection with securities of the type and in the amounts to be bought or sold (including the ability to follow instructions, provide timely reporting, maintain confidentiality, and provide market color); the Transacting Party's willingness to commit capital; the Transacting Party's reliability and financial stability; the size of the transaction; the availability of securities to borrow for short sales; the market for the security; and, as discussed more fully below, the nature, quantity and quality of research and other services and products provided by the Transacting Party. Nantahala is not required to select the Transacting Party that charges the lowest transaction cost, even if that Transacting Party can provide execution quality comparable to other Transacting Parties, and Nantahala expects at times to pay more than the lowest transaction cost available in order to obtain for the Clients, any other accounts, itself and its related persons, services and products other than the execution of securities transactions.

Nantahala does not currently use soft dollars, nor does it intend to do so in the future. If Nantahala decides to use soft dollars, it will be for items which are within the Section 28(e) "safe harbor."

**Aggregation of Orders.** Nantahala may (but is not required to) combine orders on behalf of one Client account with orders for other Client accounts for which it or its principals have trading authority, or in which it or its principals have an economic interest. When it does, Nantahala will generally allocate the securities or proceeds arising out of those transactions (and the related transaction expenses) on an average price basis among the various participants. Nantahala believes combining orders in this way will, over time, be advantageous to all participants. However, the average price could be less advantageous to a Client than if that Client had been the only account effecting the transaction or had completed its transaction before the other participants. Because of Nantahala's relationship to the Clients it manages by virtue of its position as an investment manager, there may be circumstances in which transactions for those entities may not, under certain laws, regulations and internal policies, be combined with those of some of Nantahala's and its affiliates' other Clients, which may result in less advantageous execution for those Clients.

Nantahala may place orders for the same security for different Clients at different times and in different relative amounts due to differences in investment objectives, cash availability, size of order and practicability of participating in "block" transactions. The level of participation by different Clients in the same security may also be dependent upon other factors relating to the suitability of the security for the particular Client.

In addition, Nantahala and/or its related persons or Clients may buy or sell specific securities for its or their own account that are not deemed appropriate for Client accounts at the time, based on personal investment considerations that differ from the considerations on which decisions as to investments in client accounts are made. Where

execution opportunities for a particular security are limited, Nantahala attempts in good faith to allocate such opportunities among Clients in a manner that, over time, is equitable to all clients.

**Cross Transactions.** Nantahala may (but is not obligated to) cause accounts that Nantahala manages to effect “cross” transactions (i.e., buy and sell securities from and to each other), subject to applicable law or regulation. Nantahala may do so, if Nantahala believes that the cross transaction will be beneficial to both parties.

**“Prime Brokerage,” Custody, Clearing and Settling.** The Clients and any other accounts that Nantahala manages obtain custodial, clearing and related services through what are known as “prime brokerage” arrangements. Under this type of arrangement, a “Prime Broker” (i) maintains custody of the client’s assets (either directly or through its clearing brokerage firm); (ii) provides margin credit and locates securities to borrow to facilitate short sales; (iii) arranges for the receipt and delivery of securities bought, sold, borrowed and lent; (iv) makes and receives payments for securities; (v) tenders securities in connection with tender offers, exchange offers, mergers or other corporate reorganizations; (vi) provides detailed portfolio and related reports; and (vii) provides related services. The arrangement permits the client to use other brokers to execute transactions, thereby permitting Nantahala to seek valuable research and to compare execution quality and commission rates maintaining a primary custodial relationship. By using brokerage firms for these functions, the client also may avoid paying custodial fees that banks charge other institutional investors. Prime Brokers are compensated through interest on credit balances, margin borrowings, stock loans and brokerage commissions. It is possible that a material amount of a client’s capital may be deposited with a Prime Broker as margin and collateral.

Prime Brokers may appoint sub-custodians for portions of the assets in its prime brokerage account. Nantahala may change Prime Brokers, use additional Prime Brokers, alter the terms of its arrangements with a Prime Broker, or make alternative arrangements to receive the services currently provided by a Prime Broker, all in the absolute discretion of Nantahala or its related persons.

A Prime Broker may provide, and the current prime brokers of the Clients and any other clients have in the past provided, services to Nantahala and/or their respective affiliates, distinct from the custodial, lending and related services the Prime Broker provides to the Clients. These services may include, among other things, consulting services with respect to various aspects of Nantahala’s or its related persons’ business and introducing Nantahala or its related persons to prospective advisory clients and prospective Investors in the investment funds Nantahala manages. They may be provided at lower than the market price for similar services or for no charge. A Prime Broker may also enter, and has in the past entered, into financial transactions with (including lending money to) its related persons, Nantahala or their respective affiliates, and these transactions may be on terms more favorable than the terms available with other counterparties. A Prime Broker may invest or cause an affiliate to invest in one or more Clients, including newly-formed funds.

Because Nantahala or its related persons select or recommend Prime Brokers and/or negotiate the rates of compensation clients pay to the Prime Brokers any of the foregoing transactions or arrangements may create conflicts between Nantahala's and its related persons' interests and the interests of the Clients that use the relevant Prime Broker(s). To the extent a Prime Broker provides or its related persons provide Nantahala or its affiliates with services at lower than market prices, enter into transactions on terms better for Nantahala or its affiliates than terms available in the market, or invest in a client of Nantahala, Nantahala may have an incentive to cause the Clients to accept less favorable pricing for prime brokerage services (including interest and similar charges on margin borrowings and short positions) than might be available otherwise or to continue to use that Prime Broker when the Clients would not otherwise do so. Nantahala believes the compensation Clients pay Prime Brokers is reasonable and competitive with rates charged by other prime brokers for services of comparable quality.

