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

Form 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF 1934

For quarterly period ended June 30, 2000

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _______________ to __________________

Commission File Number: 0-11576

HARRIS & HARRIS GROUP, INC.

(Exact name of registrant as specified in its charter)

| New York | 13-3119827 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

| One Rockefeller Plaza, Rockefeller Center, New York, New York | 10020 |
|---|---|
| (Address of Principal Executive Offices) | (Zip Code) |

212/332-3600

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class | Outstanding at August 8, 2000 |
|---|---|
| Common Stock, $0.01 par value per share | 9,240,831 shares |

Harris & Harris Group, Inc.
Form 10-Q, June 30, 2000

TABLE OF CONTENTS

Harris & Harris Group, Inc.
Form 10-Q, June 30, 2000

## PART I. FINANCIAL INFORMATION

### Item 1. Consolidated Financial Statements

The information furnished in the accompanying consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair presentation of the results for the interim period presented.

On June 30, 1994, the Company's shareholders approved a proposal to allow the Company to make an election to become a Business Development Company ("BDC") under the amended Investment Company Act of 1940. The Company made such election on July 26, 1995. Certain information and disclosures normally included in the consolidated financial statements in accordance with Generally Accepted Accounting Principles have been condensed or omitted as permitted by Regulation S-X and Regulation S-K. It is suggested that the accompanying consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 1999 contained in the Company's 1999 Annual Report.

On September 25, 1997, the Company's Board of Directors approved a proposal to seek qualification of the Company as a Regulated Investment Company ("RIC") under Sub-Chapter M of the Internal Revenue Code (the "Code"). At that time, the Company was taxable under Sub-Chapter C of the Code (a "C Corporation"). On April 8, 1998, the Company announced that it had received a certification from the Securities and Exchange Commission ("SEC") for 1997 relating to the Company's status under section 851(e) of the Code. That certification was necessary for the Company to qualify as a RIC for 1998 and subsequent taxable years.

In 1999, because of changes in its investment portfolio, the Company requested recertification from the SEC relating to the Company's status under section 851(e) of the Code. On February 24, 2000, the Company received the certification, and the Company intends to elect Sub-Chapter M tax treatment for 1999 and 2000. However, there can be no assurance that the Company will qualify for Sub-Chapter M treatment in subsequent years. In addition, under certain circumstances, even if the Company qualified for Sub-Chapter M treatment in a given year and elected Sub-Chapter M treatment for that year, the Company might take action in a subsequent year to ensure that it would be taxed in that subsequent year as a C Corporation, rather than as a RIC. On February 17, 1999, the Company received rulings from the Internal Revenue Service (the "IRS") regarding other issues relevant to the Company's tax status as a RIC. (See "Note 6 of Notes to Consolidated Financial Statements" contained in "Item 1. Consolidated Financial Statements" & "Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations -- Sub-Chapter M Status.")



The qualification of the Company as a RIC under Sub-Chapter M of the Code depends on it satisfying certain technical requirements regarding its income, investment portfolio and distributions. The Company was unable to satisfy these requirements for the 1998 tax year owing to the nature of the Company's ownership interest in one of its investee companies, and therefore it did not elect Sub-Chapter M status for 1998. The Company changed the nature of its ownership interest in the non-qualifying investee company effective January 1, 1999 in order to meet the Sub-Chapter M requirements. In addition, because the Company realized taxable losses in 1998, it was not strategically advantageous for the Company to elect Sub-Chapter M tax status for 1998. Moreover, the Company received a tax opinion in 1998 that the Company interprets to mean that its tax-loss carryforward at December 31, 1998 of approximately $7.0 million (resulting in a tax credit of approximately $2.5 million) would be applicable as a qualifying RIC to offset the Company's unrealized gains as of December 31, 1998. That opinion was confirmed in one of the rulings received from the IRS in February 1999.



## CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES

### ASSETS

| | June 30, 2000 (Unaudited) | December 31, 1999 (Audited) |
|---|---|---|
| Investments, at value (See accompanying schedule of investments and notes) | $ 44,236,607 | $ 63,535,651 |
| Cash and cash equivalents | 231,944 | 133,256 |
| Restricted funds (Note 5) | 147,656 | 0 |
| Funds in escrow (Note 7) | 0 | 1,327,748 |
| Interest receivable | 218 | 44,189 |
| Note receivable | 21,776 | 32,663 |
| Prepaid expenses | 35,681 | 74,328 |
| Other assets | 141,413 | 172,933 |
| Total assets | $ 44,815,295 | $ 65,320,768 |

### LIABILITIES & NET ASSETS

| | June 30, 2000 (Unaudited) | December 31, 1999 (Audited) |
|---|---|---|
| Accounts payable and accrued liabilities | $ 592,814 | $ 700,566 |
| Accrued profit sharing (Note 3) | 4,293,344 | 9,434,467 |
| Income tax liability (Note 6) | 2,672,413 | 0 |
| Deferred income tax liability (Note 6) | 1,364,470 | 1,517,774 |
| Deferred rent | 28,529 | 33,156 |
| Total liabilities | 8,951,570 | 11,685,963 |
| Commitments and contingencies (Note 7) | | |
| Net assets | $ 35,863,725 | $ 53,634,805 |
| Net assets are comprised of: | | |
| Preferred stock, $0.10 par value, 2,000,000 shares authorized; none issued | $ 0 | $ 0 |
| Common stock, $0.01 par value, 25,000,000 shares authorized; 10,692,971 issued at 6/30/00 and 12/31/99 | 106,930 | 106,930 |
| Additional paid in capital | 16,159,504 | 16,159,504 |
| Additional paid in capital - common stock warrants | 109,641 | 0 |
| Accumulated net realized income (deficit) | 3,309,454 | (5,192,860) |
| Accumulated unrealized appreciation of investments, net of deferred tax liability of $1,630,506 at 6/30/00 and $1,783,810 at 12/31/99 | 18,715,676 | 45,098,711 |
| Treasury stock, at cost, 1,452,140 shares at 6/30/00 and 12/31/99 | (2,537,480) | (2,537,480) |
| Net assets | $ 35,863,725 | $ 53,634,805 |
| Total net assets and liabilities | $ 44,815,295 | $ 65,320,768 |
| Shares outstanding | 9,240,831 | 9,240,831 |
| Net asset value per outstanding share | $ 3.88 | $ 5.80 |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three Months Ended 6/30/00 | Three Months Ended 6/30/99 | Six Months Ended 6/30/00 | Six Months Ended 6/30/99 |
|---|---|---|---|---|
| Investment income: | | | | |
| Interest from: | | | | |
| Fixed-income securities. | $ 60,861 | $ 75,999 | $ 144,815 | $ 121,208 |
| Affiliated companies . . | 12,376 | 8,689 | 34,058 | 9,317 |
| Other income. . . . . . . | 19,252 | 300 | 35,064 | 300 |
| Total investment income. | 92,489 | 84,988 | 213,937 | 130,825 |
| Expenses: | | | | |
| Profit-sharing (reversal) accrual (Note 3) . . . . | (2,465,091) | 517,229 | (4,116,427) | 1,418,570 |
| Salaries and benefits . . | 244,740 | 185,255 | 522,286 | 392,333 |
| Administration and operations . . . . . . . | 152,525 | 115,154 | 245,099 | 187,879 |
| Professional fees . . . . | 120,707 | 62,973 | 206,014 | 123,990 |
| Rent. . . . . . . . . . . | 41,634 | 41,378 | 83,109 | 82,756 |
| Directors' fees and expenses . . . . . . . . | 34,278 | 26,702 | 55,410 | 63,116 |
| Depreciation. . . . . . . | 10,000 | 12,500 | 20,000 | 25,000 |
| Custodian fees. . . . . . | 1,064 | 1,551 | 4,600 | 3,283 |
| Interest expense (Note 4) . . . . . . . . | 0 | 0 | 146,141 | 0 |
| Total expenses. . . . . | (1,860,143) | 962,742 | (2,833,768) | 2,296,927 |
| Operating income (loss) before income taxes. . . | 1,952,632 | (877,754) | 3,047,705 | (2,166,102) |
| Income tax provision (Note 6) . . . . . . . . | 0 | 0 | 0 | 0 |
| Net operating income (loss) . . . . . . . . . | 1,952,632 | (877,754) | 3,047,705 | (2,166,102) |
| Net realized gain on investments: | | | | |
| Realized gain on investments. . . . . . . | 4,332,410 | 380,270 | 8,095,682 | 11,125,818 |
| Total realized gain . . | 4,332,410 | 380,270 | 8,095,682 | 11,125,818 |
| Income tax provision (Note 6) . . . . . . . . | (1,457,455) | 0 | (2,641,073) | (2,479,821) |
| Net realized gain on investments. . . . . . . | 2,874,955 | 380,270 | 5,454,609 | 8,645,997 |
| Net realized income (loss). | 4,827,587 | (497,484) | 8,502,314 | 6,479,895 |
| Net (decrease) increase in unrealized appreciation on investments: | | | | |
| Increase as a result of investment sales. . . | 0 | 485,906 | 0 | 485,906 |
| Decrease as a result of investment sales . . . . | (9,247,287) | (55,898) | (12,452,277) | (4,840,700) |
| Increase on investments held . . . . . . . . . . | 1,094,989 | 2,996,453 | 15,433,562 | 3,055,180 |
| Decrease on investments held . . . . . . . . . . | (7,783,785) | (256,838) | (29,517,624) | (975,254) |
| Change in unrealized appreciation on investments . . . . . . | (15,936,083) | 3,169,623 | (26,536,339) | (2,274,868) |
| Income tax (provision) benefit (Note 6). . . . | 0 | (29,097) | 153,304 | 1,676,279 |
| Net (decrease) increase in unrealized appreciation on investments. . . . . | (15,936,083) | 3,140,526 | (26,383,035) | (598,589) |
| Net (decrease) increase in net assets from operations: | | | | |
| Total . . . . . . . . . . . | $(11,108,496) | $ 2,643,042 | $(17,880,721) | $ 5,881,306 |
| Per outstanding share . . | $ (1.20) | $ 0.26 | $ (1.93) | $ 0.57 |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Six Months Ended June 30, 2000 | Six Months Ended June 30, 1999 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net (decrease) increase in net assets resulting from operations. . | $(17,880,721) | $ 5,881,306 |
| Adjustments to reconcile net (decrease) increase in net assets from operations to net cash used in operating activities: | | |
| Net realized and unrealized loss (gain) on investments. . . . | 18,440,657 | (8,850,950) |
| Depreciation . . . . . . . . . . . | 20,000 | 25,000 |
| Other. . . . . . . . . . . . . . . | 83,007 | 0 |
| Changes in assets and liabilities: | | |
| Receivable from brokers. . . . . . | 0 | (428,030) |
| Interest receivable. . . . . . . . | 43,971 | (27,522) |
| Prepaid expenses . . . . . . . . . | 38,647 | 24,354 |
| Funds in escrow (Note 7) . . . . . | 1,327,748 | (1,327,748) |
| Restricted funds (Note 5). . . . . | (147,656) | 0 |
| Other assets . . . . . . . . . . . | 18,489 | 3,650 |
| Accounts payable and accrued liabilities . . . . . . . . . . . | (107,752) | (105,315) |
| Accrued profit sharing (Note 3). . | (5,141,123) | 1,418,570 |
| Income tax liability . . . . . . . | 2,672,413 | 0 |
| Deferred income tax liability. . . | (153,304) | 803,542 |
| Deferred rent. . . . . . . . . . . | (4,627) | (4,627) |
| Collection on notes receivable . . | 10,887 | 10,000 |
| Net cash used in operating activities . . . . . . . . . . . . | (779,364) | (2,577,770) |
| Cash flows from investing activities: | | |
| Sales of short-term investments and marketable securities . . . . | (4,277,993) | (3,208,695) |
| Proceeds from sale of investments. | 9,580,519 | 12,274,631 |
| Investment in private placements and loans . . . . . . . . . . . . | (4,417,500) | (2,277,001) |
| Purchase of fixed assets . . . . . | (6,974) | 0 |
| Net cash provided by investing activities. . . . . . . . . . . . | 878,052 | 6,788,935 |
| Cash flows from financing activities: | | |
| Payment of dividend. . . . . . . . | 0 | (3,647,017) |
| Proceeds from note payable . . . . | 3,000,000 | 0 |
| Payment of note payable (Note 7) . | (3,000,000) | 0 |
| Proceeds from sale of stock. . . . | 0 | 17,283 |
| Purchase of stock (Note 4) . . . . | 0 | (540,720) |
| Net cash used in financing activities. . . . . . . . . . . . | 0 | (4,170,454) |
| Net increase in cash and cash equivalents: | | |
| Cash and cash equivalents at beginning of the period . . . . . | 133,256 | 164,143 |
| Cash and cash equivalents at end of the period . . . . . . . . . . | 231,944 | 204,854 |
| Net increase in cash and cash equivalents. . . . . . . . . . . . | $ 98,688 | $ 40,711 |
| Supplemental disclosures of cash flow information: | | |
| Income taxes paid . . . . . . . . . | $ 600 | $ 797 |
| Interest paid . . . . . . . . . . . | $ 36,500 | $ 0 |

