KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.
Form N-30B-2
October 30, 2013

Midstream/Energy Fund

KMF Quarterly Report

August 31, 2013

CONTENTS

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS: This report of Kayne Anderson Midstream/Energy Fund, Inc. (the Fund) contains forward-looking statements as defined under the U.S. federal securities laws. Generally, the words believe, expect, intend, estimate, anticipate, project, will and similar expressions identify forward-looking statements, which generally are not hist in nature. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to materially differ from the Fund s historical experience and its present expectations or projections indicated in any forward-looking statement. These risks include, but are not limited to, changes in economic and political conditions; regulatory and legal changes; MLP industry risk; leverage risk; valuation risk; interest rate risk; tax risk; and other risks discussed in the Fund s filings with the Securities and Exchange Commission (SEC). You should not place undue reliance on forward-looking statements, which speak only as of the date they are made. The Fund undertakes no obligation to publicly update or revise any forward-looking statements made herein. There is no assurance that the Fund s investment objectives will be attained.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

MANAGEMENT DISCUSSION

(UNAUDITED)

Fund Overview

Kayne Anderson Midstream/Energy Fund, Inc. is a non-diversified, closed-end fund. We commenced operations on November 24, 2010. Our shares of common stock are listed on the New York Stock Exchange under the symbol KMF.

Our investment objective is to provide a high level of total return with an emphasis on making quarterly cash distributions to our stockholders. We seek to achieve that investment objective by investing at least 80% of our total assets in the securities of companies in the Midstream/Energy Sector, consisting of (a) Midstream MLPs, (b) Midstream Companies, (c) Other MLPs and (d) Other Energy Companies. We anticipate that the majority of our investments will consist of investments in Midstream MLPs and Midstream Companies. Please see the Glossary of Key Terms on page 36 for a description of these investment categories and for the meaning of capitalized terms not otherwise defined herein.

As of August 31, 2013, we had total assets of $1.1 billion, net assets applicable to our common stock of $757 million (net assets of $34.39 per share), and 22 million shares of common stock outstanding. As of August 31, 2013, we held $945 million in equity investments and $134 million in debt investments.

Recent Events

On October 21, 2013, Plains GP Holdings, L.P. (Plains GP) completed its initial public offering (IPO) and trades on the New York Stock Exchange (NYSE) under the ticker PAGP . Plains GP was formed to own a portion of the general partner of Plains All American Pipeline, L.P. All of our holdings in Plains All American GP LLC are exchangeable into shares of Plains GP on a one-for-one basis at our option. As part of the IPO, we agreed to a 15-month lock-up on its Plains GP shares (lock up expires on January 21, 2015).

Our Top Ten Portfolio Investments as of August 31, 2013

Listed below are our top ten portfolio investments by issuer as of August 31, 2013.

Holding	Sector	Amount ($ millions)	Percent of Long-Term Investments
1. The Williams Companies, Inc.	Midstream Company	$ 91.4	8.5%
2. ONEOK, Inc.	Midstream Company	82.2	7.6
3. Kinder Morgan Management, LLC	Midstream MLP	74.3	6.9
4. Kinder Morgan, Inc.	Midstream Company	71.9	6.7
5. Enbridge Energy Management, L.L.C.	Midstream MLP	66.1	6.1
6. Golar LNG Partners LP	Midstream Company	34.9	3.2
7. Plains All American GP LLC	Midstream MLP	31.1	2.9
8. Targa Resources Corp.	Midstream Company	28.4	2.6
9. Spectra Energy Corp.	Midstream Company	27.1	2.5
10. Teekay Offshore Partners L.P.	Midstream Company	25.1	2.3
		$ 532.5	49.3%

Results of Operations For the Three Months Ended August 31, 2013

Investment Income. Investment income totaled $7.0 million for the quarter and consisted primarily of net dividends and distributions and interest income on our investments. We received $9.6 million of dividends and

1

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

MANAGEMENT DISCUSSION

(UNAUDITED)

distributions, of which $5.3 million was treated as return of capital. Interest and other income was $2.7 million. We received $2.7 million of paid-in-kind dividends during the quarter, which are not included in investment income, but are reflected as an unrealized gain.

Operating Expenses. Operating expenses totaled $7.2 million, including $3.4 million of investment management fees, $2.5 million of interest expense (including non-cash amortization of debt issuance costs of $0.1 million) and $0.4 million of other operating expenses. Preferred stock distributions for the quarter were $0.8 million.

Net Investment Loss. Our net investment loss totaled $0.2 million.

Net Realized Gains. We had net realized gains of $10.0 million, which includes $1.8 million of net realized gains from option activity.

Net Change in Unrealized Gains. We had a net increase in unrealized gains of $18.9 million. The net increase consisted of $19.2 million of unrealized gains from investments and $0.3 million of net unrealized losses from option activity.

Net Increase in Net Assets Resulting from Operations. We had an increase in net assets resulting from operations of $28.7 million. This increase was comprised of net investment loss of $0.2 million, net realized gains of $10.0 million and net increase in unrealized gains of $18.9 million, as noted above.

Distribution to Common Stockholders

We pay quarterly distributions to our common stockholders, funded generally by net distributable income (NDI) generated from our portfolio investments. NDI is the amount of income received by us from our portfolio investments less operating expenses, subject to certain adjustments as described below. NDI is not a financial measure under the accounting principles generally accepted in the United States of America (GAAP). Refer to the Reconciliation of NDI to GAAP section below for a reconciliation of this measure to our results reported under GAAP.

Income from portfolio investments includes (a) cash dividends and distributions, (b) paid-in-kind dividends received (*i.e.*, stock dividends), (c) interest income from debt securities and commitment fees from private investments in public equity (PIPE investments) and (d) net premiums received from the sale of covered calls.

Operating expenses include (a) investment management fees paid to our investment adviser, (b) other expenses (mostly comprised of fees paid to other service providers) and (c) interest expense and preferred stock distributions.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

MANAGEMENT DISCUSSION

(UNAUDITED)

Net Distributable Income (NDI)

(amounts in millions, except for per share amounts)

	Three Months Ended August 31, 2013
Distributions and Other Income from Investments	
Dividends and Distributions[1]	$ 9.6
Paid-In-Kind Dividends and Distributions[1]	2.7
Interest and Other Income	2.7
Net Premiums Received from Call Options Written	2.0
Total Distributions and Other Income from Investments	17.0
Expenses	
Investment Management Fee	(3.4)
Other Expenses	(0.4)
Interest Expense	(2.4)
Preferred Stock Distributions	(0.8)
Net Distributable Income (NDI)	**$ 10.0**
Weighted Shares Outstanding	22.0
NDI per Weighted Share Outstanding	**$ 0.457**
Adjusted NDI per Weighted Share Outstanding[2]	**$ 0.459**
Distributions paid per Common Share[3]	**$ 0.46**

(1) See Note 2 (Investment Income) to the Financial Statements for additional information regarding paid-in-kind and non-cash dividends and distributions.

(2) Pacific Coast Oil Trust pays monthly dividends, but due to the timing of its ex-dividend dates, the Fund only received two dividends during its third fiscal quarter. Adjusted NDI includes the third monthly dividend attributable to the Fund s third fiscal quarter ($0.1 million adjustment).

(3) The distribution of $0.46 per share for the third quarter of fiscal 2013 was paid on October 18, 2013.

Payment of future distributions is subject to Board of Directors approval, as well as meeting the covenants of our debt agreements and terms of our preferred stock. In determining our quarterly distribution to common stockholders, our Board of Directors considers a number of factors that include, but are not limited to:

- NDI and Adjusted NDI generated in the current quarter;
- Expected NDI over the next twelve months; and

Realized and unrealized gains generated by the portfolio.

On September 25, 2013, we declared a quarterly distribution of $0.46 per common share for the third quarter of fiscal 2013 (a total distribution of $10.1 million). The distribution represents an increase of 1.1% from the prior quarter s distribution and an increase of 5.7% from the distribution for the quarter ended August 31, 2012. The distribution was paid on October 18, 2013 to common stockholders of record on October 11, 2013.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

MANAGEMENT DISCUSSION

(UNAUDITED)

Reconciliation of NDI to GAAP

The difference between distributions and other income from investments in the NDI calculation and total investment income as reported in our Statement of Operations is reconciled as follows:

- GAAP recognizes that a significant portion of the cash distributions received from MLPs is characterized as a return of capital and therefore excluded from investment income, whereas the NDI calculation includes the return of capital portion of such distributions.

- NDI includes the value of paid-in-kind dividends whereas such amounts are not included as investment income for GAAP purposes, but rather are recorded as unrealized gains upon receipt.

- NDI includes commitment fees from PIPE investments, whereas such amounts are generally not included in investment income for GAAP purposes, but rather are recorded as a reduction to the cost of the investment.

- Certain of our investments in debt securities were purchased at a discount or premium to the par value of such security. When making such investments, we consider the security s yield to maturity, which factors in the impact of such discount (or premium). Interest income reported under GAAP includes the non-cash accretion of the discount (or amortization of the premium) based on the effective interest method. When we calculate interest income for purposes of determining NDI, in order to better reflect the yield to maturity, the accretion of the discount (or amortization of the premium) is calculated on a straight-line basis to the earlier of the expected call date or the maturity date of the debt security.

- We may sell covered call option contracts to generate income or to reduce our ownership of certain securities that we hold. In some cases, we are able to repurchase these call option contracts at a price less than the premium that we received, thereby generating a profit. The premium we receive from selling call options, less (i) the amount that we pay to repurchase such call option contracts and (ii) the amount by which the market price of an underlying security is above the strike price at the time a new call option is written (if any), is included in NDI. For GAAP purposes, premiums received from call option contracts sold are not included in investment income. See Note 2 Significant Accounting Policies for a full discussion of the GAAP treatment of option contracts.

The treatment of expenses included in NDI also differs from what is reported in the Statement of Operations as follows:

- The non-cash amortization or write-offs of capitalized debt issuance costs and preferred stock offering costs related to our financings is included in interest expense and distributions on mandatory redeemable preferred stock for GAAP purposes, but is excluded from our calculation of NDI.

- NDI also includes recurring payments (or receipts) on interest rate swap contracts (excluding termination payments) whereas for GAAP purposes, these amounts are included in the realized gains/losses section of the Statement of Operations.

Liquidity and Capital Resources

Total leverage outstanding at August 31, 2013 of $323 million was comprised of $205 million of senior unsecured notes (Senior Notes), $53 million outstanding under our unsecured revolving credit facility (the Credit Facility) and $65 million of mandatory redeemable preferred stock. Total leverage represented 30% of total assets at August 31, 2013. As of October 17, 2013, we had $37 million borrowed under our Credit Facility, and we had $11 million of cash.

The Credit Facility has a $100 million commitment amount and matures on January 20, 2014. The interest rate varies between LIBOR plus 1.75% and LIBOR plus 2.25%, depending on our asset coverage ratios.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

MANAGEMENT DISCUSSION

(UNAUDITED)

Outstanding loan balances accrue interest daily at a rate equal to one-month LIBOR plus 1.75%, based on current asset coverage ratios. We pay a commitment fee of 0.35% per annum on any unused amounts of the Credit Facility. We have begun discussions with our current lenders and do not anticipate any significant issues with respect to the renewal of this facility at no less favorable terms than our existing facility. A full copy of the Credit Facility is available on our website www.kaynefunds.com.

