

GP STRATEGIES CORP
Form 10-Q
July 31, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

ý Quarterly Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934

For the quarterly period ended June 30, 2014
or

¨ 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 1-7234

GP STRATEGIES CORPORATION
(Exact name of Registrant as specified in its charter)

Delaware (State of Incorporation)	52-0845774 (I.R.S. Employer Identification No.)
70 Corporate Center 11000 Broken Land Parkway, Suite 200, Columbia, MD	21044 (Zip Code)
(Address of principal executive offices)	

(443) 367-9600

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 ý No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12(b)-2 of the Exchange Act).
Yes No

The number of shares outstanding of the registrant's common stock as of July 25, 2014 was as follows:

Class	Outstanding
Common Stock, par value \$.01 per share	19,104,157 shares

GP STRATEGIES CORPORATION AND SUBSIDIARIES

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Part I. Financial Information

Item 1. Financial Statements

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(In thousands, except per share amounts)

	June 30, 2014 (Unaudited)	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$6,026	\$5,647
Accounts and other receivables, less allowance for doubtful accounts of \$1,335 in 2014 and \$1,405 in 2013	112,807	94,662
Costs and estimated earnings in excess of billings on uncompleted contracts	34,657	22,706
Prepaid expenses and other current assets	13,659	13,523
Total current assets	167,149	136,538
Property, plant and equipment	23,163	24,560
Accumulated depreciation	(14,298	) (15,329
Property, plant and equipment, net	8,865	9,231
Goodwill	130,091	116,987
Intangible assets, net	13,997	15,129
Other assets	1,727	2,271
	\$321,829	\$280,156
Liabilities and Stockholders' Equity		
Current liabilities:		
Short-term borrowings	\$17,771	\$407
Accounts payable and accrued expenses	60,975	55,339
Billings in excess of costs and estimated earnings on uncompleted contracts	23,315	22,062
Total current liabilities	102,061	77,808
Other noncurrent liabilities	12,080	9,321
Total liabilities	114,141	87,129
Stockholders' equity:		
Common stock, par value \$0.01 per share	192	192
Additional paid-in capital	168,659	167,908
Retained earnings	40,141	27,711
Treasury stock at cost	(918	) (1,170
Accumulated other comprehensive loss	(386	) (1,614
Total stockholders' equity	207,688	193,027
	\$321,829	\$280,156

See accompanying notes to condensed consolidated financial statements.

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

(Unaudited)

(In thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Revenue	\$134,918	\$104,899	\$252,798	\$206,272
Cost of revenue	110,151	86,504	209,676	171,696
Gross profit	24,767	18,395	43,122	34,576
Selling, general and administrative expenses	11,462	9,880	23,051	18,969
Gain on change in fair value of contingent consideration, net	481	45	858	292
Operating income	13,786	8,560	20,929	15,899
Interest expense	77	66	282	166
Other income	68	93	257	322
Income before income tax expense	13,777	8,587	20,904	16,055
Income tax expense	5,664	3,340	8,474	5,883
Net income	\$8,113	\$5,247	\$12,430	\$10,172
Basic weighted average shares outstanding	19,144	19,082	19,142	19,071
Diluted weighted average shares outstanding	19,415	19,334	19,418	19,315
Per common share data:				
Basic earnings per share	\$0.42	\$0.27	\$0.65	\$0.53
Diluted earnings per share	\$0.42	\$0.27	\$0.64	\$0.53

See accompanying notes to condensed consolidated financial statements.

GP STRATEGIES CORPORATION AND SUBSIDIARIES
 Condensed Consolidated Statements of Comprehensive Income
 (Unaudited)
 (In thousands)

	Three Months Ended		Six Months Ended		
	June 30,		June 30,		
	2014	2013	2014	2013	
Net income	\$8,113	\$5,247	\$12,430	\$10,172	
Foreign currency translation adjustments	1,588	(679) 1,228	(2,587)
Comprehensive income	\$9,701	\$4,568	\$13,658	\$7,585	

See accompanying notes to condensed consolidated financial statements.

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

Six months ended June 30, 2014 and 2013

(Unaudited, in thousands)

	2014	2013	
Cash flows from operating activities:			
Net income	\$ 12,430	\$ 10,172	
Adjustments to reconcile net income to net cash provided by operating activities:			
Gain on change in fair value of contingent consideration, net	(858	) (292)
Depreciation and amortization	4,951	3,950	
Deferred income taxes	—	(273)
Non-cash compensation expense	2,316	1,909	
Changes in other operating items:			
Accounts and other receivables	(16,059	) 5,786	
Costs and estimated earnings in excess of billings on uncompleted contracts	(11,473	) (4,201)
Prepaid expenses and other current assets	347	(1,767)
Accounts payable and accrued expenses	7,176	(3,566)
Billings in excess of costs and estimated earnings on uncompleted contracts	236	(5,280)
Contingent consideration payments in excess of fair value on acquisition date	(1,043	) (373)
Other	60	(586)
Net cash provided by (used in) operating activities	(1,917	) 5,479	
Cash flows from investing activities:			
Additions to property, plant and equipment	(1,444	) (2,161)
Acquisitions, net of cash acquired	(8,666	) (13,524)
Net cash used in investing activities	(10,110	) (15,685)
Cash flows from financing activities:			
Proceeds from short-term borrowings	17,364	6,770	
Contingent consideration payments	(977	) (602)
Change in negative cash book balance	(2,477	) 2,086	
Repurchases of common stock in the open market	(1,388	) (451)
Other	75	(1)
Net cash provided by financing activities	12,597	7,802	
Effect of exchange rate changes on cash and cash equivalents	(191	) (165)
Net increase (decrease) in cash and cash equivalents	379	(2,569)
Cash and cash equivalents at beginning of period	5,647	7,761	
Cash and cash equivalents at end of period	\$ 6,026	\$ 5,192	
Supplemental disclosures of cash flow information:			
Cash paid during the period for income taxes	\$ 9,156	\$ 7,083	
See accompanying notes to condensed consolidated financial statements.			

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

(1) Basis of Presentation

GP Strategies Corporation is a global performance improvement solutions provider of training, e-Learning solutions, management consulting and engineering services. References in this report to “GP Strategies,” the “Company,” “we” and “our” are to GP Strategies Corporation and its subsidiaries, collectively.

The accompanying condensed consolidated balance sheet as of June 30, 2014 and the condensed consolidated statements of operations, comprehensive income and cash flows for the six months ended June 30, 2014 and 2013 have not been audited, but have been prepared in conformity with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2013, as presented in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013. In the opinion of management, this interim information includes all material adjustments, which are of a normal and recurring nature, necessary for a fair presentation. The results for the 2014 interim period are not necessarily indicative of results to be expected for the entire year. Certain prior year amounts have been reclassified to conform to current year presentation.

The condensed consolidated financial statements include the operations of the Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

(2) Accounting Standard Issued

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers, which provides guidance for revenue recognition. The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under today’s guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. This guidance will be effective for the Company in the first quarter of its fiscal year ending December 31, 2017. The Company is currently in the process of evaluating the impact of adoption of this ASU on the Company's consolidated financial statements.

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

(3) Significant Customers & Concentration of Credit Risk

We have a market concentration of revenue in both the automotive sector and financial & insurance sector. Revenue from the automotive industry accounted for approximately 14% and 17% of our consolidated revenue for the six months ended June 30, 2014 and 2013, respectively. Revenue from the financial & insurance industry accounted for approximately 15% and 9% of our consolidated revenue for the six months ended June 30, 2014 and 2013, respectively. In prior periods, we also had a concentration of revenue from the United States government. For the six months ended June 30, 2014 and 2013, sales to the United States government and its agencies represented approximately 9% and 10%, respectively, of our consolidated revenue. Revenue was derived from many separate contracts with a variety of government agencies that are regarded by us as separate customers. No single customer accounted for more than 10% of our consolidated revenue for the six months ended June 30, 2014 and 2013. As of June 30, 2014, billed and unbilled accounts receivable from a single financial services customer totaled \$20.9 million, or 14%, of our consolidated accounts receivable and costs and estimated earnings in excess of billings on uncompleted contracts balances.

(4) Earnings Per Share

Basic earnings per share (EPS) is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted EPS reflects the potential dilution of common stock equivalent shares that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

Our dilutive common stock equivalent shares consist of stock options and restricted stock units computed under the treasury stock method, using the average market price during the period. The following table presents instruments which were not dilutive and were excluded from the computation of diluted EPS in each period, as well as the dilutive common stock equivalent shares which were included in the computation of diluted EPS:

	Three Months Ended		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
	(In thousands)			
Non-dilutive instruments	—	26	—	31
Dilutive common stock equivalents	271	252	276	244

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

(5) Acquisitions

Effective Companies

On April 1, 2014, we completed the acquisitions of Effective People and Effective Learning (the “Effective Companies”), providers of human capital management (HCM) solutions, including sales and support of the full SAP SuccessFactors Business Education (BizX) Platform, eLearning and blended learning solutions, as well as recruitment and employee development services. The Effective Companies are headquartered in Copenhagen, Denmark. The upfront purchase price was \$9.0 million which was paid in cash at closing and is subject to a working capital adjustment which we expect will be finalized in the third quarter of 2014. In addition, the purchase agreement requires up to an additional \$6.4 million of consideration, contingent upon the achievement of certain earnings targets during the two twelve-month periods following completion of the acquisition. The purchase price allocation for the acquisition included \$1.6 million of customer-related intangible assets which are being amortized over four years from the acquisition date. None of the goodwill recorded for financial statement purposes is deductible for tax purposes. The acquired Effective Companies business is included in the Learning Solutions segment and the results of its operations have been included in the consolidated financial statements beginning April 1, 2014. The pro-forma impact of the acquisition is not material to our results of operations. The acquired Effective Companies business is included in our Denmark subsidiary and its local currency is the Danish Kroner. The purchase price allocation below was translated into U.S. dollars based on the exchange rate in effect on the date of acquisition.

The estimated fair value of the purchase price recorded by us consisted of the following (in thousands):

Cash purchase price	\$9,000	
Fair value of contingent consideration	5,345	
Estimated working capital adjustment	(91)
Total purchase price	\$14,254	

The preliminary purchase price allocation for the net assets acquired is as follows (in thousands):

Cash	\$334
Accounts receivable	1,283
Prepaid expenses and other assets	496
Property and equipment	80
Amortizable intangible assets	1,613
Goodwill	12,338
Total assets acquired	\$16,144
Accounts payable, accrued expenses and other liabilities	\$582
Billings in excess of costs and estimated earnings on uncompleted contracts	940
Deferred tax liability	368
Total liabilities assumed	1,890
Net assets acquired	\$14,254

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

Contingent Consideration

Accounting Standards Codification (“ASC”) Topic 805 requires that contingent consideration be recognized at fair value on the acquisition date and be re-measured each reporting period with subsequent adjustments recognized in the consolidated statement of operations. We estimate the fair value of contingent consideration liabilities based on financial projections of the acquired companies and estimated probabilities of achievement and discount the liabilities to present value using a weighted-average cost of capital. Contingent consideration is valued using significant inputs that are not observable in the market which are defined as Level 3 inputs pursuant to fair value measurement accounting. We believe our estimates and assumptions are reasonable; however, there is significant judgment involved. At each reporting date, the contingent consideration obligation is revalued to estimated fair value, and changes in fair value subsequent to the acquisitions are reflected in income or expense in the consolidated statements of operations, and could cause a material impact to, and volatility in, our operating results. Changes in the fair value of contingent consideration obligations may result from changes in discount periods, changes in the timing and amount of revenue and/or earnings estimates and changes in probability assumptions with respect to the likelihood of achieving the various earn-out criteria.

Below is a summary of the potential contingent consideration we may be required to pay in connection with completed acquisitions as of June 30, 2014 (dollars in thousands):

Acquisition:	Original range of potential undiscounted payments	As of June 30, 2014			Total
		Maximum contingent consideration due in			
		2014	2015	2016	
Prospero	\$0 - \$4,690	\$—	\$1,876	\$—	\$1,876
Effective Companies	\$0 - \$6,354	—	3,177	3,177	6,354
Total		\$—	\$5,053	\$3,177	\$8,230

Below is a summary of the changes in the recorded amount of contingent consideration liabilities from December 31, 2013 to June 30, 2014 for each acquisition (dollars in thousands):

Acquisition:	Liability as of December 31, 2013	Additions (Payments)	Change in Fair Value of Contingent Consideration	Foreign Currency Translation	Liability as of June 30, 2014
Bath Consulting	\$997	\$(1,005)	) \$—	\$8	\$—
Prospero	1,841	—	(1,016)	) (21)	) 804
Lorien	959	(1,015)	) 31	25	—
Effective Companies	—	5,345	127	(32)	) 5,440
Total	\$3,797	\$3,325	\$(858)	) \$(20)	) \$6,244

As of June 30, 2014 and December 31, 2013, contingent consideration included in accounts payable totaled \$2.8 million and \$2.4 million, respectively. As of June 30, 2014 and December 31, 2013, we also had accrued contingent consideration totaling \$3.4 million and \$1.4 million, respectively, related to acquisitions which is included in other long-term liabilities on the consolidated balance sheet and represents the portion of contingent consideration estimated to be payable greater than twelve months from the balance sheet date.

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

(6) Intangible Assets

Goodwill

Changes in the carrying amount of goodwill by reportable business segment for the six months ended June 30, 2014 were as follows (in thousands):

	Learning Solutions	Professional & Technical Services	Sandy	Performance Readiness Solutions	Energy Services	Total
Balance as of December 31, 2013	\$60,187	\$37,690	\$653	\$9,795	\$8,662	\$116,987
Acquisitions	12,338	—	—	—	—	12,338
Foreign currency translation	770	—	—	—	(4)	) 766
Balance as of June 30, 2014	\$73,295	\$37,690	\$653	\$9,795	\$8,658	\$130,091

Intangible Assets Subject to Amortization

Intangible assets with finite lives are subject to amortization over their estimated useful lives. The primary assets included in this category and their respective balances were as follows (in thousands):

June 30, 2014

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	\$28,421	\$(15,764)	) \$12,657
Tradenames	191	(167)	) 24
Intellectual property and other	2,362	(1,046)	) 1,316
	\$30,974	\$(16,977)	) \$13,997
December 31, 2013			
Customer relationships	\$26,470	\$(13,070)	) \$13,400
Tradenames	191	(119)	) 72
Intellectual property and other	2,364	(707)	) 1,657
	\$29,025	\$(13,896)	) \$15,129

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

(7) Stock-Based Compensation

We recognize compensation expense for stock-based compensation awards issued to employees that are expected to vest. Compensation cost is based on the fair value of awards as of the grant date.

The following table summarizes the pre-tax stock-based compensation expense included in reported net income (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Non-qualified stock options	\$ 122	\$ 123	\$ 254	\$ 245
Restricted stock units	301	188	594	379
Board of Directors stock grants	78	83	159	167
Total stock-based compensation	\$ 501	\$ 394	\$ 1,007	\$ 791

Pursuant to our 2011 Stock Incentive Plan (the "2011 Plan"), we may grant awards of non-qualified stock options, incentive stock options, restricted stock, stock units, performance shares, performance units and other incentives payable in cash or in shares of our common stock to officers, employees or members of the Board of Directors. As of June 30, 2014, we had non-qualified stock options and restricted stock units outstanding under these plans as discussed below.