The accompanying notes are an integral part of these consolidated financial statements.



CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS
(Unaudited)

| | Three Months Ended 6/30/00 | Three Months Ended 6/30/99 | Six Months Ended 6/30/00 | Six Months Ended 6/30/99 |
|---|---|---|---|---|
| Changes in net assets from operations: | | | | |

| | | | | |
|---|---|---|---|---|
| Net operating income (loss). . . . . . . . | $ 1,952,632 | $ (877,754) | $ 3,047,705 | $(2,166,102) |
| Net realized gain on investments . . . . . | 2,874,955 | 380,270 | 5,454,609 | 8,645,997 |
| Net (decrease) increase in unrealized appreciation on investments as a result of sales. . . | (9,247,287) | 430,008 | (12,298,973) | (1,874,973) |
| Net (decrease) increase in unrealized appreciation on investments held | (6,688,796) | 2,710,518 | (14,084,062) | 1,276,384 |
| Net (decrease) increase in net assets resulting from operations . . . | (11,108,496) | 2,643,042 | (17,880,721) | 5,881,306 |
| Changes in net assets from capital stock transactions: | | | | |
| Additional paid in capital on Common Stock Warrants issued . . . | 0 | 0 | 109,641 | 0 |
| Payment of dividends. | 0 | 0 | 0 | (3,647,017) |
| Proceeds from sale of treasury stock (Note 4) . . . . . . | 0 | 1,105 | 0 | 17,283 |
| Purchase of treasury stock (Note 4) . . . | 0 | (63,376) | 0 | (540,720) |
| Net increase (decrease) in net assets resulting from capital stock transactions . . . . | 0 | (62,271) | 109,641 | (4,170,454) |
| Net (decrease) increase in net assets. . . . . . | (11,108,496) | 2,580,771 | (17,771,080) | 1,710,852 |
| Net assets: | | | | |
| Beginning of the period. . . . . . . . | 46,972,221 | 21,686,790 | 53,634,805 | 22,556,709 |
| End of the period . . | $35,863,725 | $24,267,561 | $35,863,725 | $24,267,561 |

The accompanying notes are an integral part of these consolidated financial statements.



CONSOLIDATED SCHEDULE OF INVESTMENTS JUNE 30, 2000
(Unaudited)

| | Method of Valuation (3) | Shares/ Principal | Value |
|---|---|---|---|
| Investments in Unaffiliated Companies (15)(16)(17) -- 43.4% of total investments | | | |
| Publicly Traded Portfolio -- 27.8% of total investments | | | |
| Alliance Pharmaceutical Corp. (7) -- Research and development of pharmaceutical products -- 1.36% of fully diluted equity . . . . . . . . . . . . | (C) | 800,000 | $ 8,550,000 |
| Kana Communications, Inc. (1)(2)(8) -- Provides customer-centric e-business applications and systems -- 0.06% of fully diluted equity . . . . . . . . . | (C) | 67,834 | 3,777,035 |
| Total Publicly Traded Portfolio (cost: $2,192,000) . . . . . . | | | $ 12,327,035 |
| Private Placement Portfolio (Illiquid) -- 15.6% of total investments | | | |
| Essential.com, Inc. (1)(2)(9) -- Online energy and communications marketplace -- 0.73% of fully diluted equity | | | |
| Common stock. . . . . . . . . . . | (B) | 169,185 | $ 2,204,000 |

| | | | |
|---|---|---|---|
| Exponential Business Development Company -- (2)(5) Venture capital partnership focused on early stage companies | | | |
| Limited partnership interest. . (A) | | -- | 25,000 |
| Genomica Corporation (1)(2)(6)(10) -- Develops software that enables the study of complex genetic diseases -- 4.06% of fully diluted equity | | | |
| Common Stock. . . . . . . . . . (B) | | 199,800 | |
| Series A Voting Convertible Preferred Stock . . . . . . . (B) | | 1,660,200 | |
| Series C Convertible Preferred Stock . . . . . . . (A) | | 333,333 | 3,040,250 |
| Informio, Inc. (1)(2)(4)(6)(11) -- Developing audio web portal technology | | | |
| Series A Voting Convertible Preferred Stock . . . . . . . (A) | | -- | 504,601 |
| Kriton Medical, Inc. (1)(2)(6) -- Research and development of medical devices -- 1.87% of fully diluted equity | | | |
| Series B Convertible Preferred Stock . . . . . . . (A) | | 476,191 | 1,000,001 |
| MedLogic Global Corporation (1)(2)(6) -- Medical cyanoacrylate adhesive -- 0.37% of fully diluted equity | | | |
| Series B Convertible Preferred Stock . . . . . . . (D) | | 54,287 | |
| Common Stock. . . . . . . . . (D) | | 25,798 | 103,763 |
| Total Private Placement Portfolio (cost: $5,413,214) . . . . . | | | $ 6,877,615 |
| Total Investments in Unaffiliated Companies (cost: $7,605,214) . . . . . . . . . . . . . . . . . . . . . . | | | $ 19,204,650 |

The accompanying notes are an integral part of this consolidated schedule.



CONSOLIDATED SCHEDULE OF INVESTMENTS JUNE 30, 2000
(Unaudited)

| | Method of Valuation (3) | Shares/ Principal | Value |
|---|---|---|---|
| Investments in Non-Controlled Affiliated Companies (15)(17) - -- 39.0% of total investments | | | |
| Publicly Traded Portfolio -- 14.3% of total investments | | | |
| Nanophase Technologies Corporation (1)(12) -- Manufactures and markets inorganic crystals of nanometric dimensions -- 4.28% of fully diluted equity. . . | (C) | 672,916 | $ 6,321,205 |
| Total Publicly Traded Portfolio (cost: $1,162,204) . . . . . . | | | $ 6,321,205 |
| Private Placement Portfolio (Illiquid) -- 24.7% of total investments | | | |
| Experion Systems, Inc. (1)(2)(4)(6)(13) -- Business-to-business e-commerce and e-services trust-based marketing start-up -- 15.23% of fully diluted equity | | | |
| Convertible Preferred Stock. . . . | (A) | 187,500 | $ 1,500,000 |
| NeuroMetrix, Inc. (1)(2)(6) -- Medical devices for monitoring neuromuscular disorders -- 15.91% of fully diluted equity | | | |
| Series A Convertible Preferred Stock. . . . . . . . . . . . . . . | (B) | 175,000 | |
| Series B Convertible Preferred Stock. . . . . . . . . . . . . . . | (B) | 125,000 | |

| | | | |
|---|---|---|---|
| Series C-2 Convertible Preferred Stock. . . . . . . . . . . . . . | (B) | 229,620 | |
| 8% Convertible Note. . . . . . . . | (A) | 750,000 | 6,708,225 |
| PHZ Capital Partners Limited Partnership (2)(14) -- Organizes and manages investment partnerships -- 20.0% of fully diluted equity | | | |
| Limited partnership interest . . . | (D) | -- | 1,746,456 |
| Questech Corporation (1)(2)(6) -- Manufactures and markets proprietary decorative tiles and signs -- 12.38% of fully diluted equity | | | |
| Common Stock . . . . . . . . . . . | (D) | 580,037 | |
| Warrants at $5.00 expiring 11/15/09 . . . . . . . . . . . . | (A) | 1,965 | |
| Warrants at $4.00 expiring 11/28/01 . . . . . . . . . . . . | (A) | 152,422 | |
| 9% Demand Convertible Note . . . . | (A) | 100,000 | 970,218 |
| Total Private Placement Portfolio (cost: $7,338,679) . . . . . . | | | $10,924,899 |
| Total Investments in Non-Controlled Affiliated Companies (cost: $8,500,883) . . . . . . . . . . . . . . . . . | | | $17,246,104 |

The accompanying notes are an integral part of this consolidated schedule.



CONSOLIDATED SCHEDULE OF INVESTMENTS JUNE 30, 2000
(Unaudited)

| | Method of Valuation (3) | Shares/ Principal | Value |
|---|---|---|---|
| U.S. Government Obligations -- 17.6% of total investments | | | |
| U.S. Treasury Bill dated 1/13/00 due date 7/13/00 -- 4.0% yield. . . | (K) | $ 450,000 | $ 449,366 |
| U.S. Treasury Bill dated 2/3/00 due date 8/3/00 -- 5.1% yield . . . | (K) | $ 910,000 | 905,641 |
| U.S. Treasury Bill dated 2/10/00 due date 8/10/00 -- 5.3% yield. . . | (K) | $1,600,000 | 1,590,496 |
| U.S. Treasury Bill dated 8/19/99 due date 8/17/00 -- 5.4% yield. . . | (K) | $ 400,000 | 397,160 |
| U.S. Treasury Bill dated 3/9/00 due date 9/7/00 -- 5.5% yield . . . | (K) | $2,000,000 | 1,979,140 |
| U.S. Treasury Bill dated 9/16/99 due date 9/14/00 -- 5.5% yield. . . | (K) | $ 500,000 | 494,230 |
| U.S. Treasury Bill dated 4/6/00 due date 10/5/00 -- 5.7% yield. . . | (K) | $2,000,000 | 1,969,820 |
| Total Investments in U.S. Government Obligations (cost: $7,784,328). . . . . . . . . . . . . . . . . . . . . . | | | $ 7,785,853 |
| Total Investments -- 100% (cost: $23,890,425) . . . . . . . . | | | $44,236,607 |

The accompanying notes are an integral part of this consolidated schedule.



CONSOLIDATED SCHEDULE OF INVESTMENTS JUNE 30, 2000
(Unaudited)

Notes to Consolidated Schedule of Investments

(1) Represents a non-income producing security. Equity investments that have not paid dividends within the last twelve months are considered to be non-income producing.