At August 31, 2013, we had $205 million of Senior Notes outstanding, which mature between 2016 and 2023. At August 31, 2013, we had $65 million of mandatory redeemable preferred stock outstanding, which is subject to mandatory redemption in 2018 and 2020.

At August 31, 2013, our asset coverage ratios under the Investment Company Act of 1940, as amended (the 1940 Act), were 419% for debt and 334% for total leverage (debt plus preferred stock). Our long-term target asset coverage ratio with respect to our debt is 400%, but at times we may be above or below our target depending on market conditions.

As of August 31, 2013, our total leverage consisted of both fixed rate (84%) and floating rate (16%) obligations. At such date, the weighted average interest/dividend rate on our total leverage was 3.92%.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

AUGUST 31, 2013

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

Description	Shares/Units	Value
Long-Term Investments 142.5%		
Equity Investments[1] 124.8%		
United States 119.0%		
Midstream MLP[2][3] 56.5%		
Access Midstream Partners, L.P.[4]	115	$ 5,236
Atlas Pipeline Partners, L.P.	129	4,986
Buckeye Partners, L.P. Class B Units[5][6][7]	328	22,949
Crestwood Midstream Partners LP	469	12,164
Crosstex Energy, L.P.	584	10,937
DCP Midstream Partners, LP	374	17,909
Enbridge Energy Management, L.L.C.[6][8]	2,203	66,062
Energy Transfer Partners, L.P.[4][9]	204	10,453
Enterprise Products Partners L.P.[9]	321	19,084
Exterran Partners, L.P.	352	9,820
Global Partners LP	326	11,022
Inergy, L.P.	276	3,799
Inergy Midstream, L.P.	683	15,877
Kinder Morgan Management, LLC[6][8]	931	74,340
MarkWest Energy Partners, L.P.[4][10]	228	15,256
Niska Gas Storage Partners LLC	119	1,685
NuStar Energy L.P.	53	2,202
ONEOK Partners, L.P.	210	10,389
Plains All American GP LLC Unregistered[5][8][10]	7	31,057
Plains All American Pipeline, L.P.[10]	459	23,202
PVR Partners, L.P.[10]	323	7,498
QEP Midstream Partners, LP[11]	50	1,139
Regency Energy Partners LP	729	19,708
Summit Midstream Partners, LP	90	2,978
Targa Resources Partners LP[4]	63	3,054
USA Compression Partners, LP	5	113
Western Gas Partners, LP	115	6,807
Williams Partners L.P.	364	17,956
		427,682
Midstream Company[2] 55.3%		
Capital Product Partners L.P.[12]	1,354	11,997
Capital Products Partners L.P. Class B Units[5][12][13]	606	5,752
CenterPoint Energy, Inc.	708	16,244
Golar LNG Partners LP[12]	1,073	34,882
Kinder Morgan, Inc.	1,894	71,855
KNOT Offshore Partners LP[12]	543	13,059
NiSource Inc.[4]	372	10,882
ONEOK, Inc.[4]	1,599	82,231
Spectra Energy Corp.[4]	818	27,084
Targa Resources Corp.[4]	417	28,404

Teekay Offshore Partners L.P.(4)(12)	556	17,657
Teekay Offshore Partners L.P. Series A Preferred Units(12)(14)	300	7,410
The Williams Companies, Inc.(4)	2,523	91,427
		418,884

See accompanying notes to financial statements.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

AUGUST 31, 2013

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

Description	Shares/Units	Value
Other Energy 5.9%		
Enduro Royalty Trust	132	$ 2,062
HollyFrontier Corporation[4]	102	4,528
Marathon Petroleum Corporation[4]	106	7,664
NRG Yield, Inc. Class A[1]	147	4,095
Pacific Coast Oil Trust	309	5,620
Phillips 66[4]	111	6,321
SandRidge Mississippian Trust II[15]	184	2,452
Seadrill Limited[4]	126	5,810
The Southern Company	80	3,309
VOC Energy Trust	173	2,650
		44,511
Other MLP[3] 0.7%		
BreitBurn Energy Partners L.P.	183	3,235
Emerge Energy Services LP[10]	43	1,247
LRR Energy LP	52	780
		5,262
Other 0.6%		
Navios Maritime Partners L.P.[12]	330	4,651
Total United States (Cost $692,576)		900,990
Canada 5.8%		
Midstream Company[2] 5.6%		
Enbridge Inc.	303	12,412
Keyera Corp.[4]	108	5,895
Pembina Pipeline Corporation[4][9]	602	18,676
TransCanada Corporation	115	5,016
		41,999
Other Energy 0.2%		
Crescent Point Energy Corp.[4]	50	1,824
Total Canada (Cost $39,471)		43,823
Total Equity Investments (Cost $732,047)		944,813

	Interest Rate	Maturity Date	Principal Amount	
Debt Instruments 17.7%				
Upstream 15.6%				
Athlon Energy Inc.	7.375%	4/15/21	$ 5,600	5,684
Aurora Oil & Gas Limited	7.500	4/1/20	9,600	9,504
BlackBrush Oil & Gas, L.P.	(16)	6/3/19	8,688	8,819
Clayton Williams Energy, Inc.	7.750	4/1/19	8,371	8,580
Comstock Resources, Inc.	9.500	6/15/20	3,500	3,815
CrownRock, L.P.	7.125	4/15/21	4,500	4,477
El Paso Corporation	7.750	1/15/32	1,875	1,977
Halcón Resources Corporation	9.750	7/15/20	15,250	15,822
Midstates Petroleum Company, Inc.	9.250	6/1/21	7,800	7,449
Midstates Petroleum Company, Inc.	10.750	10/1/20	3,850	3,908

See accompanying notes to financial statements.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

AUGUST 31, 2013

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

Description	Interest Rate	Maturity Date	Principal Amount	Value
Upstream (continued)				
Penn Virginia Corporation	8.500%	5/1/20	$ 11,800	$ 11,800
Resolute Energy Corporation	8.500	5/1/20	3,775	3,869
Rex Energy Corporation	8.875	12/1/20	11,000	11,440
Sanchez Energy Corporation	7.750	6/15/21	7,750	7,634
Rice Drilling B LLC	(17)	10/22/18	5,591	5,479
RKI Exploration & Production, LLC	8.500	8/1/21	7,500	7,500
				117,757
Midstream Company[2] 1.1%				
SemGroup Corporation	7.500	6/15/21	4,000	4,090
Teekay Corporation	8.500	1/15/20	4,325	4,693
				8,783
Coal 1.0%				
Arch Coal, Inc.	7.250	6/15/21	9,500	7,410
Total Debt Investments (Cost $132,974)				133,950
Total Long-Term Investments (Cost $865,021)				1,078,763

	Strike Price	Expiration Date	No. of Contracts	
Liabilities				
Call Option Contracts Written[18]				
United States				
Midstream MLP				
Access Midstream Partners, L.P.	$ 50.00	9/20/13	450	(6)
Energy Transfer Partners, L.P.	50.00	9/20/13	180	(32)
Energy Transfer Partners, L.P.	52.50	9/20/13	180	(10)
Energy Transfer Partners, L.P.	55.00	9/20/13	300	(3)
MarkWest Energy Partners, L.P.	70.00	9/20/13	400	(22)
MarkWest Energy Partners, L.P.	72.50	9/20/13	360	(5)
Targa Resources Partners LP	50.00	9/20/13	300	(14)
				(92)
Midstream Company				
NiSource Inc.	30.00	9/20/13	310	(5)
NiSource Inc.	31.00	9/20/13	310	(2)
ONEOK, Inc.	52.50	9/20/13	700	(63)

ONEOK, Inc.	55.00	9/20/13	700	(11)
ONEOK, Inc.	52.50	10/18/13	1,750	(210)
ONEOK, Inc.	55.00	10/18/13	1,750	(87)
Spectra Energy Corp.	34.00	10/18/13	1,220	(67)
Targa Resources Corp.	70.00	9/20/13	320	(26)
Targa Resources Corp.	70.00	10/18/13	490	(73)
Teekay Offshore Partners L.P.	32.00	9/20/13	500	(33)
Teekay Offshore Partners L.P.	33.00	10/18/13	325	(19)
The Williams Companies, Inc.	35.00	9/20/13	1,000	(136)
The Williams Companies, Inc.	37.00	9/20/13	1,300	(40)
				(772)

See accompanying notes to financial statements.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

AUGUST 31, 2013

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

Description	Strike Price	Expiration Date	No. of Contracts	Value
Other Energy				
HollyFrontier Corporation	$ 46.50	10/18/13	250	$ (29)
HollyFrontier Corporation	48.50	10/18/13	250	(16)
Marathon Petroleum Corporation	75.00	10/18/13	250	(62)
Marathon Petroleum Corporation	77.50	10/18/13	500	(110)
Marathon Petroleum Corporation	80.00	10/18/13	250	(24)
Phillips 66	60.00	10/18/13	500	(67)
Seadrill Limited	45.00	9/20/13	250	(34)
				(342)
Total United States (Premium Received $1,513)				(1,206)
Canada				
Midstream Company				
Keyera Corp.	58.00	10/18/13	250	(34)
Pembina Pipeline Corporation	33.00	9/20/13	900	(26)
Pembina Pipeline Corporation	30.00	10/18/13	300	(48)
				(108)
Other Energy				
Crescent Point Energy Corp.	40.00	9/20/13	100	(1)
Total Canada (Premium Received $105)				(109)
Total Call Option Contracts Written (Premiums Received $1,618)				(1,315)
Credit Facility				(53,000)
Senior Unsecured Notes				(205,000)
Mandatory Redeemable Preferred Stock at Liquidation Value				(65,000)
Other Liabilities				(7,037)
Total Liabilities				(331,352)
Other Assets				9,455
Total Liabilities in Excess of Other Assets				(321,897)
Net Assets Applicable to Common Stockholders				$ 756,866

(1) Unless otherwise noted, equity investments are common units/common shares.

(2) Refer to the Glossary of Key Terms (page 36) for the definition of Midstream Companies and Midstream MLPs.

(3) Unless otherwise noted, securities are treated as a publicly-traded partnership for regulated investment company (RIC) qualification purposes. To qualify as a RIC for tax purposes, the Fund may directly invest up to 25% of its total assets in equity and debt securities of entities treated as publicly-traded partnerships. The Fund had 24.3% of its total assets invested in publicly-traded partnerships at August 31, 2013. It is the Fund s intention to be treated as a RIC for tax purposes.

(4) Security or a portion thereof is segregated as collateral on option contracts written.

(5) Fair valued securities, restricted from public sale. See Notes 2, 3 and 7 in Notes to Financial Statements.

(6) Distributions are paid-in-kind.

(7) On September 1, 2013, all of the Buckeye Partners, L.P. Class B Units were converted into common units on a one-for-one basis. As of August 31, 2013, the Fund valued the Class B Units at the same price as the common units.

See accompanying notes to financial statements.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

AUGUST 31, 2013

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

(8) Security is not treated as a publicly-traded partnership for RIC qualification purposes.

(9) In lieu of cash distributions, the Fund has elected to receive distributions in additional units/stock through the issuer s dividend reinvestment program.