Non-Qualified Stock Options

Summarized information for the Company's non-qualified stock options is as follows:

	Number of	Weighted	Weighted	Aggregate
	options	average	average	intrinsic
		exercise price	remaining	value
			contractual	
			term	
Stock Options	options	exercise price	term	value
Outstanding at December 31, 2013	569,300	\$9.41		
Granted	—	—		
Exercised	(5,900	) 9.52		
Forfeited	—	—		
Expired	—	—		
Outstanding at June 30, 2014	563,400	\$9.41	1.95	\$9,281,000
Exercisable at June 30, 2014	377,300	\$8.62	1.79	\$6,512,000

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

Restricted Stock Units

In addition to stock options, we issue restricted stock units to key employees and members of the Board of Directors based on meeting certain service goals. The stock units vest to the recipients at various dates, up to five years, based on fulfilling service requirements. We recognize the value of the market price of the underlying stock on the date of grant as compensation expense over the requisite service period. Upon vesting, the stock units are settled in shares of our common stock. Summarized share information for our restricted stock units is as follows:

	Six Months Ended June 30, 2014	Weighted average grant date fair value
	(In shares)	(In dollars)
Outstanding and unvested, beginning of period	244,031	\$22.17
Granted	6,615	24.20
Vested	(3,150)	12.45
Forfeited	—	—
Outstanding and unvested, end of period	247,496	\$22.35

(8) Short-Term Borrowings

We have a \$50 million Financing and Security Agreement (the "Credit Agreement") with a bank that expires on October 31, 2015 and is secured by certain of our assets. The Credit Agreement contains a provision to increase the maximum principal amount to \$75 million upon lender approval. The maximum interest rate on borrowings under the Credit Agreement is the daily LIBOR market index rate plus 2.25%. Based upon our financial performance, the interest rate can be reduced to a minimum of LIBOR plus 1.0%. For the six months ended June 30, 2014, the weighted average interest rate on our borrowings was 1.5%. The Credit Agreement contains covenants with respect to our minimum tangible net worth, total liabilities to tangible net worth ratio and cash flow to debt service ratio, all of which were in compliance with the Credit Agreement as of June 30, 2014. As of June 30, 2014, there were \$17.8 million of borrowings outstanding and \$31.5 million of available borrowings under the Credit Agreement.

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

(9) Income Taxes

Income tax expense was \$8.5 million, or an effective income tax rate of 40.5%, for the six months ended June 30, 2014 compared to \$5.9 million, or an effective income tax rate of 36.6%, for the six months ended June 30, 2013. During the three months ended March 31, 2013, we recorded one-time income tax benefits totaling \$0.4 million for a foreign subsidiary. Excluding these discrete items recorded in the first quarter of 2013, the effective income tax rate was 39.0% for the six months ended June 30, 2013. The increase in the effective income tax rate compared to 2013 is primarily due to a higher proportion of earnings in jurisdictions with higher tax rates. Income tax expense for the quarterly periods is based on an estimated annual effective tax rate which includes the U.S. federal, state and local, and non-U.S. statutory rates, permanent differences, and other items that may have an impact on income tax expense.

An uncertain tax position taken or expected to be taken in a tax return is recognized in the financial statements when it is more likely than not (i.e., a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities that have full knowledge of all relevant information. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Interest and penalties related to income taxes are accounted for as income tax expense. As of June 30, 2014, we had no uncertain tax positions reflected on our consolidated balance sheet. The Company files income tax returns in U.S. federal, state and local jurisdictions, and various non-U.S. jurisdictions, and is subject to audit by tax authorities in those jurisdictions. Tax years 2010 through 2013 remain open to examination by these tax jurisdictions, and earlier years remain open to examination in certain of these jurisdictions which have longer statutes of limitations.

(10) Stockholders' Equity

Changes in stockholders' equity during the six months ended June 30, 2014 were as follows (in thousands):

	Common stock	Additional paid-in capital	Retained earnings	Treasury stock at cost	Accumulated other comprehensive loss	Total stockholders' equity
Balance at December 31, 2013	\$ 192	\$ 167,908	\$ 27,711	\$(1,170)	\$ (1,614)	\$ 193,027
Net income	—	—	12,430	—	—	12,430
Foreign currency translation adjustment	—	—	—	—	1,228	1,228
Repurchases of common stock	—	—	—	(1,388)	—	(1,388)
Stock-based compensation expense	—	1,007	—	—	—	1,007
Issuance of stock for employer contributions to retirement plan	—	(32)	—	1,261	—	1,229
Other	—	(224)	—	379	—	155
Balance at June 30, 2014	\$ 192	\$ 168,659	\$ 40,141	\$(918)	\$ (386)	\$ 207,688

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

(11) Business Segments

As of June 30, 2014, we operated through five reportable business segments: (i) Learning Solutions, (ii) Professional & Technical Services, (iii) Sandy Training & Marketing, (iv) Performance Readiness Solutions, and (v) Energy Services. Our Learning Solutions segment represents an aggregation of two operating groups in accordance with the aggregation criteria in U.S. GAAP, while each of the other reportable segments represents individual operating segments. We are organized by operating group primarily based upon the markets served by each group and/or the services performed. Each operating group consists of business units which are focused on providing specific products and services to certain classes of customers or within targeted markets. Marketing and communications, accounting, finance, legal, human resources, information systems and other administrative services are organized at the corporate level. Business development and sales resources are aligned with operating groups to support existing customer accounts and new customer development.

Further information regarding our business segments is discussed below.

Learning Solutions. The Learning Solutions segment delivers training, curriculum design and development, e-Learning services, system hosting, training business process outsourcing and consulting services globally through our offices in the U.S., Europe, Asia and Canada. This segment also offers organizational performance solutions including leadership training and employee engagement tools and services. This segment serves large companies in the electronics and semiconductors, healthcare, software, financial services and other industries as well as to government agencies. The ability to deliver a wide range of training services on a global basis allows this segment to take over the entire learning function for the client, including their training personnel.

Professional & Technical Services. This segment has over four decades of experience providing training, consulting, engineering and technical services, including lean consulting, emergency preparedness, safety and regulatory compliance, chemical demilitarization and environmental services primarily to large companies in the manufacturing, steel, pharmaceutical and petrochemical industries, federal and state government agencies and large government contractors.

Sandy Training & Marketing. The Sandy Training & Marketing segment provides custom product sales training and has been a leader in serving manufacturing customers in the U.S. automotive industry for over 30 years. Sandy provides custom product sales training designed to better educate customer sales forces with respect to new vehicle features and designs, in effect rapidly increasing the sales force knowledge base and enabling them to address detailed customer queries. Furthermore, Sandy helps our clients assess their customer relationship marketing strategy, measure performance against competitors and connect with their customers on a one-to-one basis. This segment also provides technical training services to automotive manufacturers as well as customers in other industries.

Performance Readiness Solutions. This segment provides performance consulting and technology consulting services, including platform adoption, end-user training, change management, knowledge management, customer product training outsourcing and sales enablement solutions in industries such as manufacturing, aerospace, healthcare, life sciences, consumer products, financial, telecommunications, services and higher education as well as the public sector.

Energy Services. The Energy Services segment provides engineering services, products and training primarily to electric power generators. Our proprietary EtaPRO™ Performance and Condition Monitoring System provides a suite of real-time software solutions for power generation facilities and is installed on power generating units across the world. In addition to providing custom training solutions, this segment provides web-based training through our GPiLearn™ portal, which offers a variety of courses to power plant personnel in the U.S. and several other countries. This segment also provides services to users of alternative fuels, including designing and constructing liquefied natural gas (LNG), liquid to compressed natural gas (LCNG) and hydrogen fueling stations, as well as supplying fuel and equipment.

We do not allocate the following items to the segments: other income, interest expense, gain (loss) on change in fair value of contingent consideration and income tax expense. Inter-segment revenue is eliminated in consolidation and is not significant.

GP STRATEGIES CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

June 30, 2014
(Unaudited)

The following tables set forth the revenue and operating results attributable to each reportable segment and includes a reconciliation of segment revenue to consolidated revenue and operating results to consolidated income before income tax expense (in thousands):

	Three months ended		Six months ended	
	June 30, 2014	2013	June 30, 2014	2013
Revenue:				
Learning Solutions	\$61,970	\$45,185	\$114,937	\$87,919
Professional & Technical Services	18,789	17,048	38,699	35,063
Sandy Training & Marketing	20,223	20,134	34,481	35,132
Performance Readiness Solutions	14,130	12,954	27,139	28,454
Energy Services	19,806	9,578	37,542	19,704
	\$134,918	\$104,899	\$252,798	\$206,272
Operating income:				
Learning Solutions	\$3,263	\$3,554	\$4,311	\$6,766
Professional & Technical Services	1,640	1,747	4,001	2,805
Sandy Training & Marketing	1,604	1,193	2,181	1,822
Performance Readiness Solutions	1,098	316	1,599	895
Energy Services	5,700	1,705	7,979	3,319
Gain on change in fair value of contingent consideration, net	481	45	858	292
Operating income	13,786	8,560	20,929	15,899
Interest expense	77	66	282	166
Other income	68	93	257	322
Income before income tax expense	\$13,777	\$8,587	\$20,904	\$16,055

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

Results of Operations

General Overview

We are a global performance improvement solutions provider of training, e-Learning solutions, management consulting and engineering services that seeks to improve the effectiveness of organizations by providing services and products that are customized to meet the specific needs of clients. Clients include Fortune 500 companies and governmental and other commercial customers in a variety of industries. We believe we are a global leader in performance improvement, with over four decades of experience in providing solutions to optimize workforce performance.

As of June 30, 2014, we operated through five reportable business segments: (i) Learning Solutions, (ii) Professional & Technical Services, (iii) Sandy Training & Marketing, (iv) Performance Readiness Solutions, and (v) Energy Services. Our Learning Solutions segment represents an aggregation of two operating groups in accordance with the aggregation criteria in U.S. GAAP, while each of the other reportable segments represents individual operating segments. We are organized by operating group primarily based upon the markets served by each group and/or the services performed. Each operating group consists of business units which are focused on providing specific products and services to certain classes of customers or within targeted markets. Marketing and communications, accounting, finance, legal, human resources, information systems and other administrative services are organized at the corporate level. Business development and sales resources are aligned with operating groups to support existing customer accounts and new customer development.

Further information regarding each business segment is discussed below.

Learning Solutions. The Learning Solutions segment delivers training, curriculum design and development, e-Learning services, system hosting, training business process outsourcing and consulting services globally through our offices in the U.S., Europe, Asia and Canada. This segment also offers organizational performance solutions including leadership training and employee engagement tools and services. This segment serves large companies in the electronics and semiconductors, healthcare, software, financial services and other industries as well as to government agencies. The ability to deliver a wide range of training services on a global basis allows this segment to take over the entire learning function for the client, including their training personnel.

Professional & Technical Services. This segment has over four decades of experience providing training, consulting, engineering and technical services, including lean consulting, emergency preparedness, safety and regulatory compliance, chemical demilitarization and environmental services primarily to large companies in the manufacturing, steel, pharmaceutical and petrochemical industries, federal and state government agencies and large government contractors.

Sandy Training & Marketing. The Sandy Training & Marketing segment provides custom product sales training and has been a leader in serving manufacturing customers in the U.S. automotive industry for over 30 years. Sandy provides custom product sales training designed to better educate customer sales forces with respect to new vehicle features and designs, in effect rapidly increasing the sales force knowledge base and enabling them to address detailed customer queries. Furthermore, Sandy helps our clients assess their customer relationship marketing strategy, measure performance against competitors and connect with their customers on a one-to-one basis. This segment also provides technical training services to automotive manufacturers as well as customers in other industries.

Performance Readiness Solutions. This segment provides performance consulting and technology consulting services, including platform adoption, end-user training, change management, knowledge management, customer product

training outsourcing and sales enablement solutions in industries such as manufacturing, aerospace, healthcare, life sciences, consumer products, financial, telecommunications, services and higher education as well as the public sector.

Energy Services. The Energy Services segment provides engineering services, products and training primarily to electric power generators. Our proprietary EtaPRO™ Performance and Condition Monitoring System provides a suite of real-time software solutions for power generation facilities and is installed on power generating units across the world. In addition to providing custom training solutions, this segment provides web-based training through our GPiLearn™ portal, which offers a variety of courses to

power plant personnel in the U.S. and several other countries. This segment also provides services to users of alternative fuels, including designing and constructing liquefied natural gas (LNG), liquid to compressed natural gas (LCNG) and hydrogen fueling stations, as well as supplying fuel and equipment.

Acquisition

Effective Companies

On April 1, 2014, we completed the acquisitions of Effective People and Effective Learning (the “Effective Companies”), providers of human capital management (HCM) solutions, including sales and support of the full SAP SuccessFactors Business Education (BizX) Platform, eLearning and blended learning solutions, as well as recruitment and employee development services. The Effective Companies are headquartered in Copenhagen, Denmark. The upfront purchase price was \$9.0 million which was paid in cash at closing and is subject to a working capital adjustment which we expect will be finalized in the third quarter of 2014. In addition, the purchase agreement requires up to an additional \$6.4 million of consideration, contingent upon the achievement of certain earnings targets during the two twelve-month periods following completion of the acquisition. The purchase price allocation for the acquisition included \$1.6 million of customer-related intangible assets which are being amortized over four years from the acquisition date. None of the goodwill recorded for financial statement purposes is deductible for tax purposes. The acquired Effective Companies business is included in the Learning Solutions segment and the results of its operations have been included in the consolidated financial statements beginning April 1, 2014. The pro-forma impact of the acquisition is not material to our results of operations. The acquired Effective Companies business is included in our Denmark subsidiary and its local currency is the Danish Kroner. The purchase price allocation below was translated into U.S. dollars based on the exchange rate in effect on the date of acquisition.

The estimated fair value of the purchase price recorded by us consisted of the following (in thousands):

Cash purchase price	\$9,000	
Fair value of contingent consideration	5,345	
Estimated working capital adjustment	(91)
Total purchase price	\$14,254	

The preliminary purchase price allocation for the net assets acquired is as follows (in thousands):

Cash	\$334
Accounts receivable	1,283
Prepaid expenses and other assets	496
Property and equipment	80
Amortizable intangible assets	1,613
Goodwill	12,338
Total assets acquired	\$16,144
Accounts payable, accrued expenses and other liabilities	\$582
Billings in excess of costs and estimated earnings on uncompleted contracts	940
Deferred tax liability	368
Total liabilities assumed	1,890
Net assets acquired	\$14,254

Operating Highlights

Three Months ended June 30, 2014 Compared to the Three Months ended June 30, 2013

For the three months ended June 30, 2014, we had income before income tax expense of \$13.8 million compared to \$8.6 million for the three months ended June 30, 2013. Gross profit was \$24.8 million, or 18.4% of revenue, for the second quarter of 2014 compared to \$18.4 million, or 17.5% of revenue, for the second quarter of 2013. Operating income, the components of which are discussed below by segment, increased \$5.2 million or 61.1% to \$13.8 million for the second quarter of 2014 compared to \$8.6 million for the second quarter of 2013. The net increase in operating income was primarily due to a \$6.4 million increase in gross profit which was partially offset by a \$1.6 million increase in selling, general and administrative expenses (SG&A) expenses primarily due to increased costs associated with global expansion. Net income was \$8.1 million, or \$0.42 per diluted share, for the three months ended June 30, 2014, compared to net income of \$5.2 million, or \$0.27 per diluted share, for the three months ended June 30, 2013.

Revenue

(Dollars in thousands)	Three months ended	
	June 30, 2014	2013
Learning Solutions	\$61,970	\$45,185
Professional & Technical Services	18,789	17,048
Sandy Training & Marketing	20,223	20,134
Performance Readiness Solutions	14,130	12,954
Energy Services	19,806	9,578
	\$134,918	\$104,899

Learning Solutions revenue increased \$16.8 million or 37.1% during the second quarter of 2014 compared to the second quarter of 2013. The increase in revenue is due to the following:

- ▲ \$2.3 million increase attributable to the Effective Companies acquisition completed in April 2014;
- ▲ \$2.3 million increase attributable to the Lorien acquisition completed in June 2013;
- ▲ \$0.7 million increase attributable to the Prospero acquisition completed in May 2013;
- ▲ \$9.4 million increase in revenue from a global outsourcing contract with a financial services client;
- ▲ \$2.1 million net increase in e-Learning content development and training business process outsourcing (BPO) services from contracts with new clients and expansion of work with existing clients;
- ▲ \$1.7 million increase in revenue due to favorable changes in exchange rates; and
- ▲ \$0.5 million increase in leadership training and consulting services.

These revenue increases were offset by a \$2.2 million decline in UK government funded skills training services.

Professional & Technical Services revenue increased \$1.7 million or 10.2% during the second quarter of 2014 compared to the second quarter of 2013. The net decrease in revenue is due to the following:

- ▲ \$0.7 million net increase in revenue from U.S. government clients primarily due to an increase in chemical demilitarization services;
- ▲ \$0.5 million net increase in training and technical services for oil and gas clients; and
- ▲ \$0.5 million net increase in technical services for various clients.