(2) Legal restrictions on sale of investment.

(3) See Footnote to Schedule of Investments for a description of the Method of Valuation A to L.

(4) These investments were made during 2000. Accordingly, the amounts shown on the schedule represent the gross additions in 2000.

(5) No changes in valuation occurred in these investments during the six months ended June 30, 2000.

(6) These investments are development stage companies. A development stage company is defined as a company that is devoting substantially all of its efforts to establishing a new business, and either has not yet commenced its planned principal operations or has commenced such operations but has not realized significant revenue from them.

(7) As of June 30, 2000, the market price per share of Alliance Pharmaceutical Corp. (National Market Symbol: ALLP) was $11.25. The Company's holding in Alliance Pharmaceutical before a discount for illiquidity was valued at $9,000,000. During July and on August 1, 2000, the Company sold a total of 200,000 shares for total proceeds of $2,370,283. The 200,000 shares were acquired for $490,000 on February 9, 2000 through the exercise of a warrant, thereby generating a short-term gain. The Company believes that by partially offsetting current year expenses with the realized short-term gain, it will neither owe federal income taxes on this gain, nor be required to distribute any portion of this gain to shareholders. There can be no assurance of this tax treatment. On August 4, 2000, the market price per share of Alliance Pharmaceutical was $11.50.

(8) On October 5, 1999, Silknet Software, Inc. (National Market Symbol: SILK) acquired InSite Marketing Technology, Inc. On April 19, 2000, Kana Communications, Inc. (National Market Symbol: KANA) and Silknet Software completed a merger, in which the Silknet Software shares were exchanged tax free for 1.66 Kana Communications shares. Upon the completion of the merger, 90 percent of the Silknet Software/Kana Communications shares became freely tradeable, and the Company is subject to a lock-up agreement on the remaining 10 percent of the stock which expires on October 5, 2000. On June 30, 2000, the market price per share of Kana Communications was $61.875. The Company's holding in Kana Communications before a discount for the 10 percent escrow was valued at $4,197,229. On August 4, 2000, the market price per share of Kana Communications was $36.0625.

The accompanying notes are an integral part of this consolidated schedule.



(9) On June 29, 2000, Sundial Marketplace Corporation was acquired in a tax-free merger by Essential.com, Inc.

(10) In 1996, Genomica Corporation was cofounded by the Company, Cold Spring Harbor Laboratory ("CSHL"), a not-for-profit institution, and Falcon Technology Partners, LP. Mr. G. Morgan Browne serves on the Board of Directors of the Company and is Administrative Director of CSHL. In late 1998, Charles E. Harris, Chairman and CEO of Harris & Harris Group, became a trustee of CSHL.

(11) Previously named iPacer Corporation.

(12) As of June 30, 2000, the market price per share of Nanophase Technologies Corporation (National Market Symbol: NANX) was $10.4375. The Company's holding in Nanophase Technologies before a discount for illiquidity was valued at $7,023,561. On August 4, 2000, the market price per share of Nanophase Technologies was $9.75.

(13) Previously named MyPersonalAdvocate.com, Inc.

(14) Harris Partners I L.P. owns a 20 percent limited partnership interest in PHZ Capital Partners L.P. The partners of Harris Partners I L.P. are Harris & Harris Enterprises, Inc. (sole general partner) and Harris & Harris Group, Inc. (sole limited partner). Harris & Harris Enterprises, Inc. is a 100 percent owned subsidiary of Harris & Harris Group, Inc.

(15) Investments in unaffiliated companies consist of investments in which Harris & Harris Group, Inc. (the "Company") owns less than 5 percent of the investee company. Investments in non-controlled affiliated companies consist of investments where the Company owns more than 5 percent but less than 25 percent of the investee company. Investments in controlled affiliated companies consist of investments where the Company owns more than 25 percent of the investee company.

(16) The aggregate cost for federal income tax purposes of investments in unaffiliated companies is $7,605,214. The gross unrealized appreciation based on the tax cost for these securities is $12,529,448. The gross unrealized depreciation based on the tax cost for these securities is $930,012.

(17) The percentage ownership of each investee company disclosed in the Consolidated Schedule of Investments expresses the potential common equity interest in each such investee. The calculated percentage represents the amount of the issuer's common stock the Company owns or can acquire as a percentage of the issuer's total outstanding common stock plus common shares reserved for issued and outstanding warrants, convertible securities and stock options.

The accompanying notes are an integral part of this consolidated schedule.



FOOTNOTE TO CONSOLIDATED SCHEDULE OF INVESTMENTS

ASSET VALUATION POLICY GUIDELINES

The Company's investments can be classified into five broad categories for valuation purposes:

1) EQUITY-RELATED SECURITIES

2) INVESTMENTS IN INTELLECTUAL PROPERTY OR PATENTS OR RESEARCH AND DEVELOPMENT IN TECHNOLOGY OR PRODUCT DEVELOPMENT

3) LONG-TERM FIXED-INCOME SECURITIES

4) SHORT-TERM FIXED-INCOME INVESTMENTS

5) ALL OTHER INVESTMENTS

The Investment Company Act of 1940 (the "1940 Act") requires periodic valuation of each investment in the Company's portfolio to determine net asset value. Under the 1940 Act, unrestricted securities with readily available market quotations are to be valued at the current market value; all other assets must be valued at "fair value" as determined in good faith by or under the direction of the Board of Directors.

The Company's Board of Directors is responsible for (1) determining overall valuation guidelines and (2) ensuring the valuation of investments within the prescribed guidelines.

The Company's Investment and Valuation Committee, comprised of at least three or more Board members, is responsible for reviewing and approving the valuation of the Company's assets within the guidelines established by the Board of Directors.

Fair value is generally defined as the amount that an investment could be sold for in an orderly disposition over a reasonable time. Generally, to increase objectivity in valuing the assets of the Company, external measures of value, such as public markets or third-party transactions, are utilized whenever possible. Valuation is not based on long-term work-out value, nor immediate liquidation value, nor incremental value for potential changes that may take place in the future.

Valuation assumes that, in the ordinary course of its business, the Company will eventually sell its investment.

The Company's valuation policy with respect to the five broad investment categories is as follows:



EQUITY-RELATED SECURITIES

Equity-related securities are carried at fair value using one or more of the following basic methods of valuation:

A. Cost: The cost method is based on the original cost to the Company. This method is generally used in the early stages of a company's development until significant positive or negative events occur subsequent to the date of the original investment that dictate a change to another valuation method. Some examples of such events are: (1) a major recapitalization; (2) a major refinancing; (3) a significant third-party transaction; (4) the development of a meaningful public market for the company's common stock; and (5) significant positive or negative changes in the company's business.

B. Private Market: The private market method uses actual third-party transactions in the company's securities as a basis for valuation, using actual, executed, historical transactions in the company's securities by responsible third parties. The private market method may also use, where applicable, unconditional firm offers by responsible third parties as a basis for valuation.

C. Public Market: The public market method is used when there is an established public market for the class of the company's securities held by the Company. The Company discounts market value for securities that are subject to significant legal, contractual or practical restrictions, including large blocks in relation to trading volume. Other securities, for which market quotations are readily available, are carried at market value as of the time of valuation.

Market value for securities traded on securities exchanges or on the Nasdaq National Market is the last reported sales price on the day of valuation. For other securities traded in the over-the-counter market and listed securities for which no sale was reported on that day, market value is the mean of the closing bid price and asked price on that day.

This method is the preferred method of valuation when there is an established public market for a company's securities, as that market provides the most objective basis for valuation.

D. Analytical Method: The analytical method is generally used to value an investment position when there is no established public or private market in the company's securities or when the factual information available to the Company dictates that an investment should no longer be valued under either the cost or private market method. This valuation method is inherently imprecise and ultimately the result of reconciling the judgments of the Company's Investment and Valuation Committee members, based on the data available to them. The resulting valuation, although stated as a precise number, is necessarily within a range of values that vary depending upon the significance attributed to the various factors being considered. Some of the factors considered may include the financial condition and operating results of the company, the long-term potential of the business of the company, the values of similar securities issued by companies in similar businesses, the proportion of the company's securities owned by the Company and the nature of any rights to



require the company to register restricted securities under applicable securities laws.

INVESTMENTS IN INTELLECTUAL PROPERTY OR PATENTS OR RESEARCH AND DEVELOPMENT IN TECHNOLOGY OR PRODUCT DEVELOPMENT

Such investments are carried at fair value using the following basic methods of valuation:

E. Cost: The cost method is based on the original cost to the Company. Such method is generally used in the early stages of commercializing or developing intellectual property or patents or research and development in technology or product development until significant positive or adverse events occur subsequent to the date of the original investment that dictate a change to another valuation method.

F. Private Market: The private market method uses actual third-party investments in intellectual property or patents or research and development in technology or product development as a basis for valuation, using actual executed historical transactions by responsible third parties. The private market method may also use, where applicable, unconditional firm offers by responsible third parties as a basis for valuation.

G. Analytical Method: The analytical method is used to value an investment after analysis of the best available outside information where the factual information available to the Company dictates that an investment should no longer be valued under either the cost or private market method. This valuation method is inherently imprecise and ultimately the result of reconciling the judgments of the Company's Investment and Valuation Committee members. The resulting valuation, although stated as a precise number, is necessarily within a range of values that vary depending upon the significance attributed to the various factors being considered. Some of the factors considered may include the results of research and development, product development progress, commercial prospects, term of patent and projected markets.

LONG-TERM FIXED-INCOME SECURITIES

H. Fixed-Income Securities for which market quotations are readily available are carried at market value as of the time of valuation using the most recent bid quotations when available.

Securities for which market quotations are not readily available are carried at fair value using one or more of the following basic methods of valuation:

I. Fixed-Income Securities are valued by independent pricing services that provide market quotations based primarily on quotations from dealers and brokers, market transactions, and other sources.



J. Other Fixed-Income Securities that are not readily marketable are valued at fair value by the Investment and Valuation Committee.

SHORT-TERM FIXED-INCOME INVESTMENTS

K. Short-Term Fixed-Income Investments are valued at market value at the time of valuation. Short-term debt with remaining maturity of 60 days or less is valued at amortized cost.

ALL OTHER INVESTMENTS

L. All Other Investments are reported at fair value as determined in good faith by the Investment and Valuation Committee.

The reported values of securities for which market quotations are not readily available and for other assets reflect the Investment and Valuation Committee's judgment of fair values as of the valuation date using the outlined basic methods of valuation. They do not necessarily represent an amount of money that would be realized if the securities had to be sold in an immediate liquidation. The Company makes many of its portfolio investments with the view of holding them for a number of years, and the reported value of such investments may be considered in terms of disposition over a period of time. Thus valuations as of any particular date are not necessarily indicative of amounts that may ultimately be realized as a result of future sales or other dispositions of investments held.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. THE COMPANY

Harris & Harris Group, Inc. (the "Company") is a venture capital investment company operating as a business development company ("BDC") under the Investment Company Act of 1940 ("1940 Act"). A BDC is a specialized type of investment company under the 1940 Act. The Company operates as an internally managed investment company whereby its officers and employees, under the general supervision of its Board of Directors, conduct its operations.