**Client-Directed Brokerage.** If a Client or Investor in Separate Account directs Nantahala to use a specific broker or other Transacting Party, Nantahala will not negotiate the terms and conditions (including commission rates) relating to the services provided by that broker or Transacting Party; Nantahala does not have any responsibility for obtaining for the Client from any such broker or Transacting Party the best prices or particular commission rates with or through any such broker or Transacting Party; and the Client may not obtain rates as low as it might otherwise obtain if Nantahala had discretion to select Transacting Parties other than those chosen by the client.

### **Item 13 – Review of Accounts**

Nantahala performs various daily, weekly, monthly, and quarterly reviews of all Client accounts. Asset allocation, cash management, market prospects and individual issue prospects are considered. Particular attention is given to changes in company earnings, industry and company outlook, market outlook and price level.

Investors in the Clients will generally receive unaudited reports of performance monthly and will receive audited year-end financial statements annually.

### **Item 14 – Client Referrals and Other Compensation**

Registered investment advisers are required to disclose all material facts regarding any compensation or other benefits it receives, directly or indirectly, for client referrals. Nantahala has no information applicable to this Item.

### **Item 15 – Custody**

A rule under the Investment Advisers Act provides that, because Nantahala is the general partner of the Partnerships, Nantahala is considered to have “custody” of those Partnerships’ assets, even though independent custodians (Prime Brokers) actually hold those assets. That rule generally requires investment advisers that have “custody” of Client

assets to cause certain account statements detailing holdings and transactions to be sent to Clients, and imposes certain other obligations. However, advisers to investment funds like the Partnerships need not comply with those requirements if, among other things, the Partnerships provide Investors with audited financial statements by a specified time each year and those financial statements meet certain requirements. Nantahala satisfies those conditions and therefore is not subject to reporting and other obligations.

#### **Item 16 – Investment Discretion**

Nantahala is authorized to invest and trade the Clients' assets in a broad range of investments, to be selected at Nantahala's sole discretion, with no specific limitations as to type, amount, concentration, or leverage. Further, Nantahala may enter into any type of investment transaction and employ any investment methodology or strategy it deems appropriate, consistent with the Funds' offering documents, and/or a Separate Account's governing documents, as applicable.

Pursuant to the Funds' governing documents and investment management agreements between Nantahala and the Funds (or with Investors in Separate Accounts), each Investor designates Nantahala as its attorney-in-fact to execute, certify, acknowledge, file, record and swear to all instruments, agreements and documents necessary or advisable to carrying out the Clients' business and affairs, including execution of a Fund's limited partnership agreement. An Investor's execution of a subscription agreement constitutes its execution of a Client's governing documents.

#### **Item 17 – Voting Client Securities**

Nantahala exercises voting authority over Client proxies and has adopted proxy voting policies and procedures in accordance with Rule 206(4)-6 of the Investment Advisers Act of 1940, as amended. The policies require Nantahala to vote proxies received in a manner consistent with the best interests of the Client.

The policies also require Nantahala to vote Client proxies in the interest of maximizing shareholder value. To that end, Nantahala will vote in a way that it believes, consistent with its fiduciary duty, will cause the value of the issue to increase the most or decline the least. Consideration will be given to both the short and long term implications of the proposal to be voted on when considering the optimal vote. Votes on all matters are determined on a case-by-case basis and in the best interest of Clients. However, the policies permit Nantahala to abstain from voting proxies with respect to shares of a particular security which Nantahala deems to have no value or if the vote is purely administrative in nature or if it believes that its vote will have an immaterial impact on the vote's outcome. If applicable, Nantahala generally does not vote client proxies with respect to shares of a particular security that have been re-hypothecated pursuant to prime broker agreements or are on loan with prime brokers as of the record date, or where Nantahala does not have a position when voting materials are received.

Nantahala will generally vote in favor of routine corporate housekeeping proposals, including election of directors (where no corporate governance issues are implicated), selection of auditors, and increases in or reclassification of common stock, and for other proposals, voting in accordance with the recommendation of management unless such vote is determined to have an adverse effect on the interest of the Client.

Where a proxy proposal raises a material conflict between Nantahala's interests and the interests of the Client, Nantahala will seek to resolve the conflict. Where the conflict of interest is a personal conflict involving the covering member of the investment team, the covering member of the investment team will abstain from the voting decision, and another member of the investment team will make the voting decision. Nantahala may alternatively disclose material conflicts of interest to Clients and obtain their consent before voting.

Nantahala will provide, upon request, a copy of those policies and procedures and/or information concerning its voting record on account proxy matters. Such a request may be made by calling Paul Rehm at (203)909-6430 or [paul@nantahalapartners.com](mailto:paul@nantahalapartners.com).

#### **Item 18 – Financial Information**

Registered investment advisers are required in this Item to provide Investors with certain financial information or disclosures about Nantahala's financial condition. Nantahala has no financial commitment that is reasonably likely to impair its ability to meet contractual commitments to Clients.

#### **Item 19 – Requirements for State-Registered Advisers**

Not applicable.