Sandy Training & Marketing revenue increased \$0.1 million or 0.4% during the second quarter of 2014 compared to the second quarter of 2013. The net increase is primarily due to a \$0.4 million increase in publications revenue and a \$0.4 million increase in glove-box portfolio revenue due to increased vehicle sales volumes, offset by a decrease in revenue primarily due to the completion of a non-recurring project in 2013 for an automotive customer.

Performance Readiness Solutions revenue increased \$1.2 million or 9.1% during the second quarter of 2014 compared to the second quarter of 2013 primarily due to a net increase in consulting, training development and system implementation training services.

Energy Services revenue increased \$10.2 million or 106.8% during the second quarter of 2014 compared to the second quarter of 2013. This net increase is primarily due to a \$12.2 million increase in the alternative fuels business unit due to completing LNG projects under contracts awarded in 2013 and a \$0.8 million increase in training services. These increases were partially offset by a \$2.8 million decrease in software license sales and other engineering services. We anticipate that the revenue in this segment will decline in future quarters due to the completion of numerous LNG projects that occurred in the second quarter of 2014.

Gross Profit

(Dollars in thousands)	Three months ended					
	June 30,		2013			
	2014	% Revenue		% Revenue		
Learning Solutions	\$8,857	14.3	% \$8,198	18.1		%
Professional & Technical Services	3,320	17.7	% 3,281	19.2		%
Sandy Training & Marketing	3,298	16.3	% 2,936	14.6		%
Performance Readiness Solutions	2,322	16.4	% 1,512	11.7		%
Energy Services	6,970	35.2	% 2,468	25.8		%
	\$24,767	18.4	% \$18,395	17.5		%

Learning Solutions gross profit of \$8.9 million or 14.3% of revenue for the second quarter of 2014 increased by \$0.7 million or 8.0% when compared to gross profit of \$8.2 million or 18.1% of revenue for the second quarter of 2013. Approximately \$1.0 million of the net increase in gross profit is attributable to the acquisitions we completed in 2013 and 2014. The net increase was offset by a decrease in gross profit primarily due to start-up costs incurred on the implementation of a new global outsourcing contract with a financial services client and a decline in gross profit and margin in our UK government funded skills training business due to a decrease in revenue.

Professional & Technical Services gross profit was \$3.3 million or 17.7% of revenue for the second quarter of 2014 compared to gross profit of \$3.3 million or 19.2% of revenue for the second quarter of 2013. The decrease in gross margin is primarily due to an increase in lower margin subcontracted work in this segment.

Sandy Training and Marketing gross profit of \$3.3 million or 16.3% of revenue for the second quarter of 2014 increased by \$0.4 million or 12.3% when compared to gross profit of \$2.9 million or 14.6% of revenue for the second quarter of 2013. The increased profitability is due to an increase in publications and glove-box portfolio revenues noted above, as well as improved profit on technical training services.

Performance Readiness Solutions gross profit of \$2.3 million or 16.4% of revenue for the second quarter of 2014 increased by \$0.8 million or 53.6% when compared to gross profit of \$1.5 million or 11.7% of revenue for the second quarter of 2013. The gross profit increase is primarily due to the revenue increases noted above as well as a reduction in costs related to technology initiatives in 2013.

Energy Services gross profit of \$7.0 million or 35.2% of revenue for the second quarter of 2014 increased by \$4.5 million or 182.4% when compared to gross profit of \$2.5 million or 25.8% of revenue for the second quarter of 2013 primarily due to the revenue increases noted above. We anticipate that the gross profit in this segment will decline in future quarters due to the completion of numerous LNG projects that occurred in the second quarter of 2014.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$1.6 million or 16.0% from \$9.9 million for the second quarter of 2013 to \$11.5 million for the second quarter of 2014. The increase is primarily due to a \$0.9 million increase in labor and benefits expense due to international expansion, a \$0.2 million increase in expenses associated with the establishment of new foreign entities, a \$0.5 million increase in IT infrastructure costs and a \$0.3 million increase in amortization expense. These increases were offset by a decrease in acquisition related expenses during the three months ended June 30, 2014 compared to 2013.

Change in Fair Value of Contingent Consideration

We recognized a net gain on the change in fair value of contingent consideration related to acquisitions of \$0.5 million for the three months ended June 30, 2014 compared to \$0.05 million for the same period in 2013. Accounting Standards Codification (“ASC”) Topic 805, Business Combinations (“Topic 805”) requires that contingent consideration be recognized at fair value on the acquisition date and be re-measured each reporting period with subsequent adjustments recognized in the consolidated statement of operations. We estimate the fair value of contingent consideration liabilities based on financial projections of the acquired companies and estimated probabilities of achievement. We believe our estimates and assumptions are reasonable; however, there is significant judgment involved. At each reporting date, the contingent consideration obligation is revalued to estimated fair value and changes in fair value subsequent to the acquisitions are reflected in income or expense in the consolidated statements of operations, and could cause a material impact to, and volatility in, our operating results. Changes in the fair value of contingent consideration obligations may result from changes in discount periods, changes in the timing and amount of revenue and/or earnings estimates and changes in probability assumptions with respect to the likelihood of achieving the various earn-out criteria. See Note 5 to the Condensed Consolidated Financial Statements for further details regarding the potential contingent consideration payments and the changes in fair value of the related liabilities for each acquisition during the six months ended June 30, 2014.

Interest Expense

Interest expense was consistent at approximately \$0.1 million for the second quarters of both 2014 and 2013.

Other Income

Other income was consistent at approximately \$0.1 million for the second quarters of both 2014 and 2013 and consisted primarily of income from a joint venture and foreign currency gains and losses in both years.

Income Tax Expense

Income tax expense was \$5.7 million for the second quarter of 2014 compared to \$3.3 million for the second quarter of 2013. The effective income tax rate was 41.1% and 38.9% for the three months ended June 30, 2014 and 2013, respectively. The increase in income tax expense and effective income tax rate are primarily due to a higher proportion of earnings in jurisdictions with higher tax rates. Income tax expense for the quarterly periods is based on an estimated annual effective tax rate which includes the U.S. federal, state and local, and non-U.S. statutory rates, permanent differences, and other items that may have an impact on income tax expense.

Six Months ended June 30, 2014 Compared to the Six Months ended June 30, 2013

For the six months ended June 30, 2014, we had income before income tax expense of \$20.9 million compared to \$16.1 million for the six months ended June 30, 2013. Gross profit was \$43.1 million, or 17.1% of revenue, for the first half of 2014 compared to \$34.6 million, or 16.8% of revenue, for the same period in 2013. Operating income, the components of which are discussed below by segment, increased \$5.0 million or 31.6% to \$20.9 million for the first half of 2014 compared to \$15.9 million for the same period in 2013. The net increase in operating income was primarily due to a \$8.5 million increase in gross profit which was partially offset by a \$4.1 million increase in SG&A expenses primarily due to increased costs associated with global expansion. Net income was \$12.4 million, or \$0.64 per diluted share, for the six months ended June 30, 2014, compared to net income of \$10.2 million, or \$0.53 per diluted share, for the six months ended June 30, 2013.

Revenue

(Dollars in thousands)

	Six months ended	
	June 30, 2014	2013
Learning Solutions	\$114,937	\$87,919
Professional & Technical Services	38,699	35,063
Sandy Training & Marketing	34,481	35,132
Performance Readiness Solutions	27,139	28,454
Energy Services	37,542	19,704
	\$252,798	\$206,272

Learning Solutions revenue increased \$27.0 million or 30.7% during the six months ended June 30, 2014 compared to the same period in 2013. The increase in revenue is due to the following:

- ▲ \$2.3 million increase attributable to the Effective Companies acquisition completed in April 2014;
 - ▲ \$5.2 million increase attributable to the Lorien acquisition completed in June 2013;
 - ▲ \$1.8 million increase attributable to the Prospero acquisition completed in May 2013;
 - ▲ \$16.1 million increase in revenue from a global outsourcing contract with a financial services client;
 - ▲ \$2.6 million increase in revenue due to favorable changes in exchange rates;
 - ▲ \$1.1 million increase in leadership training and consulting services; and
 - ▲ \$0.9 million net increase in e-Learning content development and training business process outsourcing (BPO) services from contracts with new clients and expansion of work with existing clients.
- These revenue increases were offset by a \$3.0 million revenue decline in UK government funded skills training services.

Professional & Technical Services revenue increased \$3.6 million or 10.4% during the six months ended June 30, 2014 compared to the same period in 2013. The increase in revenue is due to the following:

- ▲ \$1.0 million net increase in training and technical services for oil and gas clients;
- ▲ \$1.0 million net increase in revenue from U.S. government clients primarily due to an increase in chemical demilitarization services;
- ▲ \$0.6 million one-time revenue adjustment relating to a final contract negotiation and close-out during the first quarter of 2014; and
- ▲ net \$1.0 million increase in technical and training services for various clients.

Sandy Training & Marketing revenue decreased \$0.7 million or 1.9% during the six months ended June 30, 2014 compared to the same period in 2013. The net decrease in revenue is due to a \$1.5 million decrease due to the completion of a non-recurring project in 2013 for an automotive customer, partially offset by a \$0.8 million increase in glove-box portfolio revenue during the first half of 2014 compared to the same period in 2013.

Performance Readiness Solutions revenue decreased \$1.3 million or 4.6% during the six months ended June 30, 2014 compared to the same period in 2013 due to a net decrease in sales enablement and system implementation training services due to various project completions. The revenue decrease was partially offset by an increase in consulting and training services.

Energy Services revenue increased \$17.8 million or 90.5% during the six months ended June 30, 2014 compared to the same period in 2013 primarily due to a \$20.7 million increase in the alternative fuels business unit due to completing LNG projects under contracts awarded in 2013 and a \$1.3 million increase in training services. These increases were partially offset by a \$4.2 million decrease in software license sales and other engineering services. We anticipate that the revenue in this segment will decline in future quarters due to the completion of numerous LNG projects that occurred in the first half of 2014.

Gross Profit

(Dollars in thousands)	Six months ended					
	June 30,		2013			
	2014	% Revenue		% Revenue		
Learning Solutions	\$15,460	13.5	% \$15,369	17.5		%
Professional & Technical Services	7,434	19.2	% 5,965	17.0		%
Sandy Training & Marketing	5,208	15.1	% 4,862	13.8		%
Performance Readiness Solutions	4,055	14.9	% 3,490	12.3		%
Energy Services	10,965	29.2	% 4,890	24.8		%
	\$43,122	17.1	% \$34,576	16.8		%

Learning Solutions gross profit of \$15.5 million or 13.5% of revenue for the six months ended June 30, 2014 increased by \$0.1 million or 0.6% when compared to gross profit of \$15.4 million or 17.5% of revenue for the same period in 2013. Approximately \$1.4 million of gross profit is attributable to the acquisitions we completed in 2013 and 2014. The net increase was offset by a decrease in gross profit primarily due to start-up costs incurred on the implementation of a new global outsourcing contract with a financial services client and a decline in gross profit and margin in our UK government funded skills training business due to a decrease in revenue.

Professional & Technical Services gross profit of \$7.4 million or 19.2% of revenue for the six months ended June 30, 2014 increased by \$1.5 million or 24.6% when compared to gross profit of \$6.0 million or 17.0% of revenue for the same period in 2013. The increase in gross profit is primarily due to the revenue increases noted above as well as a \$0.6 million one-time revenue and profit adjustment relating to a final contract negotiation and close-out during the first quarter of 2014.

Sandy Training and Marketing gross profit of \$5.2 million or 15.1% of revenue for the six months ended June 30, 2014 increased by \$0.3 million or 7.1% when compared to gross profit of \$4.9 million or 13.8% of revenue for the same period in 2013. Despite the net revenue decline in this segment, the gross profit increased due to an increase in higher margin publications and glove-box portfolio revenues noted above, as well as improved profit on technical training services.

Performance Readiness Solutions gross profit of \$4.1 million or 14.9% of revenue for the six months ended June 30, 2014 increased by \$0.6 million or 16.2% when compared to gross profit of \$3.5 million or 12.3% of revenue for the same period in 2013. Despite the revenue decline in the segment, gross profit increased due to a reduction in costs related to technology initiatives in 2013.

Energy Services gross profit of \$11.0 million or 29.2% of revenue for the six months ended June 30, 2014 increased \$6.1 million or 124.2% compared to gross profit of \$4.9 million or 24.8% of revenue for the same period in 2013 primarily due to the revenue increases noted above. We anticipate that the gross profit in this segment will decline in future quarters due to the completion of numerous LNG projects that occurred in the first half of 2014.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$4.1 million or 21.5% from \$19.0 million for the six months ended June 30, 2013 to \$23.1 million for the same period in 2014. The increase is primarily due to a \$1.6 million increase in labor and benefits expense due to international expansion, a \$0.6 million increase in expenses associated with the establishment of new foreign entities, a \$0.9 million increase in IT infrastructure costs, \$0.3 million of acquisition-related expenses and a \$0.4 million increase in amortization expense. The remainder of the increase is due to increases in business insurance, accounting, legal and facility costs during the six months ended June 30, 2014 compared to 2013.

Change in Fair Value of Contingent Consideration

We recognized a net gain on the change in fair value of contingent consideration related to acquisitions of \$0.9 million for the six months ended June 30, 2014, compared to a net gain of \$0.3 million for the six months ended June 30, 2013. ASC Topic 805 requires that contingent consideration be recognized at fair value on the acquisition date and be re-measured each reporting period with subsequent adjustments recognized in the consolidated statement of operations. We estimate the fair value of contingent consideration liabilities based on financial projections of the acquired companies and estimated probabilities of achievement. We believe our estimates and assumptions are reasonable; however, there is significant judgment involved. At each reporting date, the contingent consideration obligation is revalued to estimated fair value and changes in fair value subsequent to the acquisitions are reflected in income or expense in the consolidated statements of operations, and could cause a material impact to, and volatility in, our operating results. Changes in the fair value of contingent consideration obligations may result from changes in discount periods, changes in the timing and amount of revenue and/or earnings estimates and changes in probability assumptions with respect to the likelihood of achieving the various earn-out criteria. See Note 5 to the Condensed Consolidated Financial Statements for further details regarding the potential contingent consideration payments and the changes in fair value of the related liabilities for each acquisition during the six months ended June 30, 2014.

Interest Expense

Interest expense was \$0.3 million for the six months ended June 30, 2014 compared to \$0.2 million for the same period in 2013.

Other Income

Other income was consistent at approximately \$0.3 million for both the six-month periods ended June 30, 2014 and 2013 and consisted primarily of income from a joint venture and foreign currency gains and losses in both years.

Income Tax Expense

Income tax expense was \$8.5 million for the six months ended June 30, 2014 compared to \$5.9 million for the same period in 2013. The effective income tax rate was 40.5% and 36.6% for the six months ended June 30, 2014 and 2013, respectively. During the first quarter of 2013, we recorded one-time income tax benefits totaling \$0.4 million for a foreign subsidiary. Excluding these discrete items recorded in the first quarter, the effective income tax rate was 39.0% for the six months ended June 30, 2013. The increase in the effective income tax rate compared to 2013 is primarily due to a higher proportion of earnings in jurisdictions with higher tax rates. Income tax expense for the

quarterly periods is based on an estimated annual effective tax rate which includes the U.S. federal, state and local, and non-U.S. statutory rates, permanent differences, and other items that may have an impact on income tax expense.

Liquidity and Capital Resources

Working Capital

For the six months ended June 30, 2014, our working capital increased \$6.4 million from \$58.7 million at December 31, 2013 to \$65.1 million at June 30, 2014 primarily due to an increase in the volume of business and revenue growth. As of June 30, 2014 we had no long-term debt and had \$17.8 million of short-term borrowings outstanding. We believe that cash generated from operations and borrowings available under our Credit Agreement (\$31.5 million of available borrowings as of June 30, 2014) will be sufficient to fund our working capital and other requirements for at least the next twelve months.

As of June 30, 2014, the amount of cash and cash equivalents held outside of the U.S. by foreign subsidiaries was \$6.0 million. At the present time, we do not anticipate repatriating these balances to fund domestic operations. We would be required to accrue for and pay taxes in the U.S. in the event we decided to repatriate these funds.