The Company elected to become a BDC on July 26, 1995, after receiving the necessary approvals. From September 30, 1992 until the election of BDC status, the Company operated as a closed-end, non-diversified, investment company under the 1940 Act. Upon commencement of operations as an investment company, the Company revalued all of its assets and liabilities at fair value as defined in the 1940 Act. Prior to such time, the Company was registered and filed under the reporting requirements of the Securities and Exchange Act of 1934 as an operating company and, while an operating company, operated directly and through subsidiaries.

Harris & Harris Enterprises, Inc. ("Enterprises") is a 100 percent wholly owned subsidiary of the Company. Enterprises holds the lease for the office space, which it subleases to the Company and an unaffiliated party; owns a financial relations and consulting firm; is a partner in Harris Partners I, L.P.; and is taxed as a C corporation. Harris Partners I L.P. is a limited partnership and owns a 20 percent limited partnership interest in PHZ Capital Partners, L.P. The partners of Harris Partners I L.P. are Enterprises (sole general partner) and Harris & Harris Group, Inc. (sole limited partner).

The Company intends for 1999 and 2000 to elect treatment as a RIC. As a RIC, the Company must, among other requirements, distribute at least 90 percent of its taxable net income and may either distribute or retain its taxable net realized capital gains on investments. (See "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Sub-Chapter M Status.") There can be no assurance that the Company will qualify as a RIC or that if it does qualify, it will continue to qualify. In addition, even if the Company were to qualify as a RIC, and elected Sub-Chapter M treatment for that year, the Company might take action in a subsequent year to ensure that it would be taxed in that subsequent year as a C Corporation, rather than as a RIC.



NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of significant accounting policies followed in the preparation of the consolidated financial statements:

Principles of Consolidation. The consolidated financial statements have been prepared in accordance with Generally Accepted Accounting Principles for investment companies. All significant intercompany accounts and transactions have been eliminated in consolidation.

Cash and Cash Equivalents. Cash and cash equivalents include money market instruments with maturities of less than three months.

Portfolio Investment Valuations. Investments are stated at "fair value" as defined in the 1940 Act and in the applicable regulations of the Securities and Exchange Commission. All assets are valued at fair value as determined in good faith by, or under the direction of, the Board of Directors. See the Asset Valuation Policy Guidelines in the Footnote to Consolidated Schedule of Investments.

Securities Transactions. Securities transactions are accounted for on the date the securities are purchased or sold (trade date); dividend income is recorded on the ex-dividend date; and interest income is accrued as earned. Realized gains and losses on investment transactions are determined on the specific identification basis for financial reporting and tax reporting.

Income Taxes. Prior to January 1, 1999, the Company recorded income taxes using the liability method in accordance with the provision of Statement of Financial Accounting Standards No. 109. Accordingly, deferred tax liabilities had been established to reflect temporary differences between the recognition of income and expenses for financial reporting and tax purposes, the most significant difference of which related to the Company's unrealized appreciation on investments.

The June 30, 2000 consolidated financial statements include a provision for deferred taxes on the remaining net built-in gains as of December 31, 1998, net of the unutilized operating and capital loss carryforwards incurred by the Company through December 31, 1998. These statements also include a tax provision on realized gains which the Company retained to prepay its indebtedness, rather than distribute to shareholders as a cash distribution.

The Company pays federal, state and local income taxes on behalf of its wholly owned subsidiary, Harris & Harris Enterprises, which is a C corporation. (See Note 6. Income Taxes.)

Reclassifications. Certain reclassifications have been made to the December 31, 1999 and June 30, 1999 financial statements to conform to the June 30, 2000 presentation.

Estimates by Management. The preparation of the consolidated financial statements in conformity with Generally Accepted



Accounting Principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of June 30, 2000 and December 31, 1999, and the reported amounts of revenues and expenses for the three and six months ended June 30, 2000 and June 30, 1999. Actual results could differ from these estimates.

NOTE 3. STOCK OPTION PLAN AND EMPLOYEE PROFIT-SHARING PLAN

On August 3, 1989, the shareholders of the Company approved the 1988 Long Term Incentive Compensation Plan (the "1988 Plan"). The Company's 1988 Plan was cancelled as of December 31, 1997, canceling all outstanding stock options and eliminating all potential stock option grants. As a substitution for the 1988 Plan, the Company adopted an employee profit-sharing plan.

As of January 1, 1998, the Company began implementing the Harris & Harris Group, Inc. Employee Profit-Sharing Plan (the "1998 Plan") that provides for profit sharing equal to 20 percent of the net realized income. The 1998 Plan was terminated by the Company as of December 31, 1999, subject to the payment of any amounts owed on the 1999 realized gains under the 1998 Plan.

In March 2000, the Company paid out, under the 1998 Plan, 90 percent of the profit sharing on the 1999 realized gains of approximately $1,024,696; the remaining 10 percent or approximately $113,855 will be paid out upon the completion and filing of the Company's 1999 federal tax return.

As of January 1, 2000, the Company implemented the Harris & Harris Group, Inc. Employee Profit-Sharing Plan (the "Plan") that provides for profit sharing equal to 20 percent of the net realized income of the Company as reflected on the Consolidated Statements of Operations of the Company for such year, less the nonqualifying gain, if any.

Under the Plan, net realized income of the Company includes investment income, realized gains and losses, and operating expenses (including taxes paid or payable by the Company), but is calculated without regard to dividends paid or distributions made to shareholders, payments under the Plan, unrealized gains and losses, and loss carry-overs from other years ("Qualifying Income"). The portion of net after-tax realized gains attributable to asset values as of September 30, 1997 is considered nonqualifying gain, which reduces Qualifying Income.

As soon as practicable following the year-end audit, the Board of Directors will determine whether, and if so how much, Qualifying Income exists for a plan year, and 90 percent of the Qualifying Income will be paid out to Plan participants pursuant to the distribution percentages set forth in the Plan. The remaining 10 percent will be paid out after the Company has filed its federal tax return for that year in which Qualifying Income exists. Currently, the distribution amounts for each officer and employee are as follows: Charles E. Harris, 13.790 percent; Mel P. Melsheimer, 4.233 percent; Rachel M. Pernia, 1.524 percent; and Jacqueline M.



Matthews, 0.453 percent. If a participant leaves the Company for other than cause, the amount earned will be accrued and may subsequently be paid to such participant.

Notwithstanding any provisions of the Plan, in no event may the aggregate amount of all awards payable for any Plan year during which the Company remains a "business development company" within the meaning of 1940 Act be greater than 20 percent of the Company's "net income after taxes" within the meaning of Section 57(n)(1)(B) of the 1940 Act. In the event the awards exceed such amount, the awards will be reduced pro rata.

The Plan may be modified, amended or terminated by the Company's Board of Directors at any time with the stipulation that no such modification, amendment or termination may adversely affect any participant that has not consented to such modification, amendment or termination.

The Company calculates the Plan accrual at each quarter end based on the realized and unrealized gains at that date, net of operating expenses for the year. Any adjustments to the Plan accrual are then reflected in the Consolidated Statements of Operations for the quarter. The Plan accrual is not paid out until the gains are realized. During the second quarter of 2000, the Company, as a result of a decrease in the net unrealized appreciation reduced the profit-sharing accrual by $2,465,091, which decreased the cumulative accrual under the Plan to $4,293,344 at June 30, 2000.

The amounts payable under the Plan for the year ending December 31, 2000 will be paid out as soon as practicable following year end.

On April 26, 2000 the shareholders of the Company approved the performance goals under the Plan in accordance with Section 162(m) of the Internal Revenue Code of 1986 ("Code"). The Code generally provides that a public company such as the Company may not deduct compensation paid to its chief executive officer or to any of its four most highly compensated officers to the extent that the compensation paid to any such officer/employee exceeds $1 million in any tax year, unless the payment is made upon the attainment of objective performance goals that are approved by the Company's shareholders.

NOTE 4. CAPITAL TRANSACTIONS

In 1998, the Board of Directors approved that, effective January 1, 1998, 50 percent of all directors' fees be used to purchase Company common stock from the Company. However, effective on March 1, 1999, the directors may purchase the Company's common stock in the market, rather than from the Company. During 1998 and 1999, the directors bought directly from the Company 24,491 and 5,816 shares, respectively.

On April 15, 1998, the Company announced that the Board of Directors had approved the purchase of up to 700,000 shares of Company stock in the open market. The Company purchased a total of 401,878 shares in the open market for a total of $795,529. On July



14, 1999, the Board of Directors announced a tender offer to purchase up to 1,100,000 shares of its common stock for cash at a price equal to $1.63 per share. A total of 1,080,569 shares were tendered for a total cost, including related expenses of approximately $71,500, of $1,832,831. Of these shares, 1,075,269 were tendered by one shareholder, which tendered all of its holdings.

Since 1998, as a result of the shares purchased in the open market and through the tender offer in 1999, the Company has purchased a total of 1,482,447 shares for a total of $2,628,337, including commissions and expenses, at an average price of $1.77 per share. These shares were reduced by the purchases made by the directors.

On January 27, 2000, the Company placed privately, with an unaffiliated investor, for $3 million in cash, a one-year 12 percent note with one-year warrants to purchase 25,263 shares of the Company's common stock at $11.8750 per share. The note may be prepaid at any time. Unless the note is prepaid, six months after its issuance, the investor will receive additional one-year warrants to purchase an additional $300,000 worth of the Company's common stock at the then-current market price. During March 2000, with the proceeds from the sale of SciQuest.com stock, the Company prepaid the Note. The Company incurred total interest costs of $146,141: $36,500 on the note and $109,641 on the warrants.

NOTE 5. EMPLOYEE BENEFITS

On October 19, 1999, Charles E. Harris signed an Employment Agreement with the Company (disclosed in a Form 8-K filed on October 27, 1999) (the "Employment Agreement"), which superseded an employment agreement that was about to expire on December 31, 1999. The Employment Agreement shall terminate on December 31, 2004 ("Term") subject to either an earlier termination or an extension in accordance with the terms; on January 1, 2000 and on each day thereafter, the Term extends automatically by one day unless at any time the Company or Mr. Harris, by written notice, decides not to extend the Term, in which case the Term will expire five years from the date of the written notice.

During the period of employment, Mr. Harris shall serve as the Chairman and Chief Executive Officer of the Company. He shall be responsible for the general management of the affairs of the Company and all its subsidiaries, reporting directly to the Board of Directors of the Company. He shall serve as a member of the Board for the period of which he is elected and shall from time to time be reelected. If elected, he shall serve as President of the Company and as an officer and director of any subsidiary or affiliate of the Company.

Mr. Harris is to receive compensation under his Employment Agreement in the form of base salary of $208,315, with automatic yearly adjustments to reflect inflation. In addition, the Board may increase such salary, and consequently decrease it, but not below the level provided for by the automatic adjustments described above. Mr. Harris is also entitled to participate in the Company's Profit-Sharing Plan as well as in all compensation or employee benefit plans or programs, and to receive all benefits, perquisites, and emoluments for which salaried employees are eligible. Under the Employment Agreement, the Company is to furnish Mr. Harris with certain perquisites which include a company car, membership in certain clubs and up to a $5,000 annual reimbursement for personal, financial or tax advice.

The Employment Agreement provides Mr. Harris with life insurance for the benefit of his designated beneficiaries in the amount of $2,000,000; provides reimbursement for uninsured medical expenses (not to exceed $10,000 per annum, adjusted for inflation, over the period of the contract); disability insurance in the amount of 100 percent of his base salary; and provides Mr. Harris and his spouse with long-term care insurance. These benefits are for the term of the contract.