(10) The Fund believes that it is an affiliate of Emerge Energy Services LP, MarkWest Energy Partners, L.P., PVR Partners, L.P., Plains All American GP LLC and Plains All American Pipeline, L.P. See Note 6 Agreements and Affiliations.

(11) Security is not currently paying cash distributions but is expected to pay cash distributions within the next 12 months.

(12) This company is structured like an MLP but is not treated as a publicly-traded partnership for RIC qualification purposes.

(13) Class B Units are convertible on a one-for-one basis into common units of Capital Product Partners L.P. (CPLP) and are senior to the common units in terms of liquidation preference and priority of distributions. The Class B Units pay quarterly cash distributions of $0.21375 per unit and are convertible at any time at the option of the holder. If CPLP increases the quarterly cash distribution per common unit, the distribution per Class B Unit will increase by an equal amount. If CPLP does not redeem the Class B Units by May 2022, then the distribution increases by 25% per quarter to a maximum of $0.33345 per unit. CPLP may require that the Class B Units convert into common units after May 2015 if the common unit price exceeds $11.70 per unit, and the Class B Units are callable after May 2017 at a price of $9.27 per unit and after May 2019 at $9.00 per unit.

(14) Series A Preferred Units represent preferred equity interests in Teekay Offshore Partners L.P. (TOO). The Series A Preferred Units are perpetual and are senior to the common units in terms of liquidation preference and priority of distributions. Series A Preferred Units do not have any conversion or exchange rights and pay quarterly cash distributions of $0.453125 per unit. At any time on or after April 30, 2018, TOO may redeem the Series A Preferred Units at a redemption price of $25.00 per unit plus all accumulated and unpaid distributions.

(15) Security is treated as a publicly-traded partnership for RIC qualification purposes.

(16) Floating rate first lien secured term loan. Security pays interest at a rate of LIBOR + 650 basis points with a 1.25% LIBOR floor (7.75% as of August 31, 2013).

(17)

Floating rate second lien secured term loan. Security pays interest at a rate of LIBOR + 725 basis points with a 1.25% LIBOR floor (8.50% as of August 31, 2013).

(18) Security is non-income producing.

See accompanying notes to financial statements.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

STATEMENT OF ASSETS AND LIABILITIES

AUGUST 31, 2013

(amounts in 000 s, except share and per share amounts)

(UNAUDITED)

ASSETS	
Investments, at fair value:	
Non-affiliated (Cost $823,252)	$ 1,000,503
Affiliated (Cost $41,769)	78,260
Total investments (Cost $865,021)	1,078,763
Cash	2,815
Deposits with brokers	250
Receivable for securities sold	302
Interest, dividends and distributions receivable	3,657
Deferred debt and preferred stock offering costs and other assets	2,431
Total Assets	1,088,218
LIABILITIES	
Payable for securities purchased	556
Investment management fee payable	1,154
Call option contracts written (Premiums received $1,618)	1,315
Accrued directors fees and expenses	48
Accrued expenses and other liabilities	5,279
Credit facility	53,000
Senior unsecured notes	205,000
Mandatory redeemable preferred stock, $25.00 liquidation value per share (2,600,000 shares issued and outstanding)	65,000
Total Liabilities	331,352
NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS	$ 756,866
NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS CONSIST OF	
Common stock, $0.001 par value (22,005,876 shares issued and outstanding and 197,400,000 shares authorized)	$ 22
Paid-in capital	524,739
Accumulated net investment income less distributions not treated as tax return of capital	(33,427)
Accumulated net realized gains less distributions not treated as tax return of capital	51,492
Net unrealized gains	214,040
NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS	$ 756,866
NET ASSET VALUE PER COMMON SHARE	$ 34.39

See accompanying notes to financial statements.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

STATEMENT OF OPERATIONS

(amounts in 000 s)

(UNAUDITED)

	For the Three Months Ended August 31, 2013	For the Nine Months Ended August 31, 2013
INVESTMENT INCOME		
Income		
Dividends and distributions:		
Non-affiliated investments	$ 8,704	$ 25,806
Affiliated investments	925	2,553
Total dividends and distributions (after foreign taxes withheld of $74 and $193, respectively)	9,629	28,359
Return of capital	(5,311)	(15,270)
Net dividends and distributions	4,318	13,089
Interest and other income	2,689	8,021
Total investment income	7,007	21,110
Expenses		
Investment management fees	3,372	9,451
Professional fees	126	347
Administration fees	59	172
Directors fees and expenses	54	149
Reports to stockholders	45	108
Custodian fees	37	96
Insurance	44	131
Excise taxes		410
Other expenses	82	243
Total expenses before interest expense and preferred distributions	3,819	11,107
Interest expense and amortization of offering costs	2,528	6,977
Distributions on mandatory redeemable preferred stock and amortization of offering costs	835	2,505
Total expenses	7,182	20,589
Net Investment Income (Loss)	(175)	521
REALIZED AND UNREALIZED GAINS (LOSSES)		
Net Realized Gains		
Investments non-affiliated	8,166	30,861
Investments affiliated	102	56
Foreign currency transactions	(16)	(32)
Options	1,760	3,490
Interest rate swap contracts		(385)
Net Realized Gains	10,012	33,990
Net Change in Unrealized Gains		

Investments non-affiliated		12,698		90,794
Investments affiliated		6,410		21,535
Foreign currency translations				(5)
Options		(260)		858
Net Change in Unrealized Gains		18,848		113,182
Net Realized and Unrealized Gains		28,860		147,172
NET INCREASE IN NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS RESULTING FROM OPERATIONS	$	28,685	$	147,693

See accompanying notes to financial statements.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

STATEMENT OF CHANGES IN NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS

(amounts in 000 s, except share amounts)

	For the Nine Months Ended August 31, 2013 (Unaudited)	For the Fiscal Year Ended November 30, 2012
OPERATIONS		
Net investment income[1]	$ 521	$ 3,648
Net realized gains	33,990	36,772
Net change in unrealized gains	113,182	64,045
Net Increase in Net Assets Resulting from Operations	147,693	104,465
DIVIDENDS AND DISTRIBUTIONS TO COMMON STOCKHOLDERS[1]		
Dividends	(29,558)[2]	(28,368)[3]
Distributions net long-term capital gains	[2]	(8,804)[3]
Dividends and Distributions to Common Stockholders	(29,558)	(37,172)
CAPITAL STOCK TRANSACTIONS		
Issuance of 110,634 and 231,265 shares of common stock from reinvestment of dividends and distributions, respectively	3,505	5,889
Total Increase in Net Assets Applicable to Common Stockholders	121,640	73,182
NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS		
Beginning of period	635,226	562,044
End of period	$ 756,866	$ 635,226

(1) Distributions on the Fund s mandatory redeemable preferred stock are treated as an operating expense under GAAP and are included in the calculation of net investment income. See Note 2 Significant Accounting Policies. The Fund estimates that the distribution in the amount of $2,409 paid to mandatory redeemable preferred stockholders during the nine months ended August 31, 2013 will be characterized as a dividend (a portion of which may be eligible to be treated as qualified dividend income). This estimate is based solely on the Fund s operating results during the period and does not reflect the expected results during the fiscal year. The actual characterization of the mandatory redeemable preferred stock distributions made during the period will not be determinable until after the end of the fiscal year when the Fund can determine earnings and profits. Therefore, the characterization may differ from the preliminary estimates. Distributions in the amount of $2,803 paid to mandatory redeemable preferred stockholders for the fiscal year ended November 30, 2012 were characterized as dividend income ($2,139) and as long-term capital gains ($664). This characterization is based on the Fund s earnings and profits.

(2) This is an estimate of the characterization of the distributions paid to common stockholders for the nine months ended August 31, 2013 as either a dividend (a portion of which may be eligible to be treated as qualified dividend income) or distribution (return of capital). This estimate is based solely on the Fund s operating results during the period and does not reflect the expected results during the fiscal year. The actual characterization of the common stock distributions made during the current year will not be determinable until after the end of the fiscal year when the Fund can determine earnings and profits. Therefore, the characterization may differ from the preliminary estimates.

(3) Distributions paid to common stockholders for the fiscal year ended November 30, 2012 are characterized as either dividend income (a portion was eligible to be treated as qualified dividend income) or distributions (long-term capital gains). This characterization is based on the Fund s earnings and profits.

See accompanying notes to financial statements.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

STATEMENT OF CASH FLOWS

FOR THE NINE MONTHS ENDED AUGUST 31, 2013

(amounts in 000 s)

(UNAUDITED)

CASH FLOWS FROM OPERATING ACTIVITIES	
Net increase in net assets resulting from operations	$ 147,693
Adjustments to reconcile net increase in net assets resulting from operations to net cash used in operating activities:	
Return of capital distributions	15,270
Net realized gains (excluding foreign currency transactions)	(34,022)
Net unrealized gains (excluding foreign currency translations)	(113,187)
Accretion of bond discounts, net	(73)
Purchase of long-term investments	(433,089 for which the related loan or lease was acquired by the REIT at a time when the default was not imminent or anticipated; and

for which the REIT makes a proper election to treat the property as foreclosure property.

A REIT will not be considered to have foreclosed on a property where the REIT takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor. Property generally ceases to be foreclosure property at the end of the third taxable year following the taxable year in which the REIT acquired the property, or longer if an extension is granted by the Secretary of the Treasury. This grace period terminates and foreclosure property ceases to be foreclosure property on the first day:

on which a lease is entered into for the property that, by its terms, will give rise to income that does not qualify for purposes of the 75% gross income test disregarding income from foreclosure property, or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after such day that will give rise to income that does not qualify for purposes of the 75% gross income test disregarding income from foreclosure property;

on which any construction takes place on the property, other than completion of a building or any other improvement, where more than 10% of the construction was completed before default became imminent; or which is more than 90 days after the day on which the REIT acquired the property and the property is used in a trade or business which is conducted by the REIT, other than through an independent contractor from whom the REIT itself does not derive or receive any income.

Failure to Satisfy Gross Income Tests. If we fail to satisfy one or both of the gross income tests for any taxable year, we nevertheless may qualify as a REIT for that year if we qualify for relief under certain provisions of the U.S. federal income tax laws. Those relief provisions generally will be available if:

- our failure to meet such tests is due to reasonable cause and not due to willful neglect; and
- following such failure for any taxable year, a schedule of the sources of our income is filed with the IRS.

We cannot predict, however, whether in all circumstances we would qualify for the relief provisions. In addition, as discussed above in Taxation of Our Company, even if the relief provisions apply, we would incur a 100% tax on the gross income attributable to the greater of the amount by which we fail the 75% gross income test or the 95% gross income test, multiplied, in either case, by a fraction intended to reflect our profitability.

Asset Tests

To qualify as a REIT, we also must satisfy the following asset tests at the end of each quarter of each taxable year. First, at least 75% of the value of our total assets must consist of:

- cash or cash items, including certain receivables and money market funds;
- government securities;

41

Table of Contents

- interests in real property, including leaseholds and options to acquire real property and leaseholds;
- interests in mortgage loans secured by real property;
- stock (or transferable certificates of beneficial interest) in other REITs;
- investments in stock or debt instruments during the one-year period following our receipt of new capital that we raise through equity offerings or public offerings of debt with at least a five-year term; and
- regular or residual interests in a REMIC. However, if less than 95% of the assets of a REMIC consist of assets that are qualifying real estate-related assets under the U.S. federal income tax laws, determined as if we held such assets, we will be treated as holding directly our proportionate share of the assets of such REMIC.