Acquisition-Related Payments

We may be required to pay the following additional contingent consideration in connection with acquisitions we previously completed (dollars in thousands):

	As of June 30, 2014				Recorded Liability as of June 30, 2014
	Maximum potential contingent consideration due in				
Acquisition:	2014	2015	2016	Total	
Prospero	\$—	\$1,876	\$—	\$1,876	\$804
Effective Companies	—	3,177	3,177	6,354	5,440
Total	\$—	\$5,053	\$3,177	\$8,230	\$6,244

Significant Customers & Concentration of Credit Risk

We have a market concentration of revenue in both the automotive sector and financial & insurance sector. Revenue from the automotive industry accounted for approximately 14% and 17% of our consolidated revenue for the six months ended June 30, 2014 and 2013, respectively. Revenue from the financial & insurance industry accounted for approximately 15% and 9% of our consolidated revenue for the six months ended June 30, 2014 and 2013, respectively. In prior periods, we also had a concentration of revenue from the United States government. For the six months ended June 30, 2014 and 2013, sales to the United States government and its agencies represented approximately 9% and 10%, respectively, of our consolidated revenue. Revenue was derived from many separate contracts with a variety of government agencies that are regarded by us as separate customers. No single customer accounted for more than 10% of our consolidated revenue for the six months ended June 30, 2014 and 2013. As of June 30, 2014, billed and unbilled accounts receivable from a single financial services customer totaled \$20.9 million, or 14%, of our consolidated accounts receivable and costs and estimated earnings in excess of billings on uncompleted contracts balances.

Cash Flows

Six Months ended June 30, 2014 Compared to the Six Months ended June 30, 2013

Our cash balance increased \$0.4 million from \$5.6 million as of December 31, 2013 to \$6.0 million as of June 30, 2014. The increase in cash and cash equivalents during the six months ended June 30, 2014 resulted from cash used in operating activities of \$1.9 million, cash used in investing activities of \$10.1 million, cash provided by financing activities of \$12.6 million and a \$0.2 million negative effect of exchange rate changes on cash and cash equivalents.

Cash used in operating activities was \$1.9 million for the six months ended June 30, 2014 compared to cash provided by operating activities of \$5.5 million for the same period in 2013. The decrease in cash is primarily due to an increase in accounts receivable and unbilled receivable balances during the first half of 2014 compared to the same period in 2013.

Cash used in investing activities was \$10.1 million for the six months ended June 30, 2014 compared to \$15.7 million for the same period in 2013. The decrease in cash used in investing activities is primarily due to \$8.7 million of cash used for acquisitions, net of cash acquired, during the first half of 2014 compared to \$13.5 million of cash used for acquisitions during the same period in 2013. In addition, cash used for fixed asset additions decreased by \$0.7 million during the first half of 2014 compared to the same period in 2013.

Cash provided by financing activities was \$12.6 million for the six months ended June 30, 2014 compared to \$7.8 million for the same period in 2013. The increase in cash provided by financing activities is primarily due to an increase in short-term borrowings of \$17.4 million, offset by a \$4.6 million decrease in cash due to the change in negative cash book balance and a \$0.9 million increase in cash used for share repurchases during the six months ended June 30, 2014 compared to the same period in 2013.

Short-term Borrowings

We have a \$50 million Financing and Security Agreement (the "Credit Agreement") with a bank that expires on October 31, 2015 and is secured by certain of our assets. The Credit Agreement contains a provision to increase the maximum principal amount to \$75 million upon lender approval. The maximum interest rate on borrowings under the Credit Agreement is the daily LIBOR market index rate plus 2.25%. Based upon our financial performance, the interest rate can be reduced to a minimum of LIBOR plus 1.0%. For the six months ended June 30, 2014, the weighted average interest rate on our borrowings was 1.5%. The Credit Agreement contains covenants which require us to maintain a minimum tangible net worth of no less than \$35.0 million, a total liabilities to tangible net worth ratio of no more than 3.0 to 1.0, and a cash flow to debt service ratio of no less than 3.0 to 1.0. As of June 30, 2014, our tangible net worth was \$63.6 million, our total liabilities to tangible net worth ratio was 1.8 to 1.0 and our cash flow to debt service ratio was 62.6 to 1.0, all of which were in compliance with the Credit Agreement. As of June 30, 2014, there were \$17.8 million of borrowings outstanding and \$31.5 million of available borrowings under the Credit Agreement.

Off-Balance Sheet Commitments

As of June 30, 2014, we do not have any off-balance sheet commitments except for operating leases and letters of credit entered into in the normal course of business.

Accounting Standard Issued

We discuss recently issued accounting standards in Note 2 to the accompanying consolidated financial statements.

Forward-Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Private Securities Litigation Reform Act of 1995 provides a “safe harbor” for forward looking statements. Forward-looking statements are not statements of historical facts, but rather reflect our current expectations concerning future events and results. We use words such as “expects,” “intends,” “believes,” “may,” “will,” “should,” “could,” “anticipates,” “estimates,” “plans” and similar to indicate forward-looking statements, but their absence does not mean a statement is not forward-looking. Because these forward-looking statements are based upon management’s expectations and assumptions and are subject to risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements, including, but not limited to, those factors set forth in Item 1A - Risk Factors of the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013 and those other risks and uncertainties detailed in our periodic reports and registration statements filed with the Securities and Exchange Commission. We caution that these risk factors may not be exhaustive. We operate in a continually changing business environment, and new risk factors emerge from time to time. We cannot predict these new risk factors, nor can we assess the effect, if any, of the new risk factors on our business or the extent to which any factor or combination of factors may cause actual results to differ from those expressed or implied by these forward-looking statements.

If any one or more of these expectations and assumptions proves incorrect, actual results will likely differ materially from those contemplated by the forward-looking statements. Even if all of the foregoing assumptions and expectations prove correct, actual results may still differ materially from those expressed in the forward-looking statements as a result of factors we may not anticipate or that may be beyond our control. While we cannot assess the future impact that any of these differences could have on our business, financial condition, results of operations and cash flows or the market price of shares of our common stock, the differences could be significant. We do not undertake to update any forward-looking statements made by us, whether as a result of new information, future events or otherwise. You are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in this report.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

The Company has no material changes to the disclosure on this matter made in its Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain a comprehensive set of disclosure controls and procedures (as defined in Rules 13a-15(e) and under the Securities Exchange Act of 1934 (“Exchange Act”)) designed to provide reasonable assurance that information required to be disclosed in our filings under the Exchange Act is recorded, processed, summarized and reported accurately and within the time periods specified in the SEC’s rules and forms. Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures are effective in providing reasonable assurance of the achievement of the objectives described above.

Internal Control Over Financial Reporting

During the quarter ended June 30, 2014, there was no change in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d—15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

The Company has no material changes to the disclosure on this matter made in its Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

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

The following table provides information about the Company's share repurchase activity for the three months ended June 30, 2014:

Month	Issuer Purchases of Equity Securities			Total number of shares purchased as part of publicly announced program	Approximate dollar value of shares that may yet be purchased under the program (1)
	Total number of shares purchased	Average price paid per share			
April 1 - 30, 2014	509	(2) \$26.69		—	\$3,991,000
May 1 - 31, 2014	29,296	(2) \$24.37		29,296	\$3,276,000
June 1 - 30, 2014	15,013	(2) \$23.47		15,013	\$2,923,000

We have a share repurchase program under which we may repurchase shares of our common stock from time to time in the open market subject to prevailing business and market conditions and other factors. There is no expiration date for the repurchase program.

Includes shares surrendered by employees to satisfy minimum tax withholding obligations on restricted stock units which vested and shares surrendered to exercise stock options and satisfy the related minimum tax withholding obligations during the second quarter of 2014.

Item 6. Exhibits

- 31.1 Certification of Chief Executive Officer of the Company dated July 31, 2014 pursuant to Securities and Exchange Act Rule 13d-14(a)/15(d-14(a), as adopted pursuant to Section 302 and 404 of the Sarbanes-Oxley Act of 2002.*
Certification of Executive Vice President and Chief Financial Officer of the Company dated July 31, 2014
- 31.2 pursuant to Securities and Exchange Act Rule 13d-14(a)/15(d-14(a), as adopted pursuant to Section 302 and 404 of the Sarbanes-Oxley Act of 2002.*
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer of the Company dated July 31, 2014 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*
The following materials from GP Strategies Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated 101 Balance Sheets; (ii) Condensed Consolidated Statements of Operations; (iii) Condensed Consolidated Statements of Comprehensive Income, (iv) Condensed Consolidated Statements of Cash Flows; and (v) Notes to Condensed Consolidated Financial Statements. *

*Filed herewith.

SIGNATURES

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

GP STRATEGIES CORPORATION

July 31, 2014

/s/ Scott N. Greenberg
Scott N. Greenberg
Chief Executive Officer

July 31, 2014

/s/ Sharon Esposito-Mayer
Sharon Esposito-Mayer
Executive Vice President and Chief Financial Officer

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urity (with either a different exercise price or expiration date or both) to be written. If the Trust is not able to enter into a closing transaction or an offsetting position, it will be required to maintain the securities subject to the call, or the collateral underlying the put, even though it might not be advantageous to do so, until a closing transaction can be entered into or the option is exercised or expires.

The Trust's ability to close out its position as a writer of an option is dependent upon the existence of a liquid secondary market. There is no assurance that a liquid market will exist, particularly in the case of OTC options, since OTC options will generally be closed out only by entering into a closing transaction with a dealer. In the case of OTC options, the Trust is also subject to the credit risk associated with its counterparties.

Stock Index Options. The Trust may purchase and sell (write) options on stock indices (index options). Index options are similar to options on securities except that, rather than taking or making delivery of securities underlying the option at a specified price upon exercise, an index option gives the holder the right to receive cash upon exercise of the option if the level of the stock index upon which the option is based is greater, in the case of a call, or less, in the case of a put, than the exercise price of the option.

The Trust will enter into transactions in index options for a number of reasons including, for example, to hedge against adverse price movements in the stock market generally or in particular market segments. If the Investment Adviser anticipates a general market decline, the Trust could purchase a stock index put option. If the expected market decline materialized, the resulting decrease in the value of the Trust's portfolio securities would be offset to the extent of the increase in the value of the put option. If the Investment Adviser anticipates a market rise, the Trust may purchase a stock index call option to enable the Trust to participate in the rise until the Trust completes anticipated purchases of securities. Purchasing and selling stock index options may also enable the Investment Adviser to achieve changes in equity positions more efficiently. Stock index options involve risks similar to those associated with options on securities. Because exercises of stock index options are settled in cash, however, call writers such as the Trust cannot provide in advance for their potential settlement obligations by acquiring and holding the underlying securities.

Futures Contracts and Options on Futures Contracts

Futures Contracts. The Trust may enter into contracts for the purchase or sale for future delivery (a futures contract) of baskets of securities, financial indices, financial instruments or foreign currencies. The Trust would purchase or sell futures contracts to attempt to protect the value of

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its securities from market-wide price movements and fluctuations in interest or foreign exchange rates without actually buying or selling securities or foreign currency.

A sale of a futures contract (or a short futures position) means the assumption of a contractual obligation to deliver the securities or currency underlying the contract at a specified price at a specified future time. A purchase of a futures contract (or a long futures position) means the assumption of a contractual obligation to acquire the securities or currency underlying the contract at a specified price at a specified future time.

Options on Futures Contracts. Upon exercise of a call option, the Trust receives a long position in the underlying futures contract. As with the purchase of futures contracts, when the Trust is not fully invested it may purchase a call option on a futures contract to hedge against a market advance in which it would not otherwise participate. The purchase of a put option on a futures contract is similar in some respects to the purchase of protective put options on portfolio securities. Upon exercise of a put option, the Trust receives a short position in the underlying futures contract. For example, the Trust may purchase a put option on a futures contract to hedge the Trust's portfolio against the risk of declining securities values. The writing of a call option on a futures contract constitutes a partial

hedge against declining prices of the components of the futures contract, whereas the writing of a put option on a futures contract constitutes a partial hedge against increasing prices of the financial instrument which is deliverable upon termination of the futures contracts. If the options expire unexercised, the Trust will retain the full amount of the option premium, which provides a partial hedge against any increase in the price of securities which the Trust intends to purchase. If a put or call option the Trust has written is exercised, the Trust will incur a loss which will be reduced by the amount of the premium it receives.

Margin Requirements. At the time a futures contract is purchased or sold, the Trust must allocate cash or securities as a deposit payment (initial margin). It is expected that the initial margin on U.S. exchanges may range from approximately 1% to approximately 10% of the value of the securities or commodities underlying the contract. Under certain circumstances, however, such as periods of high volatility, the Trust may be required by an exchange to increase the level of its initial margin payment. Additionally, initial margin requirements may be increased generally in the future by regulatory action. An outstanding futures contract is valued daily and the payment in cash of variation margin may be required, a process known as mark to the market .

Regulatory Limitations on the Use of Futures Contracts and Options on Futures Contracts. Regulations of the CFTC applicable to the Trust currently require that the Trust limits its transactions in commodity futures or commodity options and swaps such that either (i) the aggregate initial margin and premiums required to establish such positions (excluding positions established solely for bona fide hedging purposes) will not exceed 5% of the liquidation value of the Trust or (ii) the aggregate net notional value of such positions (excluding positions established solely for bona fide hedging purposes) does not exceed 100% of the liquidation value of the Trust. The Investment Adviser reserves the right to comply with such different standard as may be established by CFTC rules and regulations with respect to the purchase or sale of futures contracts or options thereon.

Considerations Concerning Futures Contracts and Options on Futures Contracts. Futures contracts entail special risks. The ordinary spreads between values in the cash and futures markets, due to differences in the character of these markets, are subject to distortions relating to (1) investor s obligations to meet additional variation margin requirements, (2) decisions to make or take delivery, rather than entering into offsetting transactions and (3) the difference between margin requirements in the securities markets and margin deposit requirements in the futures markets. The possibility of such distortion means that a correct forecast of general market, foreign exchange rate or interest rate trends by the Investment Adviser may still not result in a successful transaction. The Trust s ability to establish and close out positions in futures contracts and options on futures contracts will be subject to the development and maintenance of a liquid market. Although the Trust generally will purchase or sell only those futures contracts and options thereon for which there appears to be a liquid market, there is no assurance that a liquid market on an exchange will exist for any particular futures contract or option thereon at any particular time. Under certain circumstances, exchanges may establish daily limits in the amount that the price of a futures contract or related options contract may vary either up or down from the previous day s settlement price. Once the daily limit has been reached in a particular contract, no trades may be made that day at a price beyond that limit.

Exchange Rate Risk

The Trust may enter into forward foreign currency exchange contracts (forward contracts) and may purchase and sell (or write) exchange-traded or OTC options on currencies, foreign currency futures contracts and options on foreign currency futures contracts to protect against a decline in the U.S. Dollar equivalent value of its foreign currency portfolio securities or the payments thereon that may result from an adverse change in foreign currency exchange rates. The accurate projection of short-term currency market movements is extremely difficult, and the successful execution of a short-term hedging strategy is highly uncertain.

Forward Contracts. A forward contract obligates one party to purchase and the other party to sell a definite amount of a given foreign currency at some specified future date. In some circumstances the purchase or sale of appropriate forward contracts may help offset declines in the U.S.

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Dollar equivalent value of the Trust's foreign currency denominated assets and income available for distribution to the Trust's Shareholders that result from adverse changes in the exchange rate between the U.S. Dollar and the various foreign currencies in which the Trust's assets or income may be denominated. The U.S. Dollar equivalent value of the principal of and rate of return on foreign currency denominated securities will decline if the exchange rate of the U.S. Dollar rises in relation to that currency.

Such declines could be partially or completely offset by an increase in the value of a forward contract on that foreign currency.

While the use of foreign currency forward contracts may protect the Trust against declines in the U.S. Dollar equivalent value of its assets, their use will reduce the possible gain from advantageous changes in the value of the U.S. Dollar against particular currencies in which their assets are denominated. Moreover, the use of foreign currency forward contracts will not eliminate fluctuations in the underlying U.S. Dollar equivalent value of the prices of or rates of return on the assets held in the portfolio and the use of such techniques will subject the Trust to certain risks.

The foreign exchange markets can be highly volatile, subject to sharp price fluctuations. In addition, trading forward contracts can involve a degree of leverage. As a result, relatively small movements in the rates of exchange between the currencies underlying a contract could result in immediate and substantial losses to the Trust. Trading losses that are not offset by corresponding gains in assets being hedged could sharply reduce the value of the Trust's portfolio.