The Employment Agreement provides for the Company to adopt a supplemental executive retirement plan (the "SERP") for the benefit of Mr. Harris. Under the SERP, the Company will cause an amount equal to one-twelfth of the Mr. Harris's current base salary to be credited each month (a "Monthly Credit") to a special account maintained for this purpose on the books of the Company for the benefit of Mr. Harris (the "SERP Account"). The amounts credited to the SERP Account will be deemed invested or reinvested in such mutual funds or U.S. Government securities as determined by Mr. Harris. The SERP Account will be credited and debited to reflect the deemed investment returns, losses and expenses attributed to such deemed investments and reinvestments. Mr. Harris's benefit under the SERP will equal the balance in the SERP Account and such benefit will always be 100 percent vested (i.e., not forfeitable). Mr. Harris will determine the form and timing of the distribution of the balance in the SERP Account; provided, however, in the event of the termination, the balance in the SERP Account will be distributed to Mr. Harris or his beneficiary, as the case may be, in a lump-sum payment within 30 days of such termination. The Company established a rabbi trust for the purpose of accumulating funds to satisfy the obligations incurred by the Company under the SERP. The restricted funds for the SERP Plan total $147,656 as of June 30, 2000. Mr. Harris's rights to benefits pursuant to this SERP will be no greater than those of a general creditor of the Company.

The Employment Agreement provides severance pay in the event of termination without cause or by constructive discharge and also provides for certain death benefits payable to the surviving spouse equal to the executive's base salary for a period of two years.

In addition, Mr. Harris is entitled to receive severance pay pursuant to the severance compensation agreement that he entered into with the Company, effective August 15, 1990. The severance compensation agreement provides that if, following a change in control of the Company, as defined in the agreement, such individual's employment is terminated by the Company without cause or by the executive within one year of such change in control, the individual shall be entitled to receive compensation in a lump sum payment equal to 2.99 times the individual's average annualized compensation and payment of other welfare benefits. If Mr. Harris's termination is without cause or is a constructive discharge, the amount payable under the Employment Agreement will be reduced by the amounts paid pursuant to the severance compensation agreement.

As of January 1, 1989, the Company adopted an employee benefits program covering substantially all employees of the Company under a 401(k) Plan and Trust Agreement. As of January 1, 1999, the Company adopted the Harris & Harris Pension Plan and Trust, a money purchase plan which would allow the Company to stay compliant with the 401(k)



top-heavy regulations and deduction limitation regulations. Contributions to the plan are at the discretion of the Company.

On June 30, 1994, the Company adopted a plan to provide medical and health insurance for retirees, their spouses and dependents who, at the time of their retirement, have ten years of service with the Company and have attained 50 years of age or have attained 45 years of age and have 15 years of service with the Company. On February 10, 1997, the Company amended this plan to include employees who "have seven full years of service and have attained 58 years of age." The coverage is secondary to any government provided or subsequent employer provided health insurance plans. Based upon actuarial estimates, as of June 30, 2000, the Company had a reserve of $317,600 for the plan.

NOTE 6. INCOME TAXES

The Company intends to elect Sub-Chapter M status for the year ended December 31, 1999. Accordingly, on February 23, 1999, the

Company declared a cash dividend of $0.35 per share (for a total of $3,647,017) as a result of the long-term capital gain generated in 1999 by the acquisition of NBX Corporation by 3Com Corporation. The Company utilized net operating loss and capital loss carryforwards of approximately $6.3 million in order to retain most of the remaining long-term capital gain to invest in new opportunities. Approximately $300,000 of the long-term capital gain was not distributed during 1999. Therefore for the year ended December 31, 1999, the Company incurred approximately $26,044 in excise taxes.

The Company had incurred net ordinary and capital losses for a total of approximately $7.0 million (which results in a tax credit of approximately $2.5 million) during its C Corporation taxable years of which $0.8 million still remains available for use. A corporation that elects to qualify as a RIC continues to be taxable as a C Corporation on any gains realized within 10 years of its qualification as a RIC from sales of assets that were held by the corporation on the effective date of the election ("C Corporation Assets") to the extent of any gain built into the assets on such date ("Built-In Gain"). On February 17, 1999, the Company received a ruling from the IRS concluding that the Company can carry forward its C Corporation losses to offset any Built-In Gains resulting from sales of its C Corporation Assets. That ruling may enable the Company to retain some or all of the proceeds from such sales without disqualifying itself as a RIC or incurring corporate level income tax, depending on whether the Company's sale of C Corporation Assets with Built-In Gains will generate C Corporation E&P. In general, a RIC is not permitted to have, as of the close of any RIC taxable year, E&P accumulated during any C Corporation taxable year. However, because the realization of Built-In Gains will occur while the Company is a RIC, a strong argument exists that, under current law and IRS pronouncements, the sale of C Corporation Assets with Built-In Gains during RIC taxable years will not generate C Corporation E&P. The Company intends to use the remaining $0.8 million loss carryforward (which results in a tax credit of approximately $0.3 million) to reduce its taxes which are the result of Built-In Gains.

Continued qualification as a RIC requires the Company to satisfy certain portfolio diversification requirements in future years. The Company's ability to satisfy those requirements may not be controllable by the Company. (See "Item 2. Management's



Discussion and Analysis of Financial Condition and Results of Operation -- Sub-Chapter M Status.") There can be no assurance that the Company will qualify as a RIC for 2000 or subsequent years or that, if it does qualify, it will continue to elect RIC status.

During the six months ended June 30, 2000, the Company accrued a net tax provision of $2,487,769 consisting primarily of a provision on the gains realized on the sale of its position of SciQuest.com. The Company plans to retain the proceeds rather than distribute such funds to shareholders as a cash dividend.

For the three and six months ended June 30, 2000 and 1999, the Company's income tax provision was allocated as follows:

| | Three Months Ended June 30, 2000 | Three Months Ended June 30, 1999 | Six Months Ended June 30, 2000 | Six Months Ended June 30,1999 |
|---|---|---|---|---|
| Investment operations. | $ 0 | $ 0 | $ 0 | $ 0 |
| Realized gain on investments . . . | 1,457,455 | 0 | 2,641,073 | 2,479,821 |
| Net increase (decrease) in unrealized appreciation on investments. . . . . | 0 | 29,097 | (153,304) | (1,676,279) |
| Total income tax provision. . . . . . | $1,457,455 | $ 29,097 | $ 2,487,769 | $ 803,542 |

The above tax provision (benefit) consists of the following:

| | | | | |
|---|---|---|---|---|
| Current -- Federal . . | $1,457,455 | $ 0 | $ 2,641,073 | $ 0 |
| Deferred -- Federal. . | 0 | 29,097 | (153,304) | 803,542 |
| Total income tax provision. . . . . . | $1,457,455 | $ 29,097 | $ 2,487,769 | $ 803,542 |

The Company's net deferred tax liability at June 30, 2000 and December 31, 1999 consists of the following:

| | June 30, 2000 | December 31, 1999 |
|---|---|---|
| Tax on unrealized appreciation on investments. . . . . . . . . . . . | $ 1,630,506 | $ 1,783,810 |
| Net operating loss and capital loss carryforward . . . . . . . . . . | $ (266,036) | $ (266,036) |
| Net deferred income tax liability . . . | $ 1,364,470 | $ 1,517,774 |

NOTE 7. COMMITMENTS AND CONTINGENCIES

During 1993, the Company signed a ten-year lease with sublet provisions for office space. In 1995, this lease was amended to include additional office space. During 1999, the Company sublet this space to an unaffiliated party. Rent expense under this lease was $41,634 and $41,378 for the three months ended June 30, 2000 and June 30, 1999, and $83,109 and $82,756 for the six months ended June 30, 2000 and June 30, 1999, respectively. Future minimum lease payments in each of the following years are: 2001 -- $178,561; 2002 - -- $178,561; 2003 -- $101,946.



The Company had a total of $1,475,276 of funds in escrow as of December 31, 1999 as a result of the acquisition of NBX Corporation by 3Com Corporation. These funds were in a one-year interest-bearing escrow account for the benefit of the Company, subject to any 3Com Corporation warranty claims associated with its acquisition of NBX Corporation. The Company set up a reserve of 10 percent for any potential claims, therefore the funds in escrow reflected $1,327,748 net of the reserve of $147,528. The Company received the full escrow monies including interest for a total of $1,541,136 on March 6, 2000.

NOTE 8. SUBSEQUENT EVENTS

During July and on August 1, 2000, the Company sold a total of 200,000 shares of Alliance Pharmaceutical for total proceeds of $2,370,283. The 200,000 shares were acquired for $490,000 on February 9, 2000 through the exercise of a warrant, thereby generating a short-term gain. The Company believes that by partially offsetting current year expenses with the realized short-term gain, it will neither owe federal income taxes on this gain, nor be required to distribute any portion of this gain to shareholders. There can be no assurance of this tax treatment.

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

The Company accounts for its operations under Generally Accepted Accounting Principles for investment companies. On this basis, the principal measure of its financial performance is captioned "Net increase (decrease) in net assets from operations," which is the sum of three elements. The first element is "Net operating income (loss)," which is the difference between the Company's income from interest, dividends, and fees and its operating expenses, net of applicable income tax benefit. The second element is "Net realized gain on investments," which is the difference between the proceeds received from dispositions of portfolio securities and their stated cost, net of applicable income tax provisions (benefits). These two elements are combined in the Company's financial statements and reported as "Net realized income." The third element, "Net decrease in unrealized appreciation on investments," is the net change in the fair value of the Company's investment portfolio, net of decrease in deferred income taxes that would become payable if the unrealized appreciation were realized through the sale or other disposition of the investment portfolio.

"Net realized gain on investments" and "Net (decrease) increase in unrealized appreciation on investments" are directly related. When a security is sold to realize a (loss) gain, net unrealized appreciation (increases) decreases and net realized gain increases.

Financial Condition

The Company's total assets and net assets were, respectively, $44,815,295 and $35,863,725 at June 30, 2000, compared with $65,320,768 and $53,634,805 at December 31, 1999.

Among the significant changes in the six months ended June 30, 2000 were: (1) decline in the value of the Company's holdings in



SciQuest.com of $31,981,750 offset by the gain realized on the sale of the Company's position in SciQuest.com of $7,407,377; (2) the decline in the value of the Company's holding in Silknet Software (which subsequently merged with Kana Communications) and Questech Corporation, of $1,622,027 and $1,165,879, respectively; (3) increases in the values of the Company's holdings in Nanophase Technologies, Alliance Pharmaceutical, Genomica and Essential.com, (which on June 29, 2000 acquired Sundial Marketplace in a tax-free merger) of $2,995,410, $3,019,000, $1,330,520, and $854,467 respectively; (4) a decrease in the Company's profit-sharing plan of $4,116,427 reflected in a credit to the profit-sharing accrual, which generated operating income for the six months ended June 30, 2000 of $3,047,705. In addition, the Company increased its total tax liability by $2,519,109 to reflect a tax on the gains realized on the sale of its investment in SciQuest.com. The Company plans to retain the proceeds rather than distribute the funds to shareholders as a cash dividend. (See "Consolidated Statements of Operations" contained in "Item 1. Consolidated Financial Statements.")

The changes in the values of SciQuest.com, Kana Communications, Nanophase Technologies and Alliance Pharmaceutical occurred during a period of extreme volatility of publicly traded, small capitalization, high technology stocks.