Second, of our investments not included in the 75% asset class, the value of our interest in any one issuer s securities (other than any TRS we may own) may not exceed 5% of the value of our total assets, or the 5% asset test.

Third, of our investments not included in the 75% asset class, we may not own (i) more than 10% of the total voting power of any one issuer s outstanding securities, which we refer to as the 10% vote test, or (ii) more than 10% of the total value of any one issuer s outstanding securities, which we refer to as the 10% value test.

Fourth, no more than 25% of the value of our total assets may consist of the securities of one or more TRSs.

Fifth, no more than 25% of the value of our total assets may consist of the securities of TRSs and other non-TRS taxable subsidiaries and other assets that are not qualifying assets for purposes of the 75% asset test, or the 25% securities test.

For purposes of the 5% asset test, the 10% vote test, the 10% value test and the 25% securities test, the term securities does not include stock in another REIT, equity or debt securities of a qualified REIT subsidiary, mortgage loans or mortgage-backed securities that constitute real estate assets. For purposes of the 10% value test, the term securities does not include:

- Straight debt securities, which is defined as a written unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the debt is not convertible, directly or indirectly, into stock, and (ii) the interest rate and interest payment dates are not contingent on profits, the borrower s discretion, or similar factors. Straight debt securities do not include any securities issued by a partnership or a corporation in which we or any controlled TRS (i.e., a TRS in which we own directly or indirectly more than 50% of the voting power or value of the stock) hold non- straight debt securities that have an aggregate value of more than 1% of the issuer s outstanding securities. However, straight debt securities include debt subject to the following contingencies:

a contingency relating to the time of payment of interest or principal, as long as either (i) there is no change to the effective yield of the debt obligation, other than a change to the annual yield that does not exceed the greater of 0.25% or 5% of the annual yield, or (ii) neither the aggregate issue price nor the aggregate face amount of the issuer s debt obligations held by us exceeds $1 million and no more than 12 months of unaccrued interest on the debt obligations can be required to be prepaid; and

a contingency relating to the time or amount of payment upon a default or prepayment of a debt obligation, as long as the contingency is consistent with customary commercial practice.

Any loan to an individual or an estate.

Any section 467 rental agreement, other than an agreement with a related party tenant.

Any obligation to pay rents from real property.

42

- Certain securities issued by governmental entities.

- Any security issued by a REIT.

- Any debt instrument of an entity treated as a partnership for U.S. federal income tax purposes to the extent of our interest as a partner in the partnership.

- Any debt instrument of an entity treated as a partnership for U.S. federal income tax purposes not described in the preceding bullet points if at least 75% of the partnership s gross income, excluding income from prohibited transactions, is qualifying income for purposes of the 75% gross income test described above in Gross Income Tests.

For purposes of the 10% value test, our proportionate share of the assets of a partnership is our proportionate interest in any securities issued by the partnership, without regard to the securities described in the last two bullet points above.

We believe that our investments in Agency RMBS will be qualifying assets for purposes of the 75% asset test because they are real estate assets or government securities. With respect to Agency RMBS that are pass-through certificates, we believe that the Agency RMBS will be treated as interests in a grantor trust and that Agency RMBS that are CMOs (including IOs, IIOs, and POs) will be treated as regular interests in a REMIC for U.S. federal income tax purposes. In the case of Agency RMBS treated as interests in a grantor trust, we are treated as owning an undivided beneficial ownership interest in the mortgage loans held by the grantor trust. Such mortgage loans will generally qualify as real estate assets to the extent that they are secured by real property. IRS Revenue Procedure 2011-16, provides a safe harbor under which the IRS has stated that it will not challenge a REIT s treatment of a loan as being, in part, a qualifying real estate asset in an amount equal to the lesser of (i) the fair market value of the real property securing the loan determined as of the date the REIT committed to acquire the loan or (ii) the fair market value of the loan on the date of the relevant quarterly REIT asset testing date. Additionally, although the IRS has ruled generally that Agency RMBS that are pass-through certificates are real estate assets for purposes of the 75% asset test, it is not clear how this guidance would apply to secondary market purchases of Agency RMBS that are pass-through certificates at a time when a portion of one or more mortgage loans backing the Agency RMBS is not treated as real estate assets as a result of the loans not being treated as fully secured by real property. In the case of Agency RMBS that are CMOs, which will be treated as regular interests in a REMIC, such interests will generally qualify as real estate assets. If less than 95% of the assets of the REMIC are real estate assets, however, then only a proportionate part of our interest in the REMIC interests will qualify as real estate assets. To the extent any Agency RMBS are not treated as real estate assets, we expect such Agency RMBS will be treated as government securities because they are issued or guaranteed as to principal or interest by the United States or by a person controlled or supervised by and acting as an instrumentality of the government of the United States pursuant to authority granted by the Congress of the United States.

We have entered and intend to continue to enter into repurchase agreements under which we would nominally sell certain of our Agency RMBS to a counterparty and simultaneously enter into an agreement to repurchase the sold assets in exchange for a purchase price that reflects a financing charge. Based on positions the IRS has taken in analogous situations, we believe that these transactions will be treated as secured debt and that we will be treated for REIT asset and gross income test purposes as the owner of the Agency RMBS that are the subject of any such agreement notwithstanding that such agreements may transfer record ownership of the assets to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the Agency

RMBS during the term of the sale and repurchase agreement, in which case we could fail to qualify as a REIT.

We have purchased, and may purchase in the future, Agency RMBS through delayed delivery contracts, including TBAs. The law is unclear with respect to the qualification of delayed delivery contracts as real estate assets or government securities for purposes of the 75% asset test. Until we receive a favorable private letter ruling from the IRS or we receive an opinion from counsel to the effect that delayed delivery contracts should be

43

Table of Contents

treated as qualifying assets for purposes of the 75% asset test, we will limit our aggregate investment in delayed delivery contracts, including TBAs, and any nonqualifying assets to no more than 25% of our total assets at the end of any calendar quarter and will limit our investment in the delayed delivery contracts of any one issuer to less than 5% of our total assets at the end of any calendar quarter. Accordingly, our ability to purchase Agency RMBS through delayed delivery transactions could be limited. Moreover, even if we are advised by counsel that delayed delivery transactions should be treated as qualifying assets, it is possible that the IRS could successfully take the position that such assets are not qualifying assets. In the event that such assets were determined not to be qualifying for the 75% asset test, we could be subject to a penalty tax or we could fail to qualify as a REIT. See Failure to Qualify.

We monitor the status of our assets for purposes of the various asset tests and seek to manage our portfolio to comply at all times with such tests. There can be no assurance, however, that we will be successful in this effort. In this regard, we will need to value our investment in our assets to ensure compliance with the asset tests. Although we seek to be prudent in making these estimates, there can be no assurances that the IRS might not disagree with these determinations and assert that a different value is applicable in which case we might not satisfy the 75% asset test and the other asset tests and, thus could fail to qualify as a REIT. If we fail to satisfy the asset tests at the end of a calendar quarter, we will not lose our REIT status if:

- we satisfied the asset tests at the end of the preceding calendar quarter; and
- the discrepancy between the value of our assets and the asset test requirements arose from changes in the market values of our assets and was not wholly or partly caused by the acquisition of one or more non-qualifying assets.

If we did not satisfy the condition described in the second item, above, we still could avoid disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which it arose.

In the event that we violate the 5% asset test, the 10% vote test or the 10% value test described above at the end of any calendar quarter, we will not lose our REIT qualification if (i) the failure is de minimis (up to the lesser of 1% of the total value of our assets or $10 million) and (ii) we dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identified such failure. In the event of a failure of any of the asset tests (other than a de minimis failure described in the preceding sentence), as long as the failure was due to reasonable cause and not due to willful neglect, we will not lose our REIT qualification if we (i) dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identified such failure, (ii) file a schedule with the IRS describing the assets that caused such failure in accordance with regulations promulgated by the Secretary of the Treasury and (iii) pay a tax equal to the greater of $50,000 or the highest rate of U.S. federal corporate income tax (currently, 35%) on the net income from the nonqualifying assets during the period in which we failed to satisfy the asset tests.

We believe that the investments that we will hold will satisfy the foregoing asset test requirements. However, we will not obtain independent appraisals to support our conclusions as to the value of our assets and securities, or the real estate collateral for the mortgage loans that support our Agency RMBS. Moreover, the values of some assets may not be susceptible to a precise determination. As a result, there can be no assurance that the IRS will not contend that our ownership of securities and other assets violates one or more of the asset tests applicable to REITs.

Distribution Requirements

Each taxable year we must distribute dividends, other than capital gain dividends and deemed distributions of retained capital gain, to our stockholders in an aggregate amount at least equal to:

the sum of:

90% of our REIT taxable income, computed without regard to the dividends paid deduction and our net capital gain, and

44

Table of Contents

90% of our after-tax net income, if any, from foreclosure property, minus

the sum of certain items of non-cash income.

We must pay such distributions in the taxable year to which they relate, or in the following taxable year if either (i) we declare the distribution before we timely file our U.S. federal income tax return for the year and pay the distribution on or before the first regular dividend payment date after such declaration, or (ii) we declare the distribution in October, November or December of the taxable year, payable to stockholders of record on a specified day in any such month, and we actually pay the dividend before the end of January of the following year. The distributions under clause (i) are taxable to the stockholders in the year in which paid, and the distributions in clause (ii) are treated as paid on December 31 of the prior taxable year. In both instances, these distributions relate to our prior taxable year for purposes of the 90% distribution requirement.

We will pay U.S. federal income tax on taxable income, including net capital gain, that we do not distribute to stockholders. Furthermore, if we fail to distribute during a calendar year, or by the end of the following January after the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of:

85% of our REIT ordinary income for such year,

95% of our REIT capital gain income for such year, and

any undistributed taxable income from prior periods,

we will incur a 4% nondeductible excise tax on the excess of such required distribution over the amounts we actually distribute. We may elect to retain and pay income tax on the net long-term capital gain we receive in a taxable year. If we so elect, we will be treated as having distributed any such retained amount for purposes of the 4% nondeductible excise tax described above. We intend to make timely distributions sufficient to satisfy the annual distribution requirements and to avoid corporate income tax and the 4% nondeductible excise tax.

It is possible that, from time to time, we may experience timing differences between the actual receipt of income and actual payment of deductible expenses and the inclusion of that income and deduction of such expenses in arriving at our REIT taxable income. Possible examples of those timing differences include the following:

Because we may deduct capital losses only to the extent of our capital gains, we may have taxable income that exceeds our economic income.

We will recognize taxable income in advance of the related cash flow if any of our Agency RMBS are deemed to have original issue discount. We generally must accrue original issue discount based on a constant yield method that takes into account projected prepayments but that defers taking into account losses until they are actually incurred.