Options on Foreign Currencies. Similarly, the Trust may purchase and sell (or write) put and call options on foreign currencies to protect against a decline in the U.S. Dollar equivalent value of its portfolio securities or payments due thereon or a rise in the U.S. Dollar equivalent cost of securities that it intends to purchase. A foreign currency put option grants the holder the right, but not the obligation, at a future date to sell a specified amount of a foreign currency to its counterparty at a predetermined price. Conversely, a foreign currency call option grants the holder the right, but not the obligation, to purchase at a future date a specified amount of a foreign currency at a predetermined price. Where currency exchange rates do not move in the direction or to the extent anticipated, however, the Trust could sustain losses on transactions in foreign currency options which would require it to forego a portion or all of the benefits of advantageous changes in such rates.

As with options on securities or futures contracts, the Trust may write options on foreign currencies in order to receive a premium that may wholly or partially offset any declines in the value of its portfolio securities denominated in foreign currencies. When the Trust writes options on foreign currencies, the Trust also may be required to forego all or a portion of the benefits that might otherwise have been obtained from favorable movements in exchange rates.

Futures Contracts and Options on Futures Contracts on Foreign Currencies. Buyers and sellers of foreign currency futures contracts are subject to the same risks that apply to the use of futures generally. In addition, there are risks associated with foreign currency futures contracts and their use as hedging devices similar to those associated with options on foreign currencies described above. Further, settlement of a foreign currency futures contract must occur within the country issuing the underlying currency. Thus, the Trust must accept or make delivery of the underlying foreign currency in accordance with any U.S. or foreign restrictions or regulations regarding the maintenance of foreign banking arrangements by U.S. residents and may be required to pay any fees, taxes or charges associated with such delivery that are assessed in the country of the underlying currency.

Options on foreign currency futures contracts may involve certain additional risks. Trading options on foreign currency futures contracts is relatively new. The ability to establish and close out positions in such options is subject to the maintenance of a liquid secondary market. To mitigate this problem, the Trust will not purchase or write options on foreign currency futures contracts unless and until, in the Investment Adviser's opinion, the market for such options has developed sufficiently that the risks in connection with such options are not greater than the risks in connection with transactions in the underlying foreign currency futures contracts. Compared to the purchase or sale of foreign currency futures contracts, the purchase of call or put options thereon involves less potential risk to the Trust because the maximum amount at risk is the premium paid for the option (plus transaction costs). However, there may be circumstances when the purchase of a call or put option on a foreign currency futures contract would result in a loss, such as when there is no movement in the price of the underlying currency or futures contract, whereas use of the underlying futures contract would not result in a loss.

Coverage Requirements

All options on securities, securities indices, other indices and foreign currencies written by the Trust are required to be covered. When the Trust writes a call option during the life of the option, the Trust may own or have the

contractual right to acquire the securities or foreign currency subject to the option, or may maintain with the Trust's custodian in a segregated account cash, U.S. Government Securities, other appropriate high quality liquid debt obligations or other liquid securities in an amount at least equal to the market value of the securities or foreign currency underlying the option or may utilize any other instrument or transaction consistent with Commission guidelines. When the Trust writes a put option, the Trust may maintain with the Trust's custodian in a segregated account cash, U.S. Government Securities, other appropriate high quality debt obligations or other liquid securities in an amount at least equal to the exercise price of the option or may utilize any other instrument or transaction consistent with Commission guidelines.

All futures and forward currency contracts purchased or sold by the Trust are also required to be covered. When the Trust purchases a futures or forward currency contract, the Trust will maintain with the Trust's custodian in a segregated account an amount of cash, U.S. Government Securities, other appropriate high quality liquid debt obligations or other liquid securities so that the amount so segregated, plus the amount of initial and variation margin held in the account of its broker, if applicable, equals the market value of the futures or forward currency contract or may utilize any other instrument or transaction consistent with Commission guidelines.

When the Trust sells a futures or forward currency contract, during the life of the futures or forward currency contract, the Trust will own or have the contractual right to acquire the securities or foreign currency subject to the futures or forward currency contract, or will maintain with the Trust's custodian in a segregated account cash, U.S. Government Securities, other appropriate high quality liquid debt obligations or other liquid securities in an amount at least equal to the market value of the securities or foreign currency underlying the futures or forward currency contract or may utilize any other instrument or transaction consistent with Commission guidelines.

If the market value of the contract moves adversely to the Trust, or if the value of the securities in the segregated account declines, the Trust will be required to deposit additional cash or securities in the segregated account at a time when it may be disadvantageous to do so.

INVESTMENT RESTRICTIONS

The Trust has adopted certain fundamental restrictions, which, like its investment objective, may not be changed without the affirmative vote of the holders of a majority of the Trust's outstanding Shares. As used in this SAI, a majority of the Trust's outstanding Shares means the lesser of (1) 67% of the Shares represented at a meeting at which more than 50% of the outstanding Shares are represented or (2) more than 50% of the outstanding Shares. The Trust may not:

1. With respect to 75% of its total assets, invest in securities of any one issuer if immediately after and as a result of such investment more than 5% of the total assets of the Trust, taken at market value, would be invested in the securities of such issuer. This restriction does not apply to investments in U.S. Government Securities.
2. Purchase or sell commodities or commodities contracts. The prohibition on the purchase or sale of commodities applies to the purchase or sale of physical commodities.
3. Purchase or sell real estate; provided that the Trust may invest in securities secured by real estate or interests therein or issued by companies which invest in real estate or interests therein.

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4. Purchase any securities on margin or make short sales of securities, except for short-term credit necessary for the clearance of portfolio transactions.
5. Underwrite securities of other issuers, except to the extent that, in connection with the disposition of its portfolio securities, the Trust may be deemed an underwriter under federal or state securities law.
6. Invest less than 25% of its net assets in securities of companies in the healthcare industries.
7. Invest more than 40% of the Trust's net assets in venture capital or other Restricted Securities.

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8. Issue senior securities or borrow amounts in excess of 10% of its net assets at the time of borrowing, and then only from banks as a temporary measure for extraordinary or emergency purposes or for the repurchase of its securities. The Trust will not repurchase its securities during periods when it has outstanding borrowings in excess of 5% of its net assets. The Trust will not borrow for investment purposes.
9. Mortgage, pledge, hypothecate or in any manner transfer, as security for indebtedness, any securities owned or held by the Trust, except as may be necessary in connection with permitted borrowings under 9 above.
10. Make loans of money, except by the purchase of debt obligations in which the Trust may invest consistent with its investment objective and policies. The Trust reserves the authority to enter into repurchase agreements and to make loans of its portfolio securities to qualified institutional investors, brokers, dealers, banks or other financial institutions, so long as the terms of the loans are not inconsistent with the requirements of the Investment Company Act. Such loans may not exceed an aggregate amount of 33 1/3% of the Trust's net assets. Repurchase agreements are subject to the percentage limitation described in investment policy 5. below. See also Repurchase Agreement.
11. Purchase securities of other investment companies except in connection with a merger, consolidation, acquisition or reorganization, if (a) more than 10% of its total assets would be invested in securities of other investment companies, (b) more than 5% of its total assets would be invested in the securities of any one investment company, or (c) the Trust would own more than 3% of any other investment company's securities.

In addition, the Trust has adopted the following investment policies, which may be changed by the action of the Board of Trustees (the Board) without Shareholder approval:

1. The Trust, under normal circumstances, will have at least 80% of its net assets invested in securities of Healthcare Companies. This investment policy may not be changed without 60 days' prior notice to Shareholders.
2. To the extent not invested in the Healthcare Company, assets of the Trust will be invested in cash, U.S. Government Securities, money market instruments or money market mutual funds for liquidity. When, in the opinion of the Investment Adviser, adverse market conditions or industry expectations support such action, the Trust may temporarily take a defensive position of up to 75% of net assets in such liquid investments. The money market instruments in which the Trust may invest include certificates of deposit and bankers' acceptances issued by domestic branches of federally-insured U.S. banks and savings and loan associations and commercial paper and high and upper medium grade corporate debt securities rated, as of the date of purchase, among the highest rating categories of Moody's Investors Service Inc. (Aaa, Aa or A for bonds; MIG-1, MIG-2 or MIG-3 for notes; P-1 for commercial paper) or Standard & Poor's Corporation (AAA, AA or A for bonds; SP-1+ to SP-2 for notes; A-1 for commercial paper). The Trust also may invest in shares of money market mutual funds that invest in money market instruments and U.S. Government Securities. Money market mutual funds are investment companies and the Trust's investments in those companies are subject to the limitations set forth in 11 under Investment Restrictions. As a shareholder in money market mutual funds, the Trust will bear its ratable share of such companies' expenses, including investment adviser or management fees, and will remain subject to payment of fees to the Investment Adviser.
3. The Trust may invest up to 5% of its net assets in warrants, valued at market value. Warrants acquired in units or attached to other securities are not subject to this restriction.

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4. The Trust may not enter into repurchase agreements with respect to more than 10% of its net assets. It is the Trust's present intention to enter into repurchase agreements for a relatively short period (usually not more than one week) only with commercial banks and registered broker-dealers and only with respect to U.S. Government Securities and money market instruments. Repurchase agreements may also be viewed as loans made by the Trust which are collateralized by the securities subject to repurchase. The Trust intends to take possession of collateral, and the Investment Adviser will monitor repurchase transactions to ensure that the value of the underlying securities will be at least equal at all times to the total amount of the repurchase obligation, including the interest factor. See also Repurchase Agreements.

5. The Trust may not invest more than 20% of its net assets at the time of purchase in securities of foreign issuers. Such issuers are expected to be companies domiciled in Canada, Western Europe and Japan. The Trust may buy and sell foreign currencies for the purpose of settlement of transactions in foreign securities, but presently does not intend to engage in hedging operations such as buying contracts for purchase in the future of foreign currencies. Any such hedging operations would be limited to 5% of net assets.

Except as otherwise noted, all percentage limitations set forth above apply immediately after a purchase and a subsequent change in the applicable percentage resulting from market fluctuations does not require elimination of any security from the portfolio.

TRUSTEES AND OFFICERS

Overall responsibility for general oversight of the Trust rests with the Board of Trustees (the Board). The Board is comprised of seven individuals, six of whom are not interested persons of the Trust (as that term is defined in Section 2(a)(19) of the Investment Company Act) (Independent Trustee). The Chairman of the Board is an Independent Trustee. The Chairman presides at meetings of the Trustees, participates in the preparation of the agenda for meetings of the Board, and acts as a liaison between the Independent Trustees and the Trust's management between Board meetings. Except for any duties specified herein, the designation as Chairman does not impose any obligations or standards greater than or different from other Trustees.

The Board holds regular quarterly meetings each year to consider and address matters involving the Trust. The Board also may hold special meetings to address matters arising between regular meetings. The Independent Trustees also meet outside the presence of management in executive session at least quarterly and have engaged independent legal counsel to assist them in performing their oversight responsibilities.

The Board has established Audit, Governance and Nominating, Valuation and Qualified Legal Compliance Committees to assist the Board in the oversight of the management and affairs of the Trust. All of the members of these Committees are Independent Trustees, except for Dr. Omstead, who serves on the Valuation Committee. From time to time the Board may establish additional committees or informal working groups to deal with specific matters.

The Trust is subject to a number of risks including investment, compliance, operational and valuation risks. Although the Investment Adviser and the officers of the Trust are responsible for managing these risks on a day-to-day basis, the Board has adopted, and periodically reviews, policies and procedures designed to address these risks. As part of its regular oversight of the Trust, the Board, directly or through a Committee, interacts with the Trust's Chief Compliance Officer, the Trust's independent public accounting firm, and legal counsel to the Trust. These interactions include discussing the Trust's risk management and controls with the independent registered public accounting firm engaged by the Trust, reviewing valuation policies and procedures and the valuations of specific restricted securities, and receiving periodic reports from the Trust's Chief Compliance Officer regarding compliance matters relating to the Trust and its major service providers, including results of the implementation and testing of the Trust's and such providers' compliance programs. The Board's oversight function is facilitated by management reporting processes designed to provide information to the Board regarding the identification, assessment, and management of critical risks and the controls and policies and procedures used to mitigate those risks. The Board reviews its role in supervising the Trust's risk management from time to time and may change the manner in which it fulfills its oversight responsibilities at its discretion at any time.

The Board has determined that its leadership structure is appropriate for the Trust because it enables the Board to exercise informed and independent judgment over matters under its purview, allocates responsibility among committees in a manner that fosters effective oversight and allows the Board to devote appropriate resources to specific issues in a flexible manner as they arise. The Board periodically reviews its leadership structure as well as its overall structure, composition, and functioning, and may make changes at its discretion at any time.

The Trust's Declaration of Trust provides that the Trust will indemnify Trustees and officers and may indemnify employees and agents of the Trust against liabilities and expenses incurred in connection with claims or litigation in which they may be involved because of their offices with the Trust. However, nothing in the Declaration of Trust or the By-laws of the Trust protects or indemnifies a Trustee, officer, employee or agent against any liability to which

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he or she would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office.

The names of the Trustees and officers of the Trust, their addresses, ages and principal occupations during the past five years, and, in the case of the Trustees, their positions with certain other organizations and publicly-held companies, are provided in the tables below. Trustees that are deemed interested persons (as that term is defined in Section 2(a)(19) of the Investment Company Act) of the Trust or the Investment Adviser are included in the table titled Interested Trustees. Trustees who are not interested persons as described above are referred to as Independent Trustees. The Trust and H&Q Life Sciences Investors (HQL), another closed-end investment company advised by the Investment Adviser, are the only two portfolios in the Fund Complex.

Trustees

NAMES, ADDRESSES(1) AND DATES OF BIRTH	POSITION WITH THE TRUST, TERM OF OFFICE(2) AND LENGTH OF TIME SERVED	PRINCIPAL OCCUPATION(S) DURING PAST 5 YEARS AND OTHER DIRECTORSHIPS HELD	NUMBER OF PORTFOLIOS IN TRUST COMPLEX OVERSEEN BY TRUSTEE
INDEPENDENT TRUSTEES:			
Michael W. Bonney 8/1958	Trustee (since 2011)	Chief Executive Officer and Director, Cubist Pharmaceuticals, Inc. (since 2012); President, Chief Executive Officer and Director, Cubist Pharmaceuticals, Inc. (2003-2012); President, Cubist Pharmaceuticals, Inc. (2002-2003); Director, NPS Pharmaceuticals, Inc. (since 2005); Chairman of the Board of Trustees, Bates College (since 2010); Trustee, Bates College (since 2002) Board member of the Pharmaceutical Research and Manufacturers of America (PhRMA) (since 2009).	2
Rakesh K. Jain, Ph.D. 12/1950	Trustee (since 2007)	Director, Steele Lab of Tumor Biology at Massachusetts General Hospital (since 1991); A.W. Cook Professor of Tumor Biology (Radiation Oncology) at Harvard Medical School (since 1991); Ad hoc Consultant/Scientific Advisory Board Member for pharmaceutical/biotech companies (various times since 2002); Ad hoc Consultant, Gershon Lehman Group (since 2004); Advisory Committee Member, Department of Biotechnology, Government of India (2004 -2009); Director, Co-Founder, XTuit Pharmaceuticals, Inc. (since 2011).	2
Oleg M. Pohotsky 3/1947	Trustee (since 2000) Chairman (since 2012)	Consultant and Managing Partner, Right Bank Partners (since 2002); Adviser, Board of Advisers, Kaufman & Co. LLC (since 2008); Director, Avanguardco Investment Holdings (since 2010); Director, New America High Income Fund, Inc. (since 2013).	2

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William S. Reardon, CPA 6/1946	Trustee (since 2010)	Independent Consultant (since 2002); Director, Idera Pharmaceuticals, Inc. (since 2002); Director, Synta Pharmaceuticals, Inc. (since 2004).	2
Uwe E. Reinhardt, Ph.D. 9/1937	Trustee (since 1988)	Professor of Economics, Princeton University (since 1968); Director, Boston Scientific Corporation (since 2002); Director, Amerigroup, Inc. (since 2002).	2
Lucinda H. Stebbins, CPA 11/1945	Trustee (since 2006)	Independent Consultant, Deutsche Bank (since 2004); Director, Bald Peak Land Company (since 2008); Trustee, Massachusetts Hospital School (1997-2008).	2

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NAMES, ADDRESSES(1) AND DATES OF BIRTH	POSITION WITH THE TRUST, TERM OF OFFICE(2) AND LENGTH OF TIME SERVED	PRINCIPAL OCCUPATION(S) DURING PAST 5 YEARS AND OTHER DIRECTORSHIPS HELD	NUMBER OF PORTFOLIOS IN TRUST COMPLEX OVERSEEN BY TRUSTEE
INTERESTED TRUSTEES:			
Daniel R. Omstead, Ph.D. (3) 7/1953	President (since 2001) Trustee (since 2003)	President of the Fund and H&Q Life Sciences Investors (since 2001); President, Chief Executive Officer and Managing Member of Tekla Capital Management LLC (since 2002); Director, AlterG, Inc. (since 2013); Director, Magellan Diagnostics, Inc. (since 2006); Director, Palyon Medical Corporation (since 2009); Director, Dynex Corporation (since 2012); Director, IlluminOss Medical, Inc. (since 2012).	2

(1) The address for each Trustee is: H&Q Healthcare Investors, 2 Liberty Square, 9th Floor, Boston, Massachusetts, 02109, 617-772-8500.