Net asset value per share ("NAV") was $3.88 at June 30, 2000 versus $5.80 at December 31, 1999.

The Company's shares outstanding remained unchanged during the six months ended June 30, 2000.

The Company's financial condition is dependent on the success of its investments. The Company has invested a substantial portion of its assets in private development stage or start-up companies. These private businesses tend to be thinly capitalized, unproven, small companies that lack management depth or have no history of operations. At June 30, 2000, $18,648,240 or 41.6 percent of the Company's total assets consisted of investments at fair value in publicly traded securities (two of the three investments were in private equities at the time the Company made the investments) of which net unrealized appreciation was $15,294,036; $17,802,514 or 39.7 percent of the Company's total assets consisted of non-publicly traded securities at fair value in private businesses, of which net unrealized appreciation was $5,050,621.

At December 31, 1999, $41,556,607 or 63.6 percent of the Company's total assets consisted of investments at fair value in publicly traded securities (that were private businesses at the time the Company made the investments), of which net unrealized appreciation was $38,864,873; $18,892,731 or 29.0 percent of the Company's total assets consisted of non-publicly traded securities at fair value in private businesses and publicly traded companies, of which net unrealized appreciation was $8,553,549.

The decrease in the value of publicly traded securities from $41,556,607 at December 31, 1999 to $18,648,240 at June 30, 2000 is primarily owing to the decrease in the value of SciQuest.com and the sale of the Company's position in SciQuest.com; the decrease in the value of Kana Communications; offset by the increase from the



reclassification of Alliance Pharmaceutical by the conversion of the note and warrants to a publicly-traded security and the increase in the market values of Alliance Pharmaceutical and Nanophase Technologies. The changes in the values of SciQuest.com, Kana Communications, Nanophase Technologies and Alliance Pharmaceutical occurred during a period of extreme volatility of publicly traded, small capitalization, high technology stocks. The volatility of the overall market will continue to have an impact on the performance of the Company's investments. The value of the Company's investments will vary on a quarterly basis. (See "Risk Factors")

The decrease in the value of the non-publicly traded securities from $18,892,731 at December 31, 1999 to $17,802,514 at June 30, 2000 resulted from the reclassification of Alliance Pharmaceutical to a publicly traded security by the conversion of the note and the exercise of the warrant, the dissolution of and subsequent liquidation of Adaptive Web Technologies and the decrease in the value of the Company's investment in Questech Corporation net of its additional $100,000 investment in that company. These decreases were offset by the additional investment in and the increase in the value of Genomica and Sundial Marketplace (which on June 29, 2000 was acquired in a tax-free merger by Essential.com) as well as the Company's new investments in Experion Systems (formerly named MyPersonalAdvocate.com, Inc.) and Informio (formerly named iPacer Corporation).

A summary of the Company's investment portfolio is as follows:

| | June 30, 2000 | December 31, 1999 |
|---|---|---|
| Investments, at cost | $23,890,425 | $16,653,130 |
| Unrealized appreciation | 20,346,182 | 46,882,521 |
| Investments, at fair value | $44,236,607 | $63,535,651 |

The accumulated unrealized appreciation on investments net of deferred taxes is $18,715,676 at June 30, 2000, versus $45,098,711 at December 31, 1999.

Following an initial investment in a private company, the Company may make additional investments in such investee in order to: (1) increase its ownership percentage; (2) to exercise warrants or options that were acquired in a prior financing; (3) to preserve the Company's proportionate ownership in a subsequent financing; or (4) attempt to preserve or enhance the value of the Company's investment. Such additional investments are referred to as "follow-on" investments.  There can be no assurance that the Company will make follow-on investments or have sufficient funds to make additional investments. The failure to make such follow-on investments could jeopardize the viability of the investee company and the Company's investment or could result in a missed opportunity for the Company to participate to a greater extent in an investee's successful operations.  The Company attempts to maintain adequate liquid capital to make follow-on investments in its private investee portfolio companies.  The Company may elect not to make a follow-on investment either because it does not want to increase its concentration of risk or because it prefers other opportunities, even though the follow-on investment opportunity appears attractive.



The following table is a summary of the cash investments made by the Company in its private placement portfolio during the six months ended June 30, 2000:

| New Investments: | Amount |
|---|---|
| Experion Systems, Inc. (1) | $1,500,000 |
| Informio, Inc. (2) | $ 500,000 |
| Additional Investments: | |
| Genomica Corporation | $ 500,000 |
| Loans: | |
| NeuroMetrix, Inc. | $ 750,000 |
| Questech Corporation | $ 100,000 |
| Sundial Marketplace Corporation (3) | $ 150,000 |
| Exercise of Warrants Held: | |
| Alliance Pharmaceutical Corp. | $ 490,000 |
| Sundial Marketplace Corporation (3) | $ 427,500 |
| Total | $4,417,500 |

(1) Formerly named MyPersonalAdvocate.com, Inc.
(2) Formerly named iPacer Corporation
(3) Acquired by Essential.com, Inc.

Results of Operations

Investment Income and Expenses:

The Company realized a net operating income (loss) of $3,047,705 and ($2,166,102) for the six months ended June 30 2000, and 1999, respectively.  The Company's net operating income in the six months ended June 30, 2000 reflected a decrease in the employee profit-sharing accrual that resulted in a credit to expenses of $4,116,427.

The Company's principal objective is to achieve capital appreciation.  Therefore, a significant portion of the investment portfolio is structured to maximize the potential for capital appreciation and provides little or no current yield in the form of dividends or interest.  The Company does earn interest income from fixed-income securities, including U.S. Government Obligations.  The amount of interest income earned varies based upon the average balance of the Company's fixed-income portfolio and the average yield on this portfolio.

The Company had interest income from fixed-income securities of $144,815 and $121,208 for the six months ended June 30, 2000 and 1999, respectively. The increase of $23,607 or 19.5 percent is the result of an increase in the balance of the Company's fixed income portfolio during the first three months of the six months ended June 30, 2000 versus the same period in 1999. The balance of the



Company's fixed income portfolio increased as a result of the funds received during March 1999 as a result of the sale of NBX as well as the $3,000,000 one-year, 12 percent note placed privately by the Company during January 2000. Accordingly, the Company incurred total interest costs of $146,141 on this note during the six months ended June 30, 2000.

The Company had interest income from affiliated companies of $34,058 and $9,317 for the six months ended June 30, 2000 and 1999, respectively. The increase of $24,741 or 265.5 percent is owing to the increase in outstanding loans to the investee companies during the six months ended June 30, 2000 versus the six months ended June 30, 1999. The amount of outstanding loans to investee companies varies depending on the investee companies' needs. Typically, loans made to investee companies are bridge loans and are converted into equity at the next financing.

The Company had other income of $35,064 and $300 for the six months ended June 30, 2000 and June 30, 1999, respectively. The other income in 2000 represents rental income; in December of 1999, the Company started subleasing office space to an unaffiliated party. The Company did not have any rental income in the six months ended June 30, 1999.

Operating expenses were ($2,833,768) and $2,296,927 for the six months ended June 30, 2000 and June 30, 1999, respectively. The operating expenses for the six months ended June 30, 2000 reflect a decrease in the employee profit-sharing accrual resulting in a credit to expenses of $4,116,427, that reduced the total expenses for that period by such amount. Salaries and benefits increased $129,953 or 33.1 percent primarily as the result of the Company's contribution to the Supplemental Executive Retirement Plan or SERP which started January 1, 2000 for Mr. Harris. Administration and operations increased $57,220 or 30.4 percent as a result of increased printing and distribution costs for the Company's shareholder reports as a result of a significant increase in the number of beneficial shareholders from last year to this year. Professional fees increased $82,024 or 66.2 percent as a result of increased legal fees due to legal review and preparation of corporate documents for the Company's annual meeting. Most of the Company's operating expenses are related to employee and director compensation, office and rent expenses and consulting and professional fees (primarily legal and accounting fees).

The portion of profit sharing accruals resulting from the realized gains during 2000, net of operating expenses and taxes for the year, will be paid out as soon as practicable following the 2000 year-end audit.

The Company realized a net operating income (loss) of $1,952,632 and ($877,754) for the three months ended June 30, 2000 and June 30, 1999, respectively. The Company's net operating income in the three months ended June 30, 2000 reflected a decrease in the employee profit-sharing accrual that resulted in a credit to expenses of $2,465,091.

The Company had interest income from fixed-income securities of $60,861 and $75,999 for the three months ended June 30, 2000 and June 30, 1999, respectively, reflecting net changes in the Company's investments in short-term fixed income securities and prevailing interest rate levels.



The Company had interest income from affiliated companies of $12,376 and $8,689 for the three months ended June 30, 2000 and June 30, 1999, respectively. The increase of $3,687 or 42.4 percent is owing to the increase in the outstanding loans of investee companies during the second quarter of 2000. The amount of outstanding loans to investee companies varies depending on the investee companies' needs. Typically, loans made to investee companies are bridge loans and are converted into equity at the next financing.

The Company had other income of $19,252 and $300 for the three months ended June 30, 2000 and June 30, 1999, respectively. The other income in 2000 represents rental income; in December of 1999, the Company started subleasing office space to an unaffiliated party. The Company did not have any rental income in the second quarter of 1999.

Operating expenses were ($1,860,143) and $962,742 for the three months ended June 30, 2000 and June 30, 1999, respectively. The operating expenses of the second quarter of 2000 reflect a decrease in the employee profit-sharing accrual, owing to the decrease in the unrealized appreciation for the three months ended June 30, 2000, resulting in a credit to expenses of $2,465,091 that reduced the total expenses for that period by such amount. Salaries and benefits increased $59,485 or 32.1 percent primarily as the result of the Company's contribution to the Supplemental Executive Retirement Plan or SERP which started January 1, 2000 for Mr. Harris. Administration and operations increased $37,371 or 32.4 percent as a result of increased printing and distribution costs for the Company's shareholder reports as a result of a significant increase in the number of beneficial shareholders from last year to this year. Professional fees increased $57,734 or 91.7 percent as a result of increased legal fees due to legal review and preparation of corporate documents for the Company's annual meeting. The remaining expenses are related to rent expenses and director compensation.

The Company has in the past relied, and continues to rely to a large extent, upon proceeds from sales of investments, rather than investment income, to defray a significant portion of its operating expenses. Because such sales cannot be predicted, the Company attempts to maintain adequate working capital to provide for fiscal periods when there are no such sales.

Realized Gains and Losses on Sales of Portfolio Securities:

During the six months ended June 30, 2000 and June 30, 1999, the Company realized gains of $8,095,682 and $11,125,818, respectively.

During the six months ended June 30, 2000, the Company realized a total gain of $8,095,682 consisting primarily of a gain of $7,407,377 on the sale of its position in SciQuest.com; $241,025 on the sale of Nanophase Technologies shares and $147,528 on the realization of the reserve on the NBX/3Com escrow (the Company received in full the escrowed funds on March 31, 2000).

During the six months ended June 30, 1999, the Company realized a gain of approximately $10,584,630 on the acquisition of NBX Corporation by 3Com Corporation; a gain of approximately $160,918 on



its sale of Princeton Video Image, Inc. stock; and received a cash distribution from PHZ Capital Partners L.P. of approximately $586,311. The Company also incurred losses of approximately $206,041 on the sale of various publicly traded investments.