We may acquire debt instruments in the secondary market for less than their face amount. The amount of such discount may be treated as "market discount" for U.S. federal income tax purposes. Accrued market discount is reported as income when, and to the extent that, we dispose of the debt investment or any payment of principal of the debt instrument is made, unless we elect to include accrued market discount in income as it accrues. Principal payments on certain debt instruments are made monthly, and consequently accrued market discount may have to be included in income each month as if the debt instrument were assured of ultimately being collected in full. If we collect less on the debt instrument than our purchase price plus the market discount we had previously reported as income, we may not be able to benefit from any offsetting loss deductions.

Although several types of non-cash income are excluded in determining the annual distribution requirement, we will incur corporate income tax and the 4% nondeductible excise tax with respect to those non-cash income items if we do not distribute those items on a current basis. As a result of the foregoing, we may have less cash than is necessary to distribute all of our taxable income and thereby avoid corporate income tax and the excise tax imposed on certain undistributed income. In such a situation, we may need to borrow funds or, if possible, pay taxable dividends of our stock or debt securities.

We may satisfy the REIT annual distribution requirements by making taxable distributions of our stock. The IRS has issued private letter rulings to other REITs treating certain distributions that are paid partly in cash and partly in stock as dividends that would satisfy the REIT annual distribution requirement and qualify for the dividends paid deduction for federal income tax purposes. Those rulings may be relied upon only by taxpayers whom they were issued, but we could request a similar ruling from the IRS. In addition, the IRS previously issued a revenue procedure authorizing publicly traded REITs to make elective cash/stock dividends, but that revenue procedure has expired. Accordingly, it is unclear whether and to what extent we will be able to make taxable dividends payable in cash and stock. We currently do not intend to pay taxable dividends payable in cash and stock.

In order for distributions to be counted towards our distribution requirement and to give rise to a tax deduction by us, they must not be preferential dividends. A dividend is not a preferential dividend if it is pro rata among all outstanding shares of stock within a particular class and is in accordance with the preferences among different classes of stock as set forth in the organizational documents.

To qualify as a REIT, we may not have, at the end of any taxable year, any undistributed earnings and profits accumulated in any non-REIT taxable year. We may satisfy the 90% distribution test with taxable distributions of our stock or debt securities.

Under certain circumstances, we may be able to correct a failure to meet the distribution requirement for a year by paying deficiency dividends to our stockholders in a later year. We may include such deficiency dividends in our deduction for dividends paid for the earlier year. Although we may be able to avoid income tax on amounts distributed as deficiency dividends, we will be required to pay interest to the IRS based upon the amount of any deduction we take for deficiency dividends.

Recordkeeping Requirements

We must maintain certain records in order to qualify as a REIT. In addition, to avoid a monetary penalty, we must request on an annual basis information from our stockholders designed to disclose the actual ownership of our outstanding stock. We intend to comply with these requirements.

Failure to Qualify

If we fail to satisfy one or more requirements for REIT qualification, other than the gross income tests and the asset tests, we could avoid disqualification if our failure is due to reasonable cause and not to willful neglect and we pay a penalty of $50,000 for each such failure. In addition, there are relief provisions for a failure of the gross income tests and asset tests, as described in Gross Income Tests and Asset Tests.

If we fail to qualify as a REIT in any taxable year, and no relief provision applies, we would be subject to U.S. federal income tax and any applicable alternative minimum tax on our taxable income at regular corporate rates. In calculating our taxable income in a year in which we fail to qualify as a REIT, we would not be able to deduct amounts paid out to stockholders. In fact, we would not be required to distribute any amounts to stockholders in that year. In such event, to the extent of our current or accumulated earnings and profits, all distributions to stockholders would be taxable as ordinary income. Subject to certain limitations of the U.S. federal income tax laws, corporate stockholders might be eligible for the dividends received deduction and stockholders taxed at individual rates might be eligible for the reduced U.S. federal income tax rate of 20% on such dividends. Unless we qualified for relief under specific statutory provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we ceased to qualify as a REIT. We cannot predict whether in all circumstances we would qualify for such statutory relief.

46

Table of Contents

Taxation of Taxable U.S. Stockholders

The term U.S. stockholder means a beneficial owner of our stock that, for U.S. federal income tax purposes, is:

- a citizen or resident of the United States;
- a corporation (including an entity treated as a corporation for U.S. federal income tax purposes) created or organized under the laws of the United States, any of its states or the District of Columbia;
- an estate whose income is subject to U.S. federal income taxation regardless of its source; or
- any trust if (i) a U.S. court is able to exercise primary supervision over the administration of such trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or (ii) it has a valid election in place to be treated as a U.S. person.

If a partnership, entity or arrangement treated as a partnership for U.S. federal income tax purposes holds our stock, the U.S. federal income tax treatment of a partner in the partnership will generally depend on the status of the partner, the activities of the partnership and certain determinations made at the partner and/or partnership level. If you are a partner in a partnership holding shares of our stock, you are urged to consult your tax advisor regarding the consequences of the ownership and disposition of our stock by the partnership.

As long as we qualify as a REIT, a taxable U.S. stockholder must generally take into account as ordinary income distributions made out of our current or accumulated earnings and profits that we do not designate as capital gain dividends or retained long-term capital gain. For purposes of determining whether a distribution is made out of our current or accumulated earnings and profits, our earnings and profits will be allocated first to our preferred stock dividends, if any, and then to our common stock dividends. A corporate U.S. stockholder will not qualify for the dividends received deduction generally available to corporations. In addition, dividends paid to a U.S. stockholder generally will not qualify for the 20% tax rate for qualified dividend income. The maximum tax rate for qualified dividend income received by U.S. stockholders taxed at individual rates is currently 20%. The maximum tax rate on qualified dividend income is lower than the maximum tax rate on ordinary income, which is currently 39.6%. Qualified dividend income generally includes dividends paid by domestic C corporations and certain qualified foreign corporations to U.S. stockholders that are taxed at individual rates. Because we are not generally subject to federal income tax on the portion of our REIT taxable income distributed to our stockholders, our dividends generally will not be eligible for the 20% rate on qualified dividend income. As a result, our ordinary REIT dividends will be taxed at the higher tax rate applicable to ordinary income. However, the 20% tax rate for qualified dividend income will apply to our ordinary REIT dividends (i) attributable to dividends received by us from non-REIT corporations, such as a TRS, and (ii) to the extent attributable to income upon which we have paid corporate income tax (e.g., to the extent that we distribute less than 100% of our taxable income). In general, to qualify for the reduced tax rate on qualified dividend income, a stockholder must hold our stock for more than 60 days during the 121-day period beginning on the date that is 60 days before the date on which our stock begins trading ex-dividend. Individuals, trusts and estates whose income exceeds certain thresholds are also subject to a 3.8% Medicare tax on dividends received from us. We may pay taxable dividends of our stock or debt securities. In the case of such a taxable distribution of our stock or debt securities, U.S. stockholders would be required to include the dividend as income and would be required to satisfy the tax liability associated with the dividend with cash from other sources, including sales of our stock or debt securities.

A U.S. stockholder generally will take into account as long-term capital gain any distributions that we properly designate as capital gain dividends without regard to the period for which the U.S. stockholder has held our stock. A corporate U.S. stockholder, however, may be required to treat up to 20% of certain capital gain dividends as ordinary income.

We may elect to retain and pay income tax on the net long-term capital gain that we recognize in a taxable year. In that case, to the extent we designate such amount on a timely notice to such stockholder, a U.S.

47

Table of Contents

stockholder would be taxed on its proportionate share of our undistributed long-term capital gain. The U.S. stockholder would receive a credit or refund for its proportionate share of the tax we paid. The U.S. stockholder would increase the basis in its stock by the amount of its proportionate share of our undistributed long-term capital gain, minus its share of the tax we paid.

A U.S. stockholder will not incur tax on a distribution in excess of our current or accumulated earnings and profits if the distribution does not exceed the adjusted basis of the U.S. stockholder s stock. Instead, the distribution will reduce the adjusted basis of the U.S. stockholder s stock. A U.S. stockholder will recognize a distribution in excess of both our current and accumulated earnings and profits and the U.S. stockholder s adjusted basis in his or her stock as long-term capital gain, or short-term capital gain if the stock has been held for one year or less. In addition, if we declare a distribution in October, November or December of any year that is payable to a U.S. stockholder of record on a specified date in any such month, such distribution shall be treated as both paid by us and received by the U.S. stockholder on December 31 of such year, provided that we actually pay the distribution during January of the following calendar year.

Stockholders may not include in their individual income tax returns any of our net operating losses or capital losses. Instead, these losses are generally carried over by us for potential offset against our future income. Taxable distributions from us and gain from the disposition of our common stock will not be treated as passive activity income and, therefore, stockholders generally will not be able to apply any passive activity losses, such as losses from certain types of limited partnerships in which the stockholder is a limited partner, against such income. In addition, taxable distributions from us and gain from the disposition of our stock generally will be treated as investment income for purposes of the investment interest limitations. We will notify stockholders after the close of our taxable year as to the portions of the distributions attributable to that year that constitute ordinary income, return of capital, and capital gain.

We may recognize taxable income in excess of our economic income, known as phantom income, in the first years that we hold certain investments, and experience an offsetting excess of economic income over our taxable income in later years. As a result, stockholders at times may be required to pay U.S. federal income tax on distributions that economically represent a return of capital rather than a dividend. These distributions would be offset in later years by distributions representing economic income that would be treated as returns of capital for U.S. federal income tax purposes. Taking into account the time value of money, this acceleration of U.S. federal income tax liabilities may reduce a stockholder s after-tax return on his or her investment to an amount less than the after-tax return on an investment with an identical before-tax rate of return that did not generate phantom income. For example, if an investor with a 30% tax rate purchases a taxable bond with an annual interest rate of 10% on its face value, the investor s before-tax return on the investment would be 10% and the investor s after-tax return would be 7%. However, if the same investor purchased our common stock at a time when the before-tax rate of return was 10%, the investor s after-tax rate of return on such common stock might be somewhat less than 7% as a result of our phantom income. In general, as the ratio of our phantom income to our total income increases, the after-tax rate of return received by a taxable stockholder will decrease.

If excess inclusion income from a taxable mortgage pool is allocated to any stockholder, that income will be taxable in the hands of the stockholder and will not be offset by any net operating losses of the stockholder that would otherwise be available. See Requirements for Qualification Taxable Mortgage Pools. As required by IRS guidance, we intend to notify our stockholders if a portion of a dividend paid by us is attributable to excess inclusion income.

Taxation of U.S. Stockholders on the Disposition of Our Stock

A U.S. stockholder who is not a dealer in securities must generally treat any gain or loss realized upon a taxable disposition of our stock as long-term capital gain or loss if the U.S. stockholder has held the stock for more than one year and otherwise as short-term capital gain or loss. In general, a U.S. stockholder will realize gain or loss in an amount equal to the difference between the sum of the fair market value of any property and the amount of cash received in such disposition and the U.S. stockholder s adjusted tax basis. A stockholder s

48

Table of Contents

adjusted tax basis generally will equal the U.S. stockholder s acquisition cost, increased by the excess of net capital gains deemed distributed to the U.S. stockholder (discussed above) less tax deemed paid on such gains and reduced by any returns of capital. However, a U.S. stockholder must treat any loss upon a sale or exchange of stock held by such stockholder for six-months or less as a long-term capital loss to the extent of capital gain dividends and any other actual or deemed distributions from us that such U.S. stockholder treats as long-term capital gain. All or a portion of any loss that a U.S. stockholder realizes upon a taxable disposition of our stock may be disallowed if the U.S. stockholder purchases our stock or substantially identical stock within 30 days before or after the disposition.