(2) Each Trustee currently is serving a three year term.

(3) Trustee considered to be an interested person within the meaning of the Investment Company Act of 1940 through his position or affiliation with the Investment Adviser.

The Board believes that each Trustee's experience, qualifications, attributes and skills on an individual basis and in combination with those of other Trustees lead to the conclusion that each Trustee should serve in such capacity. Among the attributes or skills common to all Trustees are their ability to review critically and to evaluate, question and discuss information provided to them, to interact effectively with the other Trustees, the Trust's investment adviser, the administrator and other service providers, counsel and independent registered public accounting firm, and to exercise effective and independent business judgment in the performance of their duties as Trustees. Each Trustee's ability to perform the duties of a trustee effectively has been attained and enhanced through the Trustee's education, professional training and other life experiences, such as business, consulting or public service positions and through experience from service as a member of this Trust's Board and that of H&Q, public companies, or non-profit entities or other organizations.

Michael W. Bonney: Mr. Bonney is the Chief Executive Officer and member of the Board of Directors of Cubist Pharmaceuticals, Inc., providing the Trust with valuable insight into operating matters relating to biotech companies and the overall healthcare industry. He serves on the Valuation Committee and is Chairman of the Governance and Nominating Committee of the Trust. Mr. Bonney is also a Director and Governance and Nominating Committee Chair of NPS Pharmaceuticals, Inc., is Chairman of the Board of Trustees of Bates College and is a Board member of the Pharmaceutical Research and Manufacturers of America (PhRMA). He holds a BA degree from Bates College.

Rakesh K. Jain, Ph.D.: Dr. Rakesh Jain is the Andrew Werk Cook Professor of Tumor Biology in the Department of Radiation Oncology at Harvard Medical School and the Director of the Edwin L. Steele Laboratory of Tumor Biology at Massachusetts General Hospital, providing the Trust with a valuable perspective on emerging life sciences technologies. Dr. Jain co-founded XTuit Pharmaceuticals, Inc. in 2011, where he also serves as a board member. He serves on the Governance and Nominating Committee of the Trust. Prior to joining Harvard, he was professor of chemical engineering at Columbia University and Carnegie Mellon University. Dr. Jain is regarded as a pioneer in the fields of tumor biology,

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drug delivery, in vivo imaging and bioengineering. Dr. Jain has authored more than 570 publications. He serves on advisory panels to government, industry and academia, and has served or continues to serve on editorial advisory boards of twenty journals, including Journal of Clinical Oncology and Nature Reviews Clinical Oncology. He has received more than 50 major awards and lectureships, including a Guggenheim Fellowship, the Humboldt Senior Scientist Award, the National Cancer Institute's Research Career Development Award and Outstanding Investigator Grant, the Academic Scientist of the Year Award from the Pharmaceutical Achievements Awards, the Distinguished Service Award from Nature Biotechnology and the

Innovator Award from the DoD Breast Cancer Program. He is a member of all three branches of U.S. National Academies – the Institute of Medicine, the National Academy of Engineering and the National Academy of Sciences – and the American Academy of Arts and Sciences.

Daniel R. Omstead, Ph.D.: Dr. Omstead is President and Chief Executive Officer of Tekla Capital Management LLC (the Adviser), a registered investment adviser that serves as investment adviser to HQH and HQL. Dr. Omstead is also President of HQH and HQL and serves on their Valuation Committees. Dr. Omstead is portfolio manager for the public and restricted/venture portfolios within HQH and HQL. As part of these responsibilities, Dr. Omstead is a member of the Board of Directors of several portfolio companies including AlterG, Inc., IlluminOss Medical, Inc., Magellan Biosciences, Inc., Dynex Corporation, and Palyon Medical Corporation. Prior to joining the Adviser, Dr. Omstead was President and CEO of Reprogenesis, Inc., a private development stage biotech company which developed therapies in the field of tissue engineering and regenerative medicine. Before joining Reprogenesis, Dr. Omstead was Senior Vice President, Research and Development, at Cytotherapeutics, Inc, a public biotech company. Prior to entering the biotech industry, Dr. Omstead was employed for fourteen years in positions of increasing responsibility within the pharmaceutical industry at Ortho Pharmaceutical Corporation and at the R.W. Johnson Pharmaceutical Research Institute, both divisions of Johnson & Johnson, and at Merck, Sharp and Dohme Research Laboratories, a division of Merck & Co., Inc. Dr. Omstead provides the Trust with insights into both pharmaceutical and biotech companies. Dr. Omstead holds Ph.D. and Master's Degrees in Chemical Engineering and Applied Chemistry from Columbia University and a B.S. degree in Civil Engineering from Lehigh University. He is a member of the Board of Directors of a non-profit agency that provides emergency shelter, housing and supportive services to homeless and low-income individuals and families in the Boston area. Dr. Omstead is also an Overseer at the Joslin Diabetes Center.

Oleg M. Pohotsky: Mr. Pohotsky is a corporate finance and investment professional with over forty years of diversified experience gained both in industry and in financial markets. Mr. Pohotsky serves as Chairman of the Board of Trustees of the Trust and also serves as Chairman of the Trust's Valuation Committee and serves on the Trust's Audit Committee. He has over 45 years of cumulative board experience in the full range of organization types: publicly-traded, privately-held, venture-backed and non-profit. He has also served as a director of a healthcare services company listed on the Nasdaq NMS where he was a member of the audit committee. In his various directorships he has also served on investment, compensation, personnel and executive committees. His career spanned over twenty years in the investment industry, both as an investment banker and as a venture capital and private equity investor, and included serving as chairman of the valuation and fairness opinion committee of a NYSE-member firm. Mr. Pohotsky also currently serves on the Board of Directors of Avangardco Investments Holdings, an LSE-listed agribusiness enterprise based in Ukraine, on the Board of Directors of The New America High Income Fund, Inc., a closed end fund investing in high yield securities on a leveraged basis, on the Board of Advisors of Kaufman & Co., LLC, a Boston-based boutique investment banking firm, and is affiliated with GovernanceMetrics International, Inc. as a Senior Advisor. He provides the Trust with valuable experience in valuation and the financial industry. Mr. Pohotsky holds a BSChE degree from Clarkson University, a JD degree from the University of Miami and MBA from the Harvard Business School. He has also been awarded an honorary doctorate by Clarkson University.

William S. Reardon, CPA: Mr. Reardon's personal experience as a Life Science audit partner at PricewaterhouseCoopers LLP (PwC), with a broad spectrum of companies across the corporate life cycle from startup to successful product driven pharmaceutical companies, provides the Trustees of the Trust with a valuable perspective in analyzing life science company opportunities and in valuing the venture portion of the portfolio. Until 2002 Mr. Reardon was a business assurance partner in PwC's Boston office and leader of the Life Sciences Industry Practice for New England and the Eastern U.S., working closely with many of the Firm's public clients in SEC-registered equity, convertible and R&D limited partnership offerings and many initial public offerings. He serves on the Valuation and Audit Committees of the Trust. From 1998-2000 he served on the Board of the Emerging Companies Section of the Biotechnology Industry Organization (BIO) and from 2000 to 2002 he served on the Board of Directors of the Massachusetts Biotechnology Council (MBC). During his professional career, he was a frequent speaker at BIO conferences and MBC Industry meetings on issues affecting biotechnology companies. He currently also serves as a board member and audit committee chair of two development-stage public companies, Synta Pharmaceuticals and Idera Pharmaceuticals. Mr. Reardon is member of the American Institute of CPAs and the Massachusetts Society of CPAs, with an MBA from Harvard Business School and a BA in East Asian History from Harvard College.

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Uwe E. Reinhardt, Ph.D.: Dr. Reinhardt is the James Madison Professor of Political Economy at Princeton University, teaching economics and public affairs since 1968, and has been a member of the Institute of Medicine of the National Academy of Sciences since 1978. He serves on the Audit Committee of the Trust. Dr. Reinhardt is recognized as one of the nation's leading authorities on health care economics, a prominent scholar in health care economics and a frequent speaker and author on subjects ranging from the war in Iraq to the future of Medicare. Dr. Reinhardt provides the Trust with valuable insights in healthcare economics and reform. He is a past president of the Association of Health Services Research. From 1986 to 1995 he served as a commissioner on the Physician Payment Review Committee, established in 1986 by Congress to advise it on issues related to the payment of physicians. He is a senior associate of the Judge Institute for Management of Cambridge University, UK, and a trustee of Duke University and the Duke University Health System. Dr. Reinhardt is or was a member of numerous editorial boards, among them the Journal of Health Economics, the Milbank Memorial Quarterly, Health Affairs, the New England Journal of Medicine, and the Journal of the American Medical Association. Dr. Reinhardt received his Ph.D. from Yale University.

Lucinda H. Stebbins, CPA: Ms. Stebbins brings to the Board over twenty years experience working in the fund industry, providing valuable perspectives on a variety of technical and industry matters. She serves as Chairman of the Audit Committee and is a member of the Governance and Nominating Committee of the Trust. She started her career with the investment management firm of Scudder, Stevens and Clark, which was later merged into the U.S operations of Zurich Financial Services, and then finally acquired by Deutsche Bank. She served as a Senior Vice President at Scudder Investments and subsequently as a Director at Deutsche Asset Management and was an officer of approximately 200 funds in these complexes. Ms. Stebbins' expertise is in the accounting, tax, and regulatory sides of the Fund business, and she continues to act as an independent consultant to the fund industry. Prior to joining Scudder, she was a Senior Manager at Price Waterhouse and is a member of the Massachusetts Society of CPAs. She also serves on the Board of Bald Peak Land Company and has been on a number of non-profit Boards. She holds an MBA degree from Babson College and a BA in economics from Wellesley College.

Officers

NAME, ADDRESS(1) AND DATE OF BIRTH	POSITION(S) HELD WITH THE TRUST, TERM OF OFFICE(2) AND LENGTH OF TIME SERVED	PRINCIPAL OCCUPATION(S) DURING PAST 5 YEARS AND OTHER DIRECTORSHIPS HELD
Daniel R. Omstead, Ph.D. 7/1953	President (since 2001); Trustee (since 2003)	President of the Fund and H&Q Life Sciences Investors (since 2001); President, Chief Executive Officer and Managing Member of Tekla Capital Management LLC (since 2002); Director, AlterG, Inc. (since 2013); Director, Magellan Diagnostics, Inc. (since 2006); Director, Palyon Medical Corporation (since 2009); Director, Dynex Corporation (since 2012); Director, IlluminOss Medical, Inc. (since 2012).
Laura Woodward, CPA 11/1968	Chief Compliance Officer, Secretary and Treasurer (since 2009)	Chief Compliance Officer, Secretary and Treasurer, the Fund and HQL (since 2009); Chief Compliance Officer and Vice President of Fund Administration, Tekla Capital Management LLC (since 2009); Senior Manager, PricewaterhouseCoopers LLP (1990-2009).

(1) The address for each Officer is: H&Q Healthcare Investors, 2 Liberty Square, 9th Floor, Boston, Massachusetts, 02109, 617-772-8500.

(2) Each Officer serves in such capacity for an indefinite period of time at the pleasure of the Trustees.

Ownership of Securities

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As of March 31, 2014, the Trust's Trustees and executive officers, as a group, beneficially owned less than 1% of the Trust's outstanding Shares. The information as to beneficial ownership of securities which appears below is based on statements furnished to the Trust by its Trustees and executive officers.

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To the knowledge of the Trust, as of March 31, 2014, there were no control persons of the Trust and no persons were known to own, either beneficially or of record, 5% or more of the Shares of the Trust other than First Trust Portfolios L.P. and Advisors Asset Management, Inc.

As of March 31, 2014, the dollar range of equity securities owned beneficially by each Trustee in the Trust and in any registered investment companies overseen by the Trustee within the same family of investment companies as the Trust is as follows:

Independent Trustees

Name of Trustee	Dollar Range of Equity Securities in the Trust	Aggregate Dollar Range of Equity Securities in All Registered Investment Companies Overseen by Trustee in Family of Investment Companies
Michael W. Bonney	\$10,001 - \$50,000	\$10,001 - \$50,000
Rakesh K. Jain, Ph.D.	None	None
Oleg M. Pohotsky	\$10,001 - \$50,000	\$10,001 - \$50,000
William S. Reardon, CPA	\$10,001 - \$50,000	\$10,001 - \$50,000
Uwe E. Reinhardt, Ph.D.	\$10,001 - \$50,000	Over \$100,000
Lucinda H. Stebbins, CPA	Over \$100,000	Over \$100,000

Interested Trustees

Name of Trustee	Dollar Range of Equity Securities in the Trust	Aggregate Dollar Range of Equity Securities in All Registered Investment Companies Overseen by Trustee in Family of Investment Companies
Daniel R. Omstead, Ph.D.	Over \$100,000	Over \$100,000

Dr. Omstead and Ms. Woodward serve as officers of the Trust. As of March 31, 2014, the officers of the Trust beneficially owned 35,836 Shares of the Trust, or less than 1% of the Shares outstanding on that date.

Standing Committees

Audit Committee. The Trust has an Audit Committee comprised solely of Independent Trustees who are independent as defined in the New York Stock Exchange (NYSE) Listing Standards. The Board has adopted a written charter for the Audit Committee. The Audit Committee charter is available at <http://www.teklacap.com/hql-reports.html>. The principal purpose of the Trust's Audit Committee is to assist the Board in fulfilling its responsibility to oversee the integrity of the Trust's financial statements and the Trust's compliance with legal and regulatory requirements and oversee management's conduct of the Trust's financial reporting process, including reviewing the financial reports and other financial information provided by the Trust, the Trust's systems of internal accounting and financial controls and the annual independent audit process.

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For the Trust, the Audit Committee's role is one of oversight, and it is recognized that the Trust's management is responsible for preparing the Trust's financial statements and that the outside auditor is responsible for auditing those financial statements. Although the Audit Committee member must be financially literate and one member must have accounting or financial management expertise (as determined by the Board in its business judgment), Audit Committee members are not professionally engaged in the practice of accounting or auditing and are not experts in the fields of accounting or auditing, including with respect to auditor independence. Audit Committee

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members rely, without independent verification, on the information provided to them and on the representations made by management and the Trust's independent public accountants.

The members of the Trust's Audit Committee are Mr. Pohotsky, Mr. Reardon, Dr. Reinhardt and Ms. Stebbins. Ms. Stebbins is the Chairman of the Trust's Audit Committee. The Trust's Audit Committee held four meetings during the fiscal year ended September 30, 2013.

Governance and Nominating Committee. The Trust has a Governance and Nominating Committee comprised solely of Independent Trustees who are independent as defined in the NYSE Listing Standards. During the fiscal year ended September 30, 2013, the Board maintained a governance committee and a nominating committee, each with its own written charter. The Board combined those committees and their separate written charters in December, 2013, and adopted the combined written Charter for the Committee.

The principal missions of the Committee are (i) to review, evaluate, and enhance the effectiveness of the Board in its role in governing the Trust and overseeing the management of the Trust and (ii) to promote the effective participation of qualified individuals on the Board, on committees of the Board, and as executive officers of the Trust. The Committee shall consider the Corporate Governance Guidelines that have been approved by the Board in fulfilling its mission.