During the three months ended June 30, 2000 and June 30, 1999, the Company realized gains of $4,332,410 and $380,270, respectively. During the three months ended June 30, 2000, the Company realized a total gain of $4,332,410, consisting primarily of a net gain of $4,142,388 on the sale of 417,639 shares of SciQuest.com. During the three months ended June 30, 1999, the Company sold various publicly traded securities realizing a net loss of $206,041 and received a cash distribution from PHZ Capital Partners L.P. of $586,311.

Unrealized Appreciation and Depreciation of Portfolio Securities:

The Board of Directors values the portfolio securities on a quarterly basis pursuant to the Company's Asset Valuation guidelines in accordance with the 1940 Act. (See "Footnote to Consolidated Schedule of Investments" contained in "Item 1. Consolidated Financial Statements.")

Net unrealized appreciation on investments decreased by $26,536,339 or 56.6 percent during the six months ended June 30, 2000, from $46,882,521 to $20,346,182, primarily as a result of declines in the value of SciQuest.com, Kana Communications and Questech of $31,981,750, $1,622,027 and $1,165,879, respectively, offset by increases in the value of Nanophase Technologies, Alliance Pharmaceutical, Genomica and Essential.com of $2,995,410, $3,019,000, $1,330,520 and $854,467, respectively. The changes in the values of SciQuest.com, Kana Communications, Nanophase Technologies and Alliance Pharmaceutical occurred during a period of extreme volatility of publicly traded, small capitalization, high technology stocks. (See "Risk Factors.")

Net unrealized appreciation on investments decreased by $2,274,868 or 21.8 percent during the six months ended June 30, 1999, from $10,407,549 to $8,132,681, primarily as a result of the reclassification of the NBX Corporation from unrealized to realized gain of approximately $4,716,062, offset by the increase in value of SciQuest.com, of approximately $2,350,962.

Net unrealized appreciation on investments decreased by $15,936,083 or 43.9 percent during the three months ended June 30, 2000, from $36,282,265 to $20,346,182 owing primarily as a result of declines in the value of SciQuest.com, Nanophase Technologies, Alliance Pharmaceutical and Questech of $9,247,287, $3,823,004, $2,794,900 and $1,165,879, respectively offset by an increase in Essential.com and Kana Communications of $854,467 and $239,472, respectively.

Net unrealized appreciation on investments increased by $3,169,623 or 63.8 percent during the three months ended June 30, 1999, from $4,963,058 to $8,132,681, primarily as a result of the increase in the value of SciQuest.com, of approximately $2,350,962 and Alliance Pharmaceutical of approximately $324,000.



Liquidity and Capital Resources

The Company's primary sources of liquidity are cash, receivables and freely tradeable marketable securities. The Company's secondary sources of liquidity are restricted securities of companies that are publicly traded. At June 30, 2000 and December 31, 1999, respectively, the Company's total primary liquidity was $26,688,031 and $6,622,216. On the corresponding dates, the Company's total secondary liquidity was $0 and $38,230,812, respectively.

The increase in the Company's primary source of liquidity from December 31, 1999 to June 30, 2000 is primarily owing to: (1) the proceeds from the sale of its investment in SciQuest.com stock of approximately $8,257,377; (2) the increase in the value of Nanophase Technologies of approximately $2,995,410; (3) the conversion of the Alliance Pharmaceutical Note and exercise of the warrant for a total of 800,000 shares which became freely tradeable on June 30, 2000 and had a value of $8,550,000; (4) the receipt of escrowed funds plus interest for a total of $1,541,136; and (5) the receipt of the funds from the dissolution and subsequent liquidation of Adaptive Web Technologies. These increases were offset by the (1) payment of the 1999 employee profit sharing of approximately $1,024,696; (2) the investments of $1,500,000 in Experion Systems, $500,000 in Informio, $500,000 in Genomica, $490,000 for the exercise of warrants to purchase common stock in Alliance Pharmaceutical, $577,500 in Sundial Marketplace (which was acquired on June 29, 2000 by Essential.com in a tax-free merger); (3) loans of $750,000 to NeuroMetrix, and $100,000 to Questech; and (4) the use of funds for operating expenses.

The decrease in the Company's secondary source of liquidity from December 31, 1999 to June 30, 2000 is primarily owing to the expiration of the lock-up on SciQuest.com and Silknet Software (which subsequently merged with Kana Communications).

The changes in the values of SciQuest.com, Kana Communications, Nanophase Technologies and Alliance Pharmaceutical reflected the extreme stock market volatility in the six months ended June 30, 2000.

From December 31, 1999 to June 30, 2000, the Company's liabilities for accrued employee profit sharing and deferred income tax liability changed significantly. Accrued profit sharing decreased by $5,141,123 or 54.5 percent to $4,293,344 as a result of payment of approximately $1,024,696 of the 1999 profit sharing and the decrease of $4,116,427 in the liability for accrued employee profit sharing owing to the decrease in the unrealized appreciation for the six months ended June 30, 2000.

The Company's total income tax liability increased by $2,519,109 or 165.9 percent to $4,036,883 as a result of a tax provision on realized gains on which the Company currently plans to retain the proceeds rather than distribute such funds to shareholders as a cash dividend.



Sub-Chapter M Status

On September 25, 1997, the Company's Board of Directors approved a proposal to seek qualification of the Company as a RIC under Sub-Chapter M of the Code. In order to qualify as a RIC, the Company must, in general (1) annually derive at least 90 percent of its gross income from dividends, interest and gains from the sale of securities; (2) quarterly meet certain investment diversification requirements; and (3) annually distribute at least 90 percent of its investment company taxable income as a dividend. In addition to the requirement that the Company must annually distribute at least 90 percent of its investment company taxable income, the Company may either distribute or retain its taxable net capital gains from investments, but any net capital gains not distributed could be subject to corporate level tax. Further, the Company could be subject to a four percent excise tax if it fails to distribute 98 percent of its annual taxable income and would be subject to income tax if it fails to distribute 100 percent of its taxable income.

Because of the specialized nature of its investment portfolio, the Company could satisfy the diversification requirements under Sub-Chapter M of the Code only if it received a certification from the SEC that it is "principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available." On April 8, 1998, the Company announced that it had received such a certification from the SEC for 1997.

Pursuant to the Company's receipt of the certification, the Company's Board of Directors declared and paid a one-time cash dividend of $0.75 per share to meet one of the Company's requirements for qualification for Sub-Chapter M tax treatment.

The qualification of the Company as a RIC under Sub-Chapter M of the Code depends on it satisfying certain technical requirements regarding its income, investment portfolio and distributions. The Company was unable to satisfy these requirements for the 1998 tax year owing to the nature of the Company's ownership interest in one of its investee companies. In addition, because it realized taxable losses in 1998, it was not strategically advantageous for the Company to elect Sub-Chapter M tax status for 1998. The Company changed the nature of its ownership interest in the non-qualifying investee company effective January 1, 1999 in order to meet the Sub-Chapter M requirements.

In 1999, because of changes in its investment portfolio, the Company requested recertification from the SEC relating to the Company's status under section 851(e) of the Code. On February 24, 2000, the Company received the certification, and the Company intends to elect Sub-Chapter M tax treatment for 1999. Although the SEC certification for 1999 was issued, there can be no assurance that the Company will receive such certification for 2000 or subsequent years (to the extent it needs additional certification as a result of changes in its portfolio) or that it will qualify as a RIC in 2000 or that, if it does qualify in 2000, it will continue to qualify in subsequent years. The Company plans to elect Sub-Chapter



M tax treatment for 1999. In addition, under certain circumstances, even if the Company were qualified for Sub-Chapter M treatment in 2000 and elected Sub-Chapter M treatment for that year, the Company might take action in a subsequent year to ensure that it would be taxed in that subsequent year as a C Corporation, rather than as a RIC.

The Company incurred ordinary and capital losses during its C Corporation taxable years that remain available for use and may be carried forward to its 2000 and subsequent taxable years. A C Corporation that elects to qualify as a RIC and that makes an appropriate election continues to be taxable as a C Corporation on any gains realized within 10 years of its qualification as a RIC from sales of assets that were held by the corporation on the effective date of the election ("C Corporation Assets") to the extent of any gain built into the assets on such date ("Built-In Gain").

On February 17, 1999, the Company received rulings from the IRS regarding issues relevant to the Company's tax status as a RIC, including a ruling from the IRS concluding that the Company can carry forward its C Corporation losses to offset any Built-In Gains resulting from sales of its C Corporation Assets. That ruling may enable the Company to retain some or all of the proceeds from such sales without disqualifying itself as a RIC or incurring corporate level income tax, depending on whether the Company's sale of C Corporation Assets with Built-In Gains will generate C Corporation

E&P. In general, a RIC is not permitted to have, as of the close of any RIC taxable year, E&P accumulated during any C Corporation taxable year. However, because the realization of Built-In Gains will occur while the Company is a RIC, a strong argument exists that, under current law and IRS pronouncements, the sale of C Corporation Assets with Built-In Gains during RIC taxable years will not generate C Corporation E&P. In 1999, the Company used $6.3 million of its loss carryforward (which resulted in a tax credit of approximately $2.2 million) to reduce the taxes resulting from Built-In Gains.

If necessary for liquidity purposes or to fund investment opportunities, in lieu of distributing its taxable net capital gains, the Company may retain such net capital gains and elect to be deemed to have made a distribution of the gains, or part thereof, to the shareholders under the "designated undistributed capital gain" rules of section 852(b)(3) of the Code. In such a case, the Company would have to pay a 35 percent corporate-level income tax on such "designated undistributed capital gain," but it would not have to distribute the excess of the retained "designated undistributed capital gain" over the amount of tax thereon in order to maintain its RIC status.

Tax Consequences of Net Capital Gains

The following simplified examples illustrate the tax treatment under Sub-Chapter M of the Code for the Company and its shareholders with regard to three possible alternatives, assuming a net long-term capital gain of $1.00 per share, consisting entirely of sales of non-real property assets held for more than 12 months.



Under Alternative A: 100 percent of net capital gain declared as a dividend and distributed to shareholders:

1. No federal taxation at the Company level.

2. Taxable shareholders receive a $1.00 per share dividend and pay a maximum federal tax of 20 percent* or $.20 per share, retaining $.80 per share.

Under Alternative B: 100 percent of net capital gain retained by the Company and designated as "undistributed capital gain" or deemed dividend:

1. The Company pays a corporate-level federal income tax of 35 percent on the undistributed gain or $.35 per share and retains 65 percent of the gain or $.65 per share.

2. Taxable shareholders increase their cost basis in their stock by $.65 per share. They pay a 20 percent* federal capital gains tax on 100 percent of the undistributed gain of $1.00 per share or $.20 per share in tax. Offsetting this tax, shareholders receive a tax credit equal to 35 percent of the undistributed gain or $.35 per share.

Under Alternative C: 100 percent of net capital gain retained by the Company, with no designated undistributed capital gain or deemed dividend:

1. The Company pays a corporate-level federal income tax of 35 percent on the retained gain or $.35 per share plus an excise tax of four percent of $.98 per share, or about $.04 per share.

2. There is no tax consequence at the shareholder level.

*Assumes all capital gains qualify for long-term rates of 20 percent.