Taxation of U.S. Stockholders on a Conversion of Our Preferred Stock

Except as provided below, (i) a U.S. stockholder generally will not recognize gain or loss upon the conversion of preferred stock into our common stock, and (ii) a U.S. stockholder s basis and holding period in our common stock received upon conversion generally will be the same as those of the converted preferred stock (but the basis will be reduced by the portion of adjusted tax basis allocated to any fractional share exchanged for cash). Any of our shares of common stock received in a conversion that are attributable to accumulated and unpaid dividends on the converted preferred stock will be treated as a distribution that is potentially taxable as a dividend. Cash received upon conversion in lieu of a fractional share generally will be treated as a payment in a taxable exchange for such fractional share, and gain or loss will be recognized on the receipt of cash in an amount equal to the difference between the amount of cash received and the adjusted tax basis allocable to the fractional share deemed exchanged. This gain or loss will be long-term capital gain or loss if the U.S. stockholder has held our preferred shares for more than one year at the time of conversion. U.S. stockholders are urged to consult with their tax advisors regarding the U.S. federal income tax consequences of any transaction by which such holder exchanges stock received on a conversion of preferred stock for cash or other property.

Taxation of U.S. Stockholders on a Redemption of Our Preferred Stock

A redemption of our preferred stock will be treated under Section 302 of the Code as a distribution that is taxable as dividend income (to the extent of our current or accumulated earnings and profits), unless the redemption satisfies certain tests set forth in Section 302(b) of the Code enabling the redemption to be treated as a sale of the preferred stock (in which case the redemption will be treated in the same manner as a sale described above in Taxation of U.S. Stockholders on the Disposition of Our Stock). The redemption will satisfy such tests if it (1) is substantially disproportionate with respect to the U.S. stockholder s interest in our stock, (2) results in a complete termination of the U.S. stockholder s interest in all of our classes of stock or (3) is not essentially equivalent to a dividend with respect to the stockholder, all within the meaning of Section 302(b) of the Code. In determining whether any of these tests have been met, stock considered to be owned by the holder by reason of certain constructive ownership rules set forth in the Code, as well as stock actually owned, generally must be taken into account. Because the determination as to whether any of the three alternative tests of Section 302(b) of the Code described above will be satisfied with respect to any particular U.S. stockholder of our preferred stock depends upon the facts and circumstances at the time that the determination must be made, prospective investors are urged to consult their tax advisors to determine such tax treatment. If a redemption of preferred stock does not meet any of the three tests described above, the redemption proceeds will be treated as a taxable as a dividend, as described above Taxation of Taxable U.S. Stockholders. In that case, a U.S. stockholder s adjusted tax basis in the redeemed preferred stock will be transferred to such U.S. stockholder s remaining stock holdings in us. If the U.S. stockholder does not retain any of our stock, such basis could be transferred to a related person that holds our stock or it may be lost.

Under proposed Treasury regulations, if any portion of the amount received by a U.S. stockholder on a redemption of any class of our preferred stock is treated as a distribution with respect to our stock but not as a taxable dividend, then such portion will be allocated to all shares of the redeemed class held by the redeemed stockholder just before the redemption on a pro-rata, share-by-share, basis. The amount applied to each share will first reduce the redeemed U.S. stockholder s basis in that share and any excess after the basis is reduced to zero will result in taxable gain. If the redeemed stockholder has different bases in its shares of stock, then the amount

49

Table of Contents

allocated could reduce some of the basis in certain shares of stock while reducing all the basis and giving rise to taxable gain in others. Thus, the redeemed U.S. stockholder could have gain even if such U.S. stockholder s basis in all its shares of the redeemed class exceeded such portion.

The proposed Treasury regulations permit the transfer of basis in the redeemed preferred stock to the redeemed U.S. stockholder s remaining, unredeemed preferred stock of the same class (if any), but not to any other class of stock held (directly or indirectly) by the redeemed U.S. stockholder. Instead, any unrecovered basis in the redeemed preferred stock would be treated as a deferred loss to be recognized when certain conditions are satisfied. The proposed Treasury regulations would be effective for transactions that occur after the date the regulations are published as final Treasury regulations. There can, however, be no assurance as to whether, when and in what particular form such proposed Treasury regulations will ultimately be finalized.

Capital Gains and Losses

A taxpayer generally must hold a capital asset for more than one year for gain or loss derived from its sale or exchange to be treated as long-term capital gain or loss. The highest marginal individual income tax rate currently is 39.6%. The maximum tax rate on long-term capital gain applicable to taxpayers taxed at individual rates is 20% for sales and exchanges of assets held for more than one year. The maximum tax rate on long-term capital gain from section 1250 property, or depreciable real property, is 25%, which applies to the lesser of the total amount of the gain or the accumulated depreciation on the Section 1250 property. In addition, individuals, trusts and estates whose income exceeds certain thresholds are also subject to a 3.8% Medicare tax on gain from the sale of our stock.

With respect to distributions that we designate as capital gain dividends and any retained capital gain that we are deemed to distribute, we generally may designate whether such a distribution is taxable to our stockholders taxed at individual rates at a 20% or 25% rate. Thus, the tax rate differential between capital gain and ordinary income for those taxpayers may be significant. In addition, the characterization of income as capital gain or ordinary income may affect the deductibility of capital losses. A non-corporate taxpayer may deduct capital losses not offset by capital gains against its ordinary income only up to a maximum annual amount of $3,000. A non-corporate taxpayer may carry forward unused capital losses indefinitely. A corporate taxpayer must pay tax on its net capital gain at ordinary corporate rates. A corporate taxpayer may deduct capital losses only to the extent of capital gains, with unused losses being carried back three years and forward five years.

Taxation of Tax-Exempt Stockholders

Tax-exempt entities, including qualified employee pension and profit sharing trusts and individual retirement accounts, generally are exempt from U.S. federal income taxation. However, they are subject to taxation on their UBTI. While many investments in real estate generate UBTI, the IRS has issued a ruling that dividend distributions from a REIT to an exempt employee pension trust do not constitute UBTI, provided that the exempt employee pension trust does not otherwise use the shares of the REIT in an unrelated trade or business of the pension trust. Based on that ruling, amounts that we distribute to tax-exempt stockholders generally should not constitute UBTI. However, if a tax-exempt stockholder were to finance its investment in our stock with debt, a portion of the income that it receives from us would constitute UBTI pursuant to the debt-financed property rules. Moreover, social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts, and qualified group legal services plans that are exempt from taxation under special provisions of the U.S. federal income tax laws are subject to different UBTI rules, which generally will require them to characterize distributions that they receive from us as UBTI. Furthermore, a tax-exempt stockholder s share of any excess inclusion income that we recognize would be subject to tax as UBTI.

Finally, in certain circumstances, a qualified employee pension or profit sharing trust that owns more than 10% of our stock is required to treat a percentage of the dividends that it receives from us as UBTI. Such

50

percentage is equal to the gross income that we derive from an unrelated trade or business, determined as if we were a pension trust, divided by our total gross income for the year in which we pay the dividends. That rule applies to a pension trust holding more than 10% of our stock only if:

- the percentage of our dividends that the tax-exempt trust would be required to treat as UBTI is at least 5%;
- we qualify as a REIT by reason of the modification of the rule requiring that no more than 50% of our stock be owned by five or fewer individuals that allows the beneficiaries of the pension trust to be treated as holding our stock in proportion to their actuarial interests in the pension trust; and
- either: (i) one pension trust owns more than 25% of the value of our stock or (ii) a group of pension trusts individually holding more than 10% of the value of our stock collectively owns more than 50% of the value of our stock.

Taxation of Non-U.S. Stockholders

The following discussion addresses the rules governing U.S. federal income taxation of the purchase, ownership and sale of our stock by non-U.S. stockholders. When we use the term non-U.S. stockholder, we mean beneficial owners of our stock who are not U.S. stockholders, as described above in Taxation of Taxable U.S. Stockholders, or partnerships (or entities or arrangements treated as partnerships for U.S. federal income tax purposes). The rules governing U.S. federal income taxation of non-U.S. stockholders are complex. This section is only a summary of such rules. **We urge non-U.S. stockholders to consult their tax advisers to determine the impact of federal, state, and local income tax laws on ownership of our stock, including any reporting requirements.**

A non-U.S. stockholder that receives a distribution that is not attributable to gain from our sale or exchange of a United States real property interest, or USRPI, as defined below, and that we do not designate as a capital gain dividend or retained capital gain will recognize ordinary income to the extent that we pay the distribution out of our current or accumulated earnings and profits. A withholding tax equal to 30% of the gross amount of the distribution ordinarily will apply unless an applicable tax treaty reduces or eliminates the tax. However, if a distribution is treated as effectively connected with the non-U.S. stockholder s conduct of a U.S. trade or business, the non-U.S. stockholder generally will be subject to U.S. federal income tax on the distribution at graduated rates, in the same manner as U.S. stockholders are taxed on distributions and also may be subject to the 30% branch profits tax in the case of a corporate non-U.S. stockholder. It is expected that the applicable withholding agent will withhold U.S. income tax at the rate of 30% on the gross amount of any distribution paid to a non-U.S. stockholder unless either:

- a lower treaty rate applies and the non-U.S. stockholder files with the applicable withholding agent an IRS Form W-8BEN evidencing eligibility for that reduced rate, or
- the non-U.S. stockholder files with the applicable withholding agent an IRS Form W-8ECI claiming that the distribution is effectively connected income.

However, reduced treaty rates are not available to the extent income allocated to the non-U.S. stockholder is excess inclusion income.

A non-U.S. stockholder will not incur U.S. tax on a distribution in excess of our current or accumulated earnings and profits if the excess portion of the distribution does not exceed the adjusted basis of its stock. Instead, the excess portion of the distribution will reduce the adjusted basis of that stock. A non-U.S. stockholder will be subject to tax on a distribution that exceeds both our current and accumulated earnings and profits and the adjusted basis of its stock, if the non-U.S. stockholder otherwise would be subject to tax on gain from the sale or disposition of its stock, as described below. Because we generally cannot determine at the time we make a distribution whether or not the distribution will exceed both our current and accumulated earnings and profits, it is expected that the applicable withholding agent normally will withhold tax on the entire amount of any distribution at the same rate as it would withhold on a dividend. However, by filing a U.S. tax return, a non-U.S. stockholder may obtain a refund of amounts that the applicable withholding agent withheld if we later determine that a distribution in fact exceeded our current and accumulated earnings and profits.

For payments made after June 30, 2014, a U.S. withholding tax at a 30% rate will be imposed on dividends paid on our stock received by certain non-U.S. stockholders if certain disclosure requirements related to U.S. accounts or ownership are not satisfied. In addition, if those disclosure requirements are not satisfied, a U.S. withholding tax at a 30% rate will be imposed, for payments made after December 31, 2016, on proceeds from the sale of our stock received by certain non-U.S. stockholders. If payment of withholding taxes is required, non-U.S. stockholders that are otherwise eligible for an exemption from, or reduction of, U.S. withholding taxes with respect of such dividends and proceeds will be required to seek a refund from the IRS to obtain the benefit or such exemption or reduction. We will not pay any additional amounts in respect of any amounts withheld.