The Committee reviews, discusses and makes recommendations to the Board relating to those issues that pertain to the effectiveness of the Board in carrying out its responsibilities in governing the Trust and overseeing the Trust's management. The Committee makes nominations for trustees and officers of the Trust and for membership on all committees of the Board and submits such nominations to the full Board for consideration.

The Trust's By-Laws require that each prospective trustee candidate have a college degree or equivalent business experience and provide a list of minimum qualifications for trustees, which include expertise, experience or relationships relevant to the business of the Trust. The Trust's By-Laws also require that a candidate not be serving in any of various positions with another investment company (as defined in the Investment Company Act) that focuses its investments in the healthcare and/or life sciences industries, unless such investment company is managed by the Trust's investment adviser or an affiliate, or in various positions with the investment adviser, sponsor or equivalent of such an investment company. The Committee may also take into account other factors when considering and evaluating potential trustee candidates, including but not limited to: (i) availability and commitment to attend meetings and perform responsibilities of the Board; (ii) relevant industry and related experience; (iii) educational background; (iv) financial expertise; (v) the candidate's ability, judgment and expertise; and (vi) the overall diversity of the Board's composition.

The Committee may identify prospective trustees from any reasonable source, including, but not limited to, the consultation of third-party trustee search services. The Committee will consider potential trustee candidates recommended by Shareholders, provided that the proposed candidates (i) satisfy any minimum qualifications of the Trust for its trustees; (ii) are not interested persons (as that term is defined in Section 2(a)(19) of the Investment Company Act) of the Trust or the Investment Adviser; and (iii) are independent as defined in the NYSE Listing Standards. In order to be evaluated by the Committee, trustee candidates recommended by Shareholders must also meet certain eligibility requirements as set out in the Committee's Charter. Other than those eligibility requirements, the Committee shall not evaluate Shareholder trustee nominees in a different manner than other nominees. The standard of the Committee is to treat all equally qualified nominees in the same manner.

All recommendations by Shareholders must be received by the Trust by the deadline for submission of any Shareholder proposals which would be included in the Trust's proxy statement for the next annual meeting of the Trust. Each Shareholder or Shareholder group must meet the

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requirements stated in the Committee's Charter in order to recommend a candidate. A Shareholder or Shareholder group may not submit more than one candidate per year. When recommending a trustee candidate, Shareholders must include in their notice to the Trust's Secretary: (i) the Shareholder's contact information; (ii) the trustee candidate's contact information and the number of Trust Shares owned by the proposed candidate; (iii) all information regarding the candidate that would be required to be disclosed in solicitations of proxies for elections of trustees required by Regulation 14A of the Securities Act of 1934, as amended; and (iv) a notarized letter executed by the trustee candidate, stating his or her intention to serve as a nominee and be named in the Trust's proxy statement, if nominated by the Board, and to serve as a trustee, if so elected. Once a recommendation has been timely received in proper form, the candidate will be asked to complete

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an eligibility questionnaire to assist the Trust in assessing the candidate's qualifications as a potential Independent Trustee and as someone who is independent under the NYSE Listing Standards. The Committee will make such determinations in its sole discretion and such determinations shall be final.

The members of the Committee are Mr. Bonney, Dr. Jain and Ms. Stebbins. Mr. Bonney is the Chairman of the Committee. During the fiscal year ended September 30, 2013, the former governance committee held two meetings and the former nominating committee held two meetings.

Valuation Committee. The Board has delegated to the Trust's Valuation Committee general responsibility for determining, in accordance with the Trust's valuation procedures, the value of assets held by the Trust on any day on which the net asset value per share is determined. The Valuation Committee may appoint, and has appointed, a Sub-Committee made up of employees and officers of the Investment Adviser to deal with day to day valuation decisions, subject to oversight by the Valuation Committee. The Valuation Committee shall meet as often as necessary to ensure that each action taken by the Sub-Committee is reviewed within approximately a calendar quarter of the occurrence. In connection with its review, the Valuation Committee shall ratify or revise the pricing methodologies authorized by the Sub-Committee since the last meeting of the Valuation Committee. The Valuation Committee is charged with the responsibility of determining the fair value of the Trust's securities or other assets in situations set forth in the Trust's valuation procedures.

The members of the Trust's Valuation Committee are Mr. Bonney, Dr. Omstead, Mr. Pohotsky and Mr. Reardon. Mr. Pohotsky is the Chairman of the Trust's Valuation Committee. The Trust's Valuation Committee held four meetings during the fiscal year ended September 30, 2013.

Qualified Legal Compliance Committee. The Trust has a Qualified Legal Compliance Committee (QLCC) comprised solely of Independent Trustees. The Board has adopted a written charter for the QLCC. The principal purpose of the Trust's QLCC is to review and respond to reports of Evidence of a Material Violation (as defined in the QLCC charter). Reporting Evidence of a Material Violation is required under the Standards of Professional Conduct for Attorneys adopted by the Commission under the Sarbanes-Oxley Act of 2002 (the Standards). Under the Standards, if an attorney appearing and practicing before the Commission in the representation of an issuer, such as the Trust, becomes aware of Evidence of a Material Violation by the issuer or by any officer, trustee, employee or agent of the issuer, the Standards provide for the attorney to report such evidence to the issuer's QLCC forthwith. In discharging its role, the QLCC is granted the power to investigate any Evidence of a Material Violation brought to its attention with full access to all books, records, facilities and personnel of the Trust and the power to retain outside counsel, auditors or other experts for this purpose.

The members of the Trust's QLCC are Dr. Jain, Mr. Pohotsky and Mr. Reardon. Mr. Reardon is the Chairman of the Trust's QLCC. The Trust's QLCC had no cause to meet during the fiscal year ended September 30, 2013.

Compensation of Trustees

The Trust pays each of the Trustees not affiliated with the Investment Adviser an annual fee of \$18,000. Trustees are also paid \$1,000 for each Board meeting attended in person, \$750 for each Committee meeting attended in person, and \$250 for each Board and Committee meeting attended by telephone. The Chairman of the Board receives an additional annual fee of \$5,000, the Chairmen of the Audit and Valuation Committees receive an additional annual fee of \$2,500, and the Chairman of the Governance and Nominating Committee receives an additional annual fee of \$1,250. Each member of the Audit and Valuation Committees receives an additional annual fee of \$500 and each member of the Nominating and Governance Committee receives an additional annual fee of \$250. Neither the Chairman nor any members of the Qualified Legal Committee receive additional annual fees. Independent Trustees are also reimbursed for travel expenses incurred in connection with attending such meetings. For the fiscal years ended September 30, 2013 and September 30, 2012, the Trust paid such fees and reimbursed such

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expenses amounting to \$171,721 and \$175,000, respectively, in the aggregate. No other direct compensation has been paid by the Trust or HQL to the Trustees and officers as a group. Trustees and officers of the Trust who hold positions with the Investment Adviser receive indirect compensation from the Trust in the form of the investment advisory fee paid to the Investment Adviser.

COMPENSATION TABLE
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2013

NAME OF TRUSTEE	AGGREGATE COMPENSATION FROM TRUST	PENSION OR RETIREMENT BENEFITS ACCRUED AS PART OF TRUST EXPENSES	ESTIMATED ANNUAL BENEFITS UPON RETIREMENT	TOTAL COMPENSATION FROM TRUST AND FUND COMPLEX PAID TO TRUSTEES
INDEPENDENT TRUSTEES				
Michael W. Bonney	\$ 26,500	N/A	N/A	\$ 53,000
Rakesh K. Jain, Ph.D.	\$ 28,000	N/A	N/A	\$ 56,000
Lawrence S. Lewin	\$ 2,500	N/A	N/A	\$ 5,000
Oleg M. Pohotsky	\$ 34,500	N/A	N/A	\$ 69,000
William S. Reardon	\$ 30,750	N/A	N/A	\$ 61,500
Uwe E. Reinhardt, Ph.D.	\$ 23,500	N/A	N/A	\$ 47,000
Lucinda H. Stebbins, CPA	\$ 28,000	N/A	N/A	\$ 56,000
INTERESTED TRUSTEES				
Daniel R. Omstead, Ph.D.	\$ 0	N/A	N/A	\$ 0

THE TRUST

The Trust's capitalization consists of an unlimited number of Shares, \$.01 par value. Each Share represents an equal proportionate beneficial interest in the Trust and, when issued and outstanding, will be fully paid and non-assessable by the Trust. Upon any liquidation of the Trust, Shareholders will be entitled to share pro rata in the net assets of the Trust available for distribution after paying or adequately providing for the payment of all liabilities. The Trust will send annual and semi-annual financial statements to Shareholders and may also issue more abbreviated interim reports to update Shareholders on a quarterly basis. The Trust will hold annual meetings of its Shareholders in accordance with the provisions of the Trust's By-laws and the rules of the New York Stock Exchange (NYSE).

Shareholders are entitled to one vote for each whole Share held and a proportionate fractional vote for each fractional Share held. The Trust's Shares do not have cumulative voting rights, which means that the holders of more than 50% of the Shares of the Trust voting for the election of Trustees can elect all of the Trustees, and, in such event, the holders of the remaining Shares will not be able to elect any Trustees. The Trust has a staggered Board, whereby one class of Trustees is elected each year.

The Trust is an entity of the type commonly known as a Massachusetts business trust. Under Massachusetts law, shareholders of such a trust under certain circumstances may be determined to be personally liable as partners for the Trust's obligations. However, the Trust's Declaration of Trust contains an express disclaimer of Shareholder liability for the acts or obligations of the Trust and provides for indemnification and reimbursement of expenses out of the Trust's property for any Shareholder held personally liable for the obligations of the Trust. Thus, the risk of a Shareholder incurring financial loss on account of a Trust liability is limited to circumstances in which the Trust is unable to meet its obligations from the liquidation of its portfolio investments.

The overall management of the Trust is vested in the Board. The Board approves all significant agreements between the Trust and persons or companies furnishing services to it, including the Trust's agreements with its Investment Adviser, Custodian, any foreign sub-custodians, Registrar and Transfer Agent. The management of the day-to-day operations of the Trust is delegated to its officers and to the Investment

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Adviser, subject always to the investment objective and policies of the Trust and to general supervision by the Board.

In addition, the Declaration of Trust requires the affirmative vote or consent of the holders of 75% of the Shares of the Trust to authorize certain transactions with a person or entity that is directly, or indirectly through affiliates, the beneficial owner of 5% or more of the outstanding Shares of the Trust unless the Board takes certain actions to

approve such a transaction. These provisions could make it more difficult to change the management of the Trust and could have the effect of depriving Shareholders of an opportunity to sell their Shares at a premium over prevailing market prices by discouraging a third party from seeking to obtain control of the Trust in a tender offer or similar transaction. See **Risk Factors** **Declaration of Trust** in the Trust's Prospectus.

Repurchases of Shares and Tender Offers

The Trust is a closed-end, management investment company and as such its Shareholders do not, and will not, have the right to redeem their Shares of the Trust. The Trustees, however, intend to consider, from time to time, but not less frequently than annually, the desirability of open market purchases or tender offers. Any such repurchases will be made in accordance with the applicable provisions of the Investment Company Act and Massachusetts law in open market transactions. Shares repurchased by the Trust will be held in its treasury. In March 2013, the Board approved the continuation of the repurchase program to allow the Trust to repurchase up to 12% of its outstanding shares in the open market during a one-year period beginning July 11, 2013. In March 2014, the Board approved the continuation of the repurchase program to allow the Trust to repurchase up to 12% of its outstanding shares in the open market during a one-year period beginning July 11, 2014. The share repurchase program is intended to enhance Shareholder value and potentially reduce the discount between the market price of the Trust's shares and the Trust's net asset value. There is no assurance that any action undertaken to repurchase Shares will result in the Shares trading at a price which approximates net asset value. Although the Trust has no present intention of doing so, it reserves the right to incur debt to finance such repurchases or tender offers, provided that it will not repurchase securities during the periods when it has outstanding borrowings in excess of 5% of its net assets. See **Investment Restrictions**. Interest on any borrowings to finance Share repurchase transactions will increase the Trust's expenses and will reduce the Trust's net income. There can be no assurance that Share repurchases, if any, will cause the Shares to trade at a price equal to or in excess of their net asset value. Nevertheless, the possibility that a portion of the Trust's outstanding Shares may be the subject of repurchases may reduce the spread between market price and net asset value that might otherwise exist. The Trust may not repurchase Shares except (1) on a securities exchange and after notification to Shareholders of its intent to purchase Shares within the six months preceding the purchase, (2) pursuant to a tender offer to all Shareholders, or (3) as otherwise permitted by the Commission.

The Shares of the Trust will trade in the open market at a price which will be a function of several factors, including their supply, demand, investment performance and yield. The shares of closed-end investment companies generally sell at market prices varying from their net asset value (NAV) and such shares frequently trade at a discount to NAV, but in some cases trade at a premium. The market price of the Shares will be determined by factors including trading volume of such Shares, general market and economic conditions and other factors beyond the control of the Trust. Therefore, the Trust cannot predict whether its Shares will trade at, below or above NAV. When the Trust repurchases its Shares for a price below their NAV, the NAV of those Shares that remain outstanding will be enhanced, but this does not necessarily mean that the market price of those outstanding Shares will be affected, either positively or negatively.

Conversion to Open-End Investment Company Status

Under the Declaration of Trust, the conversion of the Trust from a closed-end to an open-end investment company would require (1) the approval of the Board, and (2) the affirmative vote or consent of the holders of a majority of the Shares outstanding and entitled to vote. Such a vote would be in addition to any vote or consent required in addition to the vote or consent of Shareholders otherwise required by law or any agreement between the Trust and the NYSE. The Investment Company Act requires that the Trust receive a vote of a majority of its outstanding voting Shares in order to convert the Trust from a closed-end to an open-end investment company.

Such amendment would have to be approved by the Board prior to its submission to Shareholders. The Board is required under the Declaration of Trust to consider and vote annually upon the proposal to convert to open-end status. A proposal to convert the Trust to an open-end company might be supported or opposed by the Board depending on the Board's judgment as to its advisability in light of circumstances prevailing at the time.

Shareholders of an open-end investment company may require the company to redeem their shares at any time (except in certain circumstances as authorized by or under the Investment Company Act) at their NAV, less such redemption charge, if any, as might be in effect at the time of a redemption. Conversion to an open-end investment

company could require the disposal of illiquid investments to meet current requirements of the Commission that no more than 15% of an open-end investment company's assets consist of illiquid securities, and would likely require involuntary liquidation of portfolio securities, and the inherent realization of net long-term capital gains in connection therewith, to meet periodic requests for redemption. Moreover, Shares of the Trust would no longer be listed on the NYSE.

INVESTMENT ADVISER AND INVESTMENT ADVISORY AGREEMENT

Tekla Capital Management LLC, a limited liability company under the laws of the State of Delaware, serves as the investment adviser to the Trust. The Investment Adviser is an investment adviser registered under the Investment Advisers Act of 1940, as amended. The Investment Adviser is located at 2 Liberty Square, 9th Floor, Boston, MA 02109.

At inception, Hambrecht & Quist Capital Management Incorporated (HQCM Inc.) was the Trust's investment adviser. HQCM Inc. was formed as a wholly-owned subsidiary of Hambrecht & Quist Group. HQCM Inc. remained the Investment Adviser as The Chase Manhattan Corporation (Chase) first acquired Hambrecht & Quist Group and then merged with J.P. Morgan Incorporated to form J.P. Morgan Chase & Co. In 2002, the management of HQCM Inc. formed Hambrecht & Quist Capital Management LLC (HQCM LLC), the predecessor of the Investment Adviser, as an independent entity to effect a buyout of HQCM Inc. In this transaction, HQCM LLC acquired certain of the assets of HQCM Inc., and substantially all of the management and staff of HQCM Inc. became employees of HQCM LLC. HQCM LLC changed its name to Tekla Capital Management LLC in 2012. The Investment Adviser is owned by Daniel R. Omstead and Mary Omstead. Dr. Omstead is currently the President and Chief Executive Officer of the Investment Adviser. Mary Omstead is Dr. Omstead's wife.