Risk Factors

Investing in the Company's Stock is Highly Speculative and You Could Lose Some or All of the Amount You Invest

The value of the Company's common stock may decline and may be affected by numerous market conditions, which could result in the loss of some or all of your investment in the Company's shares. The securities markets frequently experience extreme price and volume fluctuation which affect market prices for securities of companies generally, and technology companies in particular. Because of the Company's focus on the technology sector, its stock price is likely to be impacted by these market conditions. General economic conditions, and general conditions in the Internet and information technology and life sciences and other high technology industries, will also affect the Company's stock price.



Investing in the Company's Shares May be Inappropriate for Your Risk Tolerance

Investing in the Company's shares may be inappropriate for your risk tolerance.  The Company's investments in accordance with its investment objective and principal strategies may result in an above average amount of risk and volatility or loss of principal.  The Company's investments in portfolio companies are highly speculative and aggressive and, therefore, an investment in its shares may not be suitable for you.

The Market for Venture Capital Investments is Highly Competitive. In Some Cases, the Company's Status as a Regulated Business Development Company May Hinder its Ability to Participate in Investment Opportunities.

The Company faces substantial competition in its investing activities from private venture capital funds, investment affiliates of large industrial, technology, service and financial companies, small business investment companies, wealthy individuals and foreign investors.  As a regulated business development company, the Company is required to disclose quarterly the name and business description of portfolio companies and value of any portfolio securities.  Most of the Company's competitors are not subject to this disclosure requirement.  The Company's obligation to disclose this information could hinder its ability to invest in certain portfolio companies. Additionally, other regulations, current and future, may make the Company less attractive as a potential investor to a given portfolio company than a private venture capital fund not subject to the same regulations.

Regulatory Risks

Securities and tax laws and regulations governing the Company's activities may change in ways negative to the Company's and its shareholders' interests and interpretations of such laws and regulations may change with unpredictable consequences.

The Company is Dependent Upon Key Management Personnel for Future Success

The Company is dependent for the selection, structuring, closing and monitoring of its investments on the diligence and skill of its senior management and other management members.  The future success of the Company depends to a significant extent on the continued service and coordination of its senior management team, particularly the Chairman and Chief Executive Officer.  The departure of any of the executive officers or key employees could materially adversely affect the Company's ability to implement its business strategy.  The Company does not maintain key man life insurance on any of its officers or employees.

Investment in Small, Private Companies

There are significant risks inherent in the Company's venture capital business.  The Company has invested a substantial portion of its assets in private development stage or start-up companies. These private businesses tend to be thinly capitalized, unproven, small companies with risky technologies that lack management depth



and have not attained profitability or have no history of operations.  Because of the speculative nature and the lack of a public market for these investments, there is significantly greater risk of loss than is the case with traditional investment securities.  The Company expects that some of its venture capital investments will be a complete loss or will be unprofitable and that some will appear to be likely to become successful but never realize their potential.  The Company has been risk seeking rather than risk averse in its approach to venture capital and other investments. Neither the Company's investments nor an investment in the Company is intended to constitute a balanced investment program.  The Company has in the past relied, and continues to rely to a large extent, upon proceeds from sales of investments rather than investment income to defray a significant portion of its operating expenses.

Illiquidity of Portfolio Investments

Most of the investments of the Company are or will be equity securities acquired directly from small companies. The Company's portfolio of equity securities are and will usually be subject to restrictions on resale or otherwise have no established trading market. The illiquidity of most of the Company's portfolio of equity securities may adversely affect the ability of the company to dispose of such securities at times when it may be advantageous for the Company to liquidate such investments.

Volatility and Illiquidity of Publicly Traded Holdings

When companies in which the Company has invested as private entities complete initial public offerings, they are by definition unseasoned issuers. Typically, they have relatively small capitalizations. Thus, they can be expected to be highly volatile and of uncertain liquidity. If they are perceived as suffering from adverse news or developments and/or the capital markets are in a negative phase, not only their market prices, but also their liquidity can be expected to be impacted negatively. Historically, the Company has also invested in unseasoned publicly traded companies with similar characteristics and thus with similar exposure to potential negative volatility and illiquidity.

The Inability of the Company's Portfolio Companies to Successfully Market Their Products Would Have a Negative Impact on its Investment Returns

Even if the Company's portfolio companies are able to develop commercially viable products, the market for new products and services is highly competitive and rapidly changing. Commercial success is difficult to predict and the marketing efforts of the Company's portfolio companies may not be successful.

Valuation of Portfolio Investments

There is typically no public market of equity securities of the small private companies in which the Company invests. As a result, the valuation of the equity securities in the Company's portfolio is subject to the good faith estimate of the Company's Board of Directors. (See "Asset Valuation Policy Guidelines" in "Footnote to Consolidated Schedule of Investments.") In the absence of a readily



ascertainable market value, the estimated value of the Company's portfolio of equity securities may differ significantly from the values that would be placed on the portfolio if a ready market for the equity securities existed. Any changes in estimated net asset value are recorded in the Company's statement of operations as "Change in unrealized appreciation on investments." (See "Management's Discussion and Analysis of Financial Condition and Results of Operations.")

Fluctuations of Quarterly Results

The Company's quarterly operating results could fluctuate as a result of a number of factors. These include, among others, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which the Company encounters competition in its markets and general economic conditions. As a result of these factors, results for any one quarter should not be relied upon as being indicative of performance in future quarters. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Risk of Loss of Pass Through Tax Treatment

If the Company meets certain diversification and distribution requirements under the Code, it may qualify as a RIC under the Code for pass-through tax treatment. The Company would cease to qualify for pass-through tax treatment if it were unable to comply with these requirements, or if it ceased to qualify as a BDC under the 1940 Act. The Company also could be subject to a four percent excise tax (and, in certain cases, corporate level income tax) if it failed to make certain distributions. (See "Management's Discussion and Analysis of Financial Condition -- Recent Developments -- Sub-Chapter M Status.") The lack of Sub-Chapter M tax treatment could have a material adverse effect on the total return, if any, obtainable from an investment in the Company. If the Company fails to qualify as a RIC, the Company would become subject to federal income tax as if it were an ordinary C Corporation, which would result in a substantial reduction in the Company's net assets and the amount of income available for distribution to the Company's stockholders.

Because the Company Must Distribute Income, the Company Will

Continue to Need Additional Capital

The Company will continue to need capital to fund investments and to pay for operating expenses. The Company must distribute at least 90 percent of its net operating income other than net realized long-term capital gains to its stockholders to maintain its RIC status. As a result such earnings will not be available to fund investments. If the Company fails to generate net realized long-term capital gains or to obtain funds from outside sources, it could have a material adverse effect on the Company's financial condition and results. The Company does not normally establish reserves for taxes on unrealized capital gains. To the extent that the Company retains capital gains, either as a C corporation or as a Sub-Chapter M corporation, it will have to make provisions for federal taxes and possibly state and local taxes. In addition, as a BDC, the Company is generally required to maintain a ratio of at least 200 percent of total assets to total borrowings, which may restrict its ability to borrow in certain circumstances.



Reserves for Taxes

As a Sub-Chapter M corporation, the Company does not have to pay federal income taxes on realized capital gains to the extent that such gains are distributed to shareholders. Accordingly, it does not establish reserves for taxes on its unrealized capital gains. If the Company were not to qualify or were to elect not to qualify for Sub- Chapter M tax status, it would have to establish such reserves for taxes, which would reduce its net asset value, net of a reduction in the reserve for employee profit sharing, accordingly. To the extent that the Company as a Sub-Chapter M corporation were to make a deemed distribution of net realized capital gains and were to retain such net realized capital gains, it would have to establish appropriate reserves for taxes upon making such a decision.

Forward-Looking Statements

The information contained herein contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives, portfolio growth and availability of funds. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth herein. Other factors that could cause actual results to differ materially include the uncertainties of economic, competitive and market conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the control of the Company. Although the Company believes that the assumptions underlying the forward-looking statements included herein are reasonable, any of the assumptions could be inaccurate and therefore there can be no assurance that the forward-looking statements included or incorporated by reference herein will prove to be accurate. Therefore, the inclusion of such information should not be regarded as a representation by the Company or any other person that the objectives and plans of the Company will be achieved.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's business activities contain elements of risk. The Company considers a principal type of market risk to be valuation risk. Investments are stated at "fair value" as defined in the 1940 Act and in the applicable regulations of the Securities and Exchange Commission. All assets are valued at fair value as determined in good faith by, or under the direction of, the Board of Directors. See the Asset Valuation Policy Guidelines in the Footnote to Consolidated Schedule of Investments.

Neither the Company's investments nor an investment in the Company is intended to constitute a balanced investment program. The Company has exposure to public-market price fluctuations to the extent of its publicly traded portfolio.

The Company has invested a substantial portion of its assets in private development stage or start-up companies. These private businesses tend to be thinly capitalized, unproven, small companies



that lack management depth and have not attained profitability or have no history of operations. Even if the Company's portfolio companies are able to develop commercially viable products, the market for new products and services is highly competitive and rapidly changing. Commercial success is difficult to predict and the marketing efforts of the Company's portfolio companies may not be successful. Because of the speculative nature and the lack of a public market for these investments, there is significantly greater risk of loss than is the case with traditional investment securities. The Company expects that some of its venture capital investments will be a complete loss or will be unprofitable and that some will appear to be likely to become successful but never realize their potential.

Because there is typically no public market for the equity interests of the small companies in which the Company invests, the valuation of the equity interests in the Company's portfolio is subject to the estimate of the Company's Board of Directors in accordance with the Company's Asset Valuation Policy Guidelines. In the absence of a readily ascertainable market value, the estimated value of the Company's portfolio of equity interests may differ significantly from the values that would be placed on the portfolio if a ready market for the equity interests existed. Any changes in valuation are recorded in the Company's consolidated statements of operations as "Net increase (decrease) in unrealized appreciation on investments."



PART II. OTHER INFORMATION

Item 1. Legal Proceedings
Not Applicable

Item 2. Changes in Securities and Use of Proceeds
Not Applicable

Item 3. Defaults Upon Senior Securities
Not Applicable

Item 4. Submission of Matters to a Vote of Security Holders
None

Item 5. Other Information
Recent Sales of Unregistered Securities
None

Item 6. Exhibits and Reports on Form 8-K

3.1(a) Restated Certificate of Incorporation of the Company, as amended, incorporated by reference to Exhibit 3.1(a) to the Company's Form 10-K for the year ended December 31, 1995.

3.1(b) Restated By-laws of the Company, incorporated by reference to Exhibit 3.1(b) to the Company's Form 10K for the year ended December 31, 1995.

4.1 Specimen Certificate of Common Stock, incorporated by reference to Exhibit 4 to Company's Registration Statement on Form N-2 filed October 29, 1992.

10.22 Harris & Harris Group, Inc. Employee Profit-Sharing Plan, incorporated by reference as Exhibit 10.22 to the Company's Form 10K for the year ended December 31, 1999.

11.0* Computation of per share earnings. See Consolidated Statements of Operations.

27.0* Financial Data Schedule.

(b) The Company did not file any reports on Form 8-K during the six months ended June 30, 2000.



EXHIBIT INDEX

Item Number (of Item 601 of Regulation S-K)

27. Financial Data Schedule



SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of

1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Harris & Harris Group, Inc.

By: /s/ Rachel M. Pernia

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Rachel M. Pernia, Vice President
Treasurer, Controller and
Principal Accounting Officer

Date: August 10, 2000

WARNING: THE EDGAR SYSTEM ENCOUNTERED ERROR(S) WHILE PROCESSING THIS SCHEDULE.

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