For any year in which we qualify as a REIT, a non-U.S. stockholder could incur tax on distributions that are attributable to gain from our sale or exchange of USRPI, under the Foreign Investment in Real Property Act of 1980, or FIRPTA. A USRPI includes certain interests in real property and shares in corporations at least 50% of whose assets consist of interests in real property. The term USRPI does not generally include mortgage loans or RMBS, such as Agency RMBS. As a result, we do not anticipate that we will generate material amounts of gain that would be subject to FIRPTA. Under the FIRPTA rules, a non-U.S. stockholder is taxed on distributions attributable to gain from sales of USRPIs as if the gain were effectively connected with a U.S. business of the non-U.S. stockholder. A non-U.S. stockholder thus would be taxed on such a distribution at the normal capital gain rates applicable to U.S. stockholders, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of a nonresident alien individual. A non-U.S. corporate stockholder not entitled to treaty relief or exemption also might be subject to the 30% branch profits tax on such a distribution. The applicable withholding agent would be required to withhold 35% of any such distribution that we could designate as a capital gain dividend. A non-U.S. stockholder might receive a credit against its tax liability for the amount withheld.

However, if the applicable class of our stock is regularly traded on an established securities market in the United States, capital gain distributions on our stock that are attributable to our sale of real property will be treated as ordinary dividends rather than as gain from the sale of a USRPI, as long as the non-U.S. stockholder does not own more than 5% of that class of our stock during the one-year period preceding the date of the distribution. As a result, non-U.S. stockholders generally will be subject to withholding tax on such capital gain distributions in the same manner as they are subject to withholding tax on ordinary dividends. We believe that our common stock currently is treated as regularly traded on an established securities market in the United States. If the applicable class of our stock is not regularly traded on an established securities market in the United States or the non-U.S. stockholder owned more than 5% of the applicable class of our stock any time during the one-year period prior to the distribution, capital gain distributions that are attributable to our sale of real property would be subject to tax under FIRPTA. Moreover, if a non-U.S. stockholder disposes of our stock during the 30-day period preceding a dividend payment, and such non-U.S. stockholder (or a person related to such non-U.S. stockholder) acquires or enters into a contract or option to acquire our stock within 61 days of the 1st day of the 30 day period described above, and any portion of such dividend payment would, but for the disposition, be treated as a USRPI capital gain to such non-U.S. stockholder, then such non-U.S. stockholder shall be treated as having USRPI capital gain in an amount that, but for the disposition, would have been treated as USRPI capital gain.

A non-U.S. stockholder generally will not incur tax under FIRPTA with respect to gain realized upon a disposition of our stock as long as we are not a United States real property holding corporation during a specified testing period. If at least 50% of a REIT s assets are USRPIs, then the REIT will be a United States real property holding corporation. We do not believe that we are a United States real property holding corporation based on our asset mix and investment strategy. In the unlikely event that at least 50% of the assets we hold were determined to be USRPIs, gains from the sale of our stock by a non-U.S. stockholder could be subject to a FIRPTA tax. However, even if that event were to occur, a non-U.S. stockholder generally would not incur tax

52

Table of Contents

under FIRPTA on gain from the sale of our stock if we were a domestically controlled qualified investment entity. A domestically controlled qualified investment entity includes a REIT in which, at all times during a specified testing period, less than 50% in value of its shares are held directly or indirectly by non-U.S. persons. We cannot assure you that this test will be met. If the applicable class of our stock is regularly traded on an established securities market, an additional exception to the tax under FIRPTA will be available with respect to such class of our stock, even if we do not qualify as a domestically controlled qualified investment entity at the time the non-U.S. stockholder sells such stock. Under that exception, the gain from such a sale by such a non-U.S. stockholder will not be subject to tax under FIRPTA if:

- the applicable class of our stock is treated as being regularly traded under applicable U.S. Treasury regulations on an established securities market; and

- the non-U.S. stockholder owned, actually or constructively, 5% or less of the applicable class of our stock at all times during a specified testing period.

As noted above, we believe that our common stock is currently treated as regularly traded on an established securities market.

If the gain on the sale of our stock were taxed under FIRPTA, a non-U.S. stockholder would be taxed on that gain in the same manner as U.S. stockholders, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals. Furthermore, a non-U.S. stockholder generally will incur tax on gain not subject to FIRPTA if:

- the gain is effectively connected with the non-U.S. stockholder s U.S. trade or business, in which case the non-U.S. stockholder will be subject to the same treatment as U.S. stockholders with respect to such gain, or

- the non-U.S. stockholder is a nonresident alien individual who was present in the United States for 183 days or more during the taxable year and has a tax home in the United States, in which case the non-U.S. stockholder will incur a tax of 30% on his or her net capital gains.

Information Reporting Requirements and Backup Withholding, Shares Held Offshore

We will report to our stockholders and to the IRS the amount of distributions we pay during each calendar year, and the amount of tax we withhold, if any. Under the backup withholding rules, a stockholder may be subject to backup withholding at a rate of 28% with respect to distributions unless the holder:

- is a corporation or qualifies for certain other exempt categories and, when required, demonstrates this fact; or

- provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with the applicable requirements of the backup withholding rules.

A stockholder who does not provide the applicable withholding agent with its correct taxpayer identification number also may be subject to penalties imposed by the IRS. Any amount paid as backup withholding will be creditable against the stockholder s income tax liability. In addition, the applicable withholding agent may be required to withhold a portion of capital gain distributions to any stockholders who fail to certify their U.S. status.

Backup withholding will generally not apply to payments of dividends made by us or our paying agents, in their capacities as such, to a non-U.S. stockholder provided that the non-U.S. stockholder furnishes to the applicable withholding agent the required certification as to its non-U.S. status, such as providing a valid IRS Form W-8BEN or W-8ECI, or certain other requirements are met. Notwithstanding the foregoing, backup withholding may apply if the applicable withholding agent has actual knowledge, or reason to know, that the holder is a U.S. person that is not an exempt recipient. Payments of the net proceeds from a disposition or a redemption effected outside the United States by a non-U.S. stockholder made by or through a foreign office of a broker generally will not be subject to information reporting or backup withholding. However, information reporting (but not backup withholding) generally will apply to such a payment if the broker has certain connections with the U.S. unless the broker has documentary evidence in its records that the beneficial owner is a non-U.S. stockholder and specified conditions are met or an exemption is otherwise established. Payment of the net proceeds from a disposition by a non-U.S. stockholder of stock made by or through the U.S. office of a broker is generally subject to information reporting and backup withholding unless the non-U.S. stockholder certifies under penalties of perjury that it is not a U.S. person and satisfies certain other requirements, or otherwise establishes an exemption from information reporting and backup withholding.

Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules may be refunded or credited against the stockholder s U.S. federal income tax liability if certain required information is timely furnished to the IRS. Stockholders are urged consult their tax advisors regarding application of backup withholding to them and the availability of, and procedure for obtaining an exemption from, backup withholding.

For payments made after June 30, 2014, a U.S. withholding tax at a 30% rate will be imposed on dividends paid on our stock received by U.S. stockholders who own their shares through foreign accounts or foreign intermediaries if certain disclosure requirements related to U.S. accounts or ownership are not satisfied. In addition, if those disclosure requirements are not satisfied, a U.S. withholding tax at a 30% rate will be imposed, for payments made after December 31, 2016, on proceeds from the sale of our stock received by U.S. stockholders who own their shares through foreign accounts or foreign intermediaries. We will not pay any additional amounts in respect of any amounts withheld.

Legislative or Other Actions Affecting REITs

The present federal income tax treatment of REITs may be modified, possibly with retroactive effect, by legislative, judicial or administrative action at any time. The REIT rules are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Treasury Department which may result in statutory changes as well as revisions to regulations and interpretations. Additionally, several of the tax considerations described herein are currently under review and are subject to change. Prospective securityholders are urged to consult with their own tax advisors regarding the effect of potential changes to the federal tax laws on an investment in our securities.

State, Local and Foreign Taxes

We and our subsidiaries and stockholders may be subject to state, local or foreign taxation in various jurisdictions, including those in which we or they transact business, own property or reside. The state, local or foreign tax treatment of us and our stockholders may not conform to the U.S. federal income tax treatment discussed above. Any foreign taxes incurred by us would not pass through to our securityholders against their U.S. federal income tax liability. Prospective stockholders should consult their tax advisors regarding the application and effect of state, local and foreign income and other tax laws on an investment in our securities.

Table of Contents

SELLING STOCKHOLDER

The following table sets forth certain information with respect to the selling stockholder s beneficial ownership of our common stock as of May 15, 2014. The selling stockholder acquired these shares of common stock from us in a series of private placements in 2010, 2011 and 2012 in connection with our formation and initial capitalization prior to the completion of our initial public offering. We have determined beneficial ownership in accordance with the rules of the SEC. Except as indicated by the footnotes below, we believe, based on the information furnished to us, that the selling stockholder has sole voting and investment power with respect to all shares of common stock that it beneficially owns. Based on the information provided to us by the selling stockholder, the selling stockholder is not a broker-dealer or an affiliate of a broker-dealer.

Our Manager, Bimini Advisors, LLC, is a wholly-owned subsidiary of the selling stockholder. Information about additional selling stockholders may be set forth in a prospectus supplement, in a post-effective amendment or in filings that we make with the SEC under the Exchange Act, which are incorporated by reference in this prospectus.

The selling stockholder named below and its permitted transferees, pledgees, orderees or other successors may from time to time offer and sell the shares of our common stock offered by this prospectus.

Name of Selling Stockholder	**Amount and Nature of Beneficial Ownership of Our Common Stock**	**Number of Shares of Stock Offered**	**Percent of Class**	**Number and Nature of Common Stock Owned After Resale**	**Percent of Class After Resale[(2)]**
Bimini Capital Management, Inc.[(1)]	981,665	981,665	10.8%		

(1) Bimini Advisors, LLC, our Manager, is a wholly-owned subsidiary of Bimini Capital Management, Inc., or Bimini. Robert E. Cauley and G. Hunter Haas, IV, who comprise Bimini s and our Manager s senior management team, also serve as our executive officers. The board of directors and senior management team of Bimini control the voting and dispositive powers over the shares held by Bimini. Robert E. Cauley, Robert J. Dwyer and Frank E. Jaumot serve as Bimini s board of directors.

(2) Assumes that the selling stockholder sells all of its shares of our common stock offered pursuant to this prospectus. It is difficult to estimate with any degree of certainty the amount and percentage of shares of common stock that would be held by the selling stockholder after completion of the offering. The selling stockholder may offer all, some or none of such its shares of common stock.

Table of Contents

PLAN OF DISTRIBUTION

We, or the selling stockholder, may sell the securities offered by this prospectus from time to time in one or more transactions, including without limitation:

- through underwriters or dealers;
- directly to purchasers;
- in a rights offering;
- in at the market offerings within the meaning of Rule 415(a)(4) of the Securities Act to or through a market maker or into an existing trading market on an exchange or otherwise;
- through agents;
- through a combination of any of these methods; or
- through any other method permitted by applicable law and described in a prospectus supplement.

The prospectus supplement with respect to any offering of securities will include the following information:

- the terms of the offering;
- the names of any underwriters or agents;
- the name or names of any managing underwriter or underwriters;
- the purchase price or initial public offering price of the securities;
- the net proceeds from the sale of the securities;
- any delayed delivery arrangements;

any underwriting discounts, commissions and other items constituting underwriters compensation;

any discounts or concessions allowed or reallowed or paid to dealers;

any commissions paid to agents; and

any securities exchange on which the securities may be listed.

Sale Through Underwriters or Dealers

If underwriters are used in the sale, the underwriters may resell the securities from time to time in one or more transactions, including negotiated transactions, at a fixed public offering price or at varying prices determined at the time of sale. Underwriters may offer securities to the public either through underwriting syndicates represented by one or more managing underwriters or directly by one or more firms acting as underwriters. Unless we inform you otherwise in the applicable prospectus supplement, the obligations of the underwriters to purchase the securities will be subject to certain conditions, and the underwriters will be obligated to purchase all of the offered securities if they purchase any of them. The underwriters may change from time to time any initial public offering price and any discounts or concessions allowed or reallowed or paid to dealers.

We will describe the name or names of any underwriters, dealers or agents and the purchase price of the securities in a prospectus supplement relating to the securities.

In connection with the sale of the securities, underwriters may receive compensation from us or the selling stockholder or from purchasers of the securities, for whom they may act as agents, in the form of discounts, concessions or commissions. Underwriters may sell the securities to or through dealers, and these dealers may

Table of Contents

receive compensation in the form of discounts, concessions or commissions from the underwriters and/or commissions from the purchasers for whom they may act as agents, which is not expected to exceed that customary in the types of transactions involved. Underwriters, dealers and agents that participate in the distribution of the securities may be deemed to be underwriters, and any discounts or commissions they receive from us or the selling stockholder, and any profit on the resale of the securities they realize may be deemed to be underwriting discounts and commissions, under the Securities Act. The prospectus supplement will identify any underwriter or agent and will describe any compensation they receive from us or the selling stockholder.

Underwriters could make sales in privately negotiated transactions and/or any other method permitted by law, including sales deemed to be an at-the-market offering, sales made directly on the NYSE MKT, the existing trading market for our common stock, or such other exchange or automated quotation system on which our securities trade, or sales made to or through a market maker other than on an exchange. The name of any such underwriter or agent involved in the offer and sale of our securities, the amounts underwritten, and the nature of its obligations to take our securities will be described in the applicable prospectus supplement.

Unless otherwise specified in the prospectus supplement, each series of the securities will be a new issue with no established trading market, other than our common stock, which is currently listed on the NYSE MKT. We currently intend to list any shares of common stock sold or resold pursuant to this prospectus on the NYSE MKT. We may elect to list any series of preferred stock on an exchange, but are not obligated to do so. It is possible that one or more underwriters may make a market in a series of the securities, but underwriters will not be obligated to do so and may discontinue any market making at any time without notice. Therefore, we can give no assurance about the liquidity of or the trading market for any of the securities.

Under agreements we, or our selling stockholder, may enter into, we, or our selling stockholder, may indemnify underwriters, dealers, and agents who participate in the distribution of the securities against certain liabilities, including liabilities under the Securities Act, or contribute with respect to payments that the underwriters, dealers or agents may be required to make. Unless otherwise set forth in the accompanying prospectus supplement, the obligations of any underwriters to purchase any of the securities will be subject to certain conditions precedent.

In compliance with the guidelines of the Financial Industry Regulatory Authority, Inc., or FINRA, the maximum aggregate discounts, commissions, agency fees or other items constituting underwriting compensation to be received by any FINRA member or independent broker-dealer will not exceed 8% of the aggregate offering price of the securities offered pursuant to this prospectus and any applicable prospectus supplement.

To facilitate the offering of securities, certain persons participating in the offering may engage in transactions that stabilize, maintain or otherwise affect the price of the securities. This may include over-allotments or short sales of the securities, which involve the sale by persons participating in the offering of more securities than we sold to them. In these circumstances, these persons would cover such over-allotments or short positions by making purchases in the open market or by exercising their over-allotment option, if any. In addition, these persons may stabilize or maintain the price of the securities by bidding for or purchasing securities in the open market or by imposing penalty bids, whereby selling concessions allowed to dealers participating in the offering may be reclaimed if securities sold by them are repurchased in connection with stabilization transactions. The effect of these transactions may be to stabilize or maintain the market price of the securities at a level above that which might otherwise prevail in the open market. These transactions may be discontinued at any time.

From time to time, we or our affiliates may engage in transactions with these underwriters, dealers and agents in the ordinary course of business. Underwriters have from time to time in the past provided, and may from time to time in the future provide, investment banking services to us, or the selling stockholder, for which they have in the past received, and may in the future receive, customary fees.

Table of Contents

Direct Sales and Sales through Agents

We, or the selling stockholder, may sell the securities directly. In this case, no underwriters or agents would be involved. We, or the selling stockholder, may also sell the securities through agents designated by us and the selling stockholder from time to time. In the applicable prospectus supplement, we will name any agent involved in the offer, sale or resale of the offered securities, and we will describe any commissions payable to the agent. Unless we inform you otherwise in the applicable prospectus supplement, any agent will agree to use its reasonable best efforts to solicit purchases for the period of its appointment.

We, or the selling stockholder, may sell the securities directly to institutional investors or others who may be deemed to be underwriters within the meaning of the Securities Act with respect to any sale of those securities. We will describe the terms of any sales of these securities in the applicable prospectus supplement.

Remarketing Arrangements

Securities may also be offered and sold, if so indicated in the applicable prospectus supplement, in connection with a remarketing upon their purchase, in accordance with a redemption or repayment pursuant to their terms, or otherwise, by one or more remarketing firms, acting as principals for their own accounts or as agents for us or the selling stockholder. Any remarketing firm will be identified and the terms of its agreements, if any, with us and the selling stockholder and its compensation will be described in the applicable prospectus supplement.

Delayed Delivery Contracts

If we so indicate in the applicable prospectus supplement, we, or the selling stockholder, may authorize agents, underwriters or dealers to solicit offers from certain types of institutions to purchase securities from us at the public offering price under delayed delivery contracts. Institutions with which we, or the selling stockholder, may make these delayed delivery contracts include commercial and savings banks, insurance companies, pension funds, investment companies, educational and charitable institutions and others. These contracts would provide for payment and delivery on a specified date in the future. The contracts would be subject only to those conditions described in the applicable prospectus supplement. The obligations of any purchaser under any such delayed delivery contract will be subject to the condition that the purchase of the securities shall not at the time of delivery be prohibited under the laws of the jurisdiction to which the purchaser is subject. The underwriters and other agents will not have any responsibility with regard to the validity or performance of these delayed delivery contracts. The applicable prospectus supplement will describe the commission payable for solicitation of those contracts.

General Information

We, or the selling stockholder, may have agreements with the underwriters, dealers, agents and remarketing firms to indemnify them against certain civil liabilities, including liabilities under the Securities Act, or to contribute with respect to payments that the underwriters, dealers, agents or remarketing firms may be required to make. Underwriters, dealers, agents and remarketing firms may be customers of, engage in transactions with or perform services for us, or the selling stockholder, in the ordinary course of their businesses.

Table of Contents

LEGAL MATTERS

Certain legal matters in connection with this offering including the validity of the shares being offered by this prospectus and certain tax matters will be passed upon for us by Hunton & Williams LLP. Venable LLP will issue an opinion to us regarding certain matters of Maryland law, including the validity of the shares of common stock offered by this prospectus. Certain legal matters will be passed upon for the underwriters or agents, if any, by the counsel named in the prospectus supplement.

EXPERTS

The financial statements as of December 31, 2013 and 2012 and for each of the two years in the period ended December 31, 2013 incorporated by reference in this prospectus have been so incorporated in reliance on the report of BDO USA, LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

WHERE YOU CAN FIND MORE INFORMATION

We have filed with the SEC a registration statement on Form S-3, including exhibits and schedules filed with the registration statement of which this prospectus is a part, under the Securities Act with respect to the securities covered by this prospectus. This prospectus does not contain all of the information set forth in the registration statement and exhibits and schedules to the registration statement. For further information with respect to us and the securities covered by this prospectus, reference is made to the registration statement, including the exhibits and schedules to the registration statement. Copies of the registration statement, including the exhibits and schedules to the registration statement, may be examined without charge at the public reference room of the SEC, 100 F Street, N.E., Room 1580, Washington, DC 20549. Information about the operation of the public reference room may be obtained by calling the SEC at 1-800-SEC-0300. Copies of all or a portion of the registration statement can be obtained from the public reference room of the SEC upon payment of prescribed fees. Our SEC filings, including our registration statement, are also available to you for free on the SEC s website at www.sec.gov.

We are subject to the information and reporting requirements of the Exchange Act and file periodic reports and proxy statements and make available to our stockholders annual reports containing audited financial information for each year and quarterly reports for the first three quarters of each fiscal year containing unaudited interim financial information.

Table of Contents

INCORPORATION OF CERTAIN INFORMATION BY REFERENCE

The SEC allows us to incorporate by reference into this prospectus certain information filed with the SEC, which means that we can disclose important information to you by referring you directly to certain documents. Any statement in a document incorporated by reference into this prospectus will be deemed to be modified or superseded to the extent a statement contained in this prospectus modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this prospectus. We incorporate by reference the documents listed below:

- our Annual Report on Form 10-K for the year ended December 31, 2013;
- the information specifically incorporated by reference into our Annual Report on Form 10-K for the year ended December 31, 2013 from our definitive proxy statement on Schedule 14A for our 2014 annual meeting of stockholders;
- our Quarterly Report on Form 10-Q for the three months ended March 31, 2014;
- our current report on Form 8-K filed on January 10, 2014, February 13, 2014, March 12, 2014, April 3, 2014 and April 9, 2014;
- the description of our capital stock in our Registration Statement on Form 8-A/A filed on February 13, 2013; and
- all documents filed by us under Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act on or after the date of this prospectus and before the termination of this offering.

We also specifically incorporate by reference any documents filed by us with the SEC pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act after the date on which the registration statement which this prospectus forms a part was initially filed by us with the SEC and prior to effectiveness of the registration statement.

You may request a copy of these filings at no cost, by writing to or telephoning us at the following address:

Orchid Island Capital, Inc.

3350 Flamingo Drive

Vero Beach, Florida 32963

(772) 231-1400

You may also obtain copies of this information by visiting our website at http://www.orchidislandcapital.com.

To the extent that any information contained in any Current Report on Form 8-K, or any exhibit thereto, was furnished to, rather than filed with, the SEC, such information or exhibit is specifically not incorporated by reference in this prospectus.

You should rely only on the information provided or incorporated by reference in this prospectus. We have not authorized anyone to provide you with additional or different information. You should not assume that the information in this prospectus is accurate as of any date other than the date on the front cover of this prospectus.

Table of Contents

$125,000,000

Common Stock

Prospectus Supplement

Ladenburg Thalmann **MUFG**

July 29, 2016