The Investment Advisory Agreement between the Investment Adviser and the Trust (the Advisory Agreement) provides that, subject to the supervision and direction of the Board, the Investment Adviser is responsible for the actual management of the Trust's portfolio. The Investment Adviser is also obligated to supervise or perform certain administrative and management services for the Trust and is obligated to provide the office space, facilities, equipment and personnel necessary to perform its duties under the Advisory Agreement. The responsibility for making decisions to buy, sell or hold a particular security rests with the Investment Adviser. However, the Investment Adviser may consider investment analysis from various sources, including broker-dealers with which the Trust does business. See Portfolio Transactions and Brokerage.

Subject to the supervision and direction of the Board, the Investment Adviser manages the Trust's portfolio in accordance with the Trust's investment objective and policies as stated in the Trust's Prospectus; makes investment decisions for the Trust; places purchase and sale orders for portfolio transactions for the Trust; supplies the Trust with office facilities (which may be in the Investment Adviser's own offices), statistical and research data, data processing services, clerical, internal executive and administrative services, and stationery and office supplies; directs and supervises a third party administrator or custodian in the provision to the Trust of accounting and bookkeeping services, the calculation of the net asset value of shares of the Trust, internal accounting services, and other clerical services in connection therewith; and supervises and directs a third party administrator or custodian in the preparation of reports to Shareholders of the Trust, tax returns and reports to and filings with the Commission and state Blue Sky authorities. In providing these services, the Investment Adviser provides investment research and supervision of the Trust's investments and conducts a continual program of investment, evaluation and, if appropriate, sale and reinvestment of the Trust's assets. In addition, the Investment Adviser furnishes the Trust with whatever statistical information the Trust may reasonably request with respect to the securities that the Trust may hold or contemplate purchasing.

For the services provided by the Investment Adviser under the Advisory Agreement, as of the date of this SAI, the Trust will pay a fee, computed and payable monthly, equal when annualized to (1) 2.5% of the average net assets for the month of its venture capital and other Restricted Securities (as defined) up to 25% of net assets and (2) for the month, for all other assets, 0.98% of the average net assets up to \$250 million, 0.88% of the average net assets for the next \$250 million, 0.80% of the average net assets for the next \$500 million and 0.70% of the average net assets thereafter. The aggregate monthly fee may not exceed a rate when annualized of 1.36% (approximately 0.11% per month).

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The Investment Adviser has agreed to waive a portion of advisory fees to which it otherwise might be entitled under the current fee rate schedule during the one-year period following completion of the rights offering described in the

Prospectus. During the one-year period following completion of the rights offering, the Investment Adviser will waive its fees such that the Trust will pay a fee, computed and payable monthly, equal when annualized to (1) 2.5% of the average net assets for the month of its venture capital and other Restricted Securities (as defined) up to 25% of net assets and (2) for the month, for all other assets, 0.98% of the average net assets up to \$250 million, 0.88% of the average net assets for the next \$250 million, 0.70% of the average net assets for the next \$500 million and 0.70% of the average net assets thereafter, provided that the aggregate monthly fee may not exceed a rate when annualized of 1.36% (approximately 0.11% per month).

The Investment Adviser will not participate directly in the capital appreciation of Restricted Securities. The Investment Adviser may provide managerial assistance to issuers of securities in which the Trust invests. For purposes of calculation of the investment advisory fee, average net assets for any month shall be equal to the average of the net asset value of such assets as of the last business day of such month and the net asset value of the appropriate assets as of the last business day of the preceding month. In determining average net assets for purposes of clauses (1) and (2) above, liabilities and expenses of the Trust shall be allocated pro rata based on the ratio that the assets referred to in each clause bear to the total assets of the Trust. Such fee shall be payable for each month within five business days after the end of such month.

For purposes of the calculation of the investment advisory fee, venture capital and other Restricted Securities shall be securities of issuers for which no market quotations are readily available and securities of companies for which market quotations are readily available but which are subject to legal or contractual restrictions on resale. Securities of companies for which public information is available but as to the sale of which the safe harbor provided by Rule 144(k) is not available shall be considered to be subject to legal or contractual restrictions on resale.

The Advisory Agreement provides that the Investment Adviser shall not be liable for any loss incurred by any act or omission of any broker. The Advisory Agreement also provides that the Investment Adviser shall not be liable to the Trust or to any Shareholder of the Trust for any error or judgment or for any loss suffered by the Trust in connection with rendering services under the Advisory Agreement except (1) a loss resulting from a breach of fiduciary duty with respect to the receipt of compensation for services (in which case any award of damages shall be limited to the period and the amount set forth in Section 36(b)(3) of the Investment Company Act) or (2) a loss resulting from willful misfeasance, bad faith or gross negligence on the part of the Investment Adviser, or reckless disregard of its obligations and duties under the Advisory Agreement. Subject to the foregoing, the Advisory Agreement also provides that the Trust shall indemnify the Investment Adviser, and any officer, director and employee of the Investment Adviser to the maximum extent permitted by Article V of the Trust's Declaration of Trust.

For the fiscal years ended September 30, 2013, September 30, 2012 and September 30, 2011, the Trust paid the Adviser \$5,831,878, \$4,807,619 and \$4,434,713, respectively, in advisory fees.

The services of the Investment Adviser to the Trust are not deemed to be exclusive, and nothing in the Advisory Agreement prevents the Investment Adviser, or any affiliate thereof, from providing similar services to other companies and other clients or from engaging in other activities.

Under the Advisory Agreement, the Investment Adviser has agreed to bear all expenses in connection with the performance of its services under the Advisory Agreement, including compensation of and office space for officers and employees of the Trust connected with investment and economic research, trading and investment management of the Trust, as well as the fees of all Trustees of the Trust who are affiliated persons of the Investment Adviser, as that term is defined in the Investment Company Act, or any of its affiliated persons.

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Under the Advisory Agreement, the Trust must pay (or, in the event that such expenses are paid by the Investment Adviser, shall reimburse the Investment Adviser for) all other expenses incurred in the organization and operation of the Trust including, among other things, expenses for legal and auditing services, costs of printing proxy statements, prospectuses, stock certificates and Shareholder reports, charges of the custodian, any sub-custodian and transfer agent, expenses in connection with the Dividend Reinvestment Plan, the Commission, and the Financial Regulatory Authority, Inc. (FINRA) fees, fees and expenses of the Trustees who are not affiliated persons of the Investment Adviser or any of its affiliated persons, accounting and valuation costs, administrator s fees, membership fees in trade associations, fidelity bond coverage for the Trust s officers and employees, errors and omissions insurance coverage for Trustees and officers, interest, brokerage costs, taxes, stock exchange listing fees and expenses,

expenses of qualifying the Trust's Shares for sale in various states, expenses associated with personnel performing exclusively Shareholder servicing functions, certain other organization expenses, litigation and other extraordinary or non-recurring expenses, and other expenses properly payable by the Trust. The Trust may enter into arrangements to have third parties assume any expenses for which it is responsible.

Unless earlier terminated as described below, the Advisory Agreement will remain in effect from year to year if approved annually (1) by the Board or by the holders of a majority of the Trust's outstanding Shares and (2) by the majority of the Trustees who are not parties to the Advisory Agreement or interested persons of any such party. The Advisory Agreement may be terminated without penalty by (1) the Trust or the Investment Adviser at any time without penalty upon not less than 30 and no more than 60 days' written notice or (2) a vote of the holders of a majority of the Trust's outstanding Shares, and will automatically terminate in the event of its assignment. Action by the Trust under (1) above may be taken either by (i) vote of a majority of its Trustees, or (ii) the affirmative vote of a majority of the outstanding shares of the Trust.

The Investment Advisory Agreement (Advisory Agreement) between the Trust and the Adviser provides that the Advisory Agreement will continue in effect so long as its continuance is approved at least annually by (i) by the Trustees of the Trust or the Shareholders by affirmative vote of a majority of the outstanding shares and (ii) a majority of the Trustees of the Trust who are not interested persons, by vote cast in person at a meeting called for the purpose of voting on such approval.

As described in the Prospectus, on March 28, 2014, the Board, and the independent Trustees voting separately, determined that the terms of the Advisory Agreement are fair and reasonable and approved the continuance of the Advisory Agreement as being in the best interests of the Trust and its Shareholders.

Portfolio Management

Currently Daniel R. Omstead, Ph.D., Christopher F. Brinzey, M.B.A., Frank T. Gentile, Ph.D. and Jason C. Akus, M.D./M.B.A. are members of the team that makes investments on behalf of the Trust. These members also perform other duties, including making investment decisions on behalf of H&Q Life Sciences Investors, a closed-end mutual fund, but do not otherwise manage any other accounts. Dr. Omstead has overall investment decision responsibility for the Trust and HQL.

Security Ownership of Portfolio Managers

As of March 31, 2014, the dollar range of Trust securities beneficial owned by Dr. Omstead was over \$100,000. As of March 31, 2014, none of the other members of the team owned securities of the Trust.

Portfolio Manager Compensation Structure

The Investment Adviser offers employees what it believes are competitive salaries and benefits in order to attract and retain adequate staff to provide services to the Trusts. The Investment Adviser feels the current staff level is adequate in size, experience and qualifications to effectively manage both the public and restricted portfolios of HQT and HQL. The Investment Adviser further believes that the staff has the

unique qualifications and experience to be effective in making purchase and sale decisions and subsequently manage the restricted and venture portfolio.

Dr. Omstead is an owner of the Investment Adviser. He receives compensation for his contribution to the portfolio management team and for his contribution to the general management of the Investment Adviser. As a member of the Investment Adviser, Dr. Omstead also receives distributions made to members. Currently, such distributions are principally the result of the investment advisory fees paid to the Investment Adviser by HQH and HQL.

Mr. Brinzey, Dr. Gentile and Dr. Akus receive a combination of base compensation and discretionary compensation, in the form of a cash bonus paid annually. The methodology used to determine compensation is applied to all accounts managed by the team. Two components are described in detail below.

Base Salary Compensation. The team members receive a base salary compensation linked to individual experience and responsibilities. The amount of base salary is reviewed approximately annually.

Discretionary Compensation. Discretionary compensation is in the form of a cash bonus, paid annually, which is typically up to 50% of the team member's base salary. Discretionary compensation can vary by team member and circumstances. The discretionary compensation component is determined based on four factors, including investment performance of accounts managed by the team relative to an appropriate benchmark and/or peer funds, performance of specific investments proposed by the individual, financial performance of the Investment Adviser and a qualitative assessment of the individual overall contribution to the investment team and to the Investment Adviser. Discretionary compensation is evaluated annually after the completion of the Trust's fiscal year.

PROXY VOTING POLICY AND PROCEDURES

The Board has adopted a proxy voting policy and procedure (the Proxy Voting Policy), pursuant to which the Trustees have delegated proxy voting responsibility to the Investment Adviser in accordance with the Trust's Proxy Voting Policy. A copy of the Proxy Voting Policy for the Trust and the Investment Adviser attached as Appendix A to this SAI.

A description of the Trust's proxy voting policies and procedures and information on how the Trust voted proxies relating to portfolio securities during the most recent 12-month period ended June 30, 2013 is available (i) without charge, upon request, by calling 1-800-451-2597, (ii) by writing to Tekla Capital Management LLC at 2 Liberty Square, 9th Floor, Boston, MA 02109; (iii) on the Investment Adviser's website at www.teklacap.com; and (iv) on the SEC's website at www.sec.gov.

CODE OF ETHICS

The Board and the Investment Adviser have approved a Code of Ethics under Rule 17j-1 of the Investment Company Act that covers certain personnel of the Trust and the Investment Adviser. The Code of Ethics establishes procedures for personal investing and restricts certain transactions by certain personnel covered by the Code of Ethics. Persons subject to the Code of Ethics may invest in securities for their personal investment accounts, including, in certain cases, securities that may be purchased or held by the Trust. The Code of Ethics applies to investments by covered persons in their personal accounts, the accounts of family members living in the same household, and accounts in which the covered person has a beneficial interest (i.e., ownership, voting or investment control). Some of the restrictions set forth in the Code of Ethics do not apply to the Trust's Independent Trustees. In general terms, the Code of Ethics is designed to ensure that the investing activities of covered

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personnel are conducted in a manner that avoids potential or actual conflicts of interest with the Trust and its Shareholders and that covered personnel conduct their personal investing in a manner consistent with their fiduciary duty towards the Trust and its Shareholders.

The Code of Ethics requires pre-clearance for certain investments in equities (not including mutual funds), imposes reporting requirements, and imposes sanctions for violations. Specifically, among other things, the Code of Ethics prohibits sales of securities to or purchases of securities from the Trust and prohibits the purchase or sale of any security under consideration for trading by the Trust within seven days before or after the Trust trades in the security

The Trust's Code of Ethics is filed as an exhibit to this registration statement. In addition, you may read and copy the Code of Ethics at the Commission's Public Reference Room in Washington, DC. You may obtain information on operations of the Public Reference Room by calling the Commission at (202) 551-8090. In addition, the Code of Ethics is available on the EDGAR Database on the Commission Internet site at <http://www.sec.gov>. You may obtain copies of the Code of Ethics, after paying a duplicating fee, by electronic request at the following email address:

publicinfo@sec.gov, or by writing to the Commission's Public Reference Section, 100 F Street, NE, Washington, DC 20549.

NET ASSET VALUE

The net asset value (NAV) of the Trust's Shares is calculated at the close of regular trading on the NYSE (generally 4:00 p.m., Eastern Time) every day that the NYSE is open. The Trust makes this information available daily by telephone (800) 451-2597, via its web site (www.teklacap.com) and through electronic distribution for media publication, including major internet-based financial services web sites and portals (bloomberg.com, yahoo.com, cbsmarketwatch.com, etc.). Currently, The Wall Street Journal, The New York Times and Barron's publish NAVs for closed-end investment companies at least weekly.

NAV is calculated by dividing the value of the securities held by the Trust plus any cash or other assets minus all liabilities, including accrued expenses, by the total number of Shares outstanding at such time. Securities for which market quotations are readily available are valued at market price. Portfolio securities that are traded on one or more U.S. national securities exchanges or in the over-the-counter market that are National Market System securities are valued at the last sale price or, lacking any sales, at the mean between last bid and asked prices. Other over-the-counter securities are valued at the most recent bid prices as obtained from one or more dealers that make markets in the securities. Redeemable securities issued by a registered open-end investment company are valued at net asset value per share. Other securities are valued at the mean between the closing bid and asked prices. Short-term investments that mature in 60 days or less are valued at amortized cost, unless the Board determines that such valuation does not constitute fair value.

Bonds, other than convertible bonds, are valued using a third-party pricing system. Convertible bonds are valued using this pricing system only on days when there is no sale reported. Temporary cash investments with maturity of 60 days or less are valued at amortized cost. Puts and calls generally are valued at the close of regular trading on the securities or commodities exchange on which they are primarily traded. Options on securities generally are valued at their last bid price in the case of exchange-traded options or, in the case of OTC-traded options, the average of the last bid price as obtained from two or more dealers unless there is only one dealer, in which case that dealer's price is used. Forward foreign currency contracts are valued on the basis of the value of the underlying currencies at the prevailing currency exchange rate. The prevailing currency exchange rate shall be determined within one hour of when the most recently available exchange rate information has been received based on information obtained from a bank or banks.

Securities that are primarily traded on foreign securities exchanges generally are valued at the last sale price on the exchange on which they are primarily traded. Foreign securities that are primarily traded on the foreign over-the-counter market are generally valued at the last sale quotation, if market quotations are available, or the last reported bid price if there is no active trading in a particular security on a given day. However, if intervening events result in market volatility that significantly affects the value of any such foreign securities after the close of trading on the relevant foreign market, but before the Trust values its Shares on any particular day on which the Trust is required to value its Shares, the Trust may, but is not required to, determine the value of such securities at fair value, as determined in good faith by or under the direction of the Board.

Quotations of foreign securities in foreign currencies are converted, at current exchange rates, to their U.S. Dollar equivalents in order to determine their current value. In addition, to the extent that the Trust values its foreign securities (other than ADR's and ADS's) as of the close of trading on various exchanges and over-the-counter markets throughout the world, the calculation of the Trust's net asset value may not take place contemporaneously with the valuation of foreign securities held by the Trust.

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The value of any security or other asset for which market quotations are not readily available shall be determined in a manner that most fairly reflects the security's (or asset's) fair value. Each such determination is based on a consideration of all relevant factors, which are likely to vary from one pricing context to another. Examples of such factors may include, but are not limited to: (1) the type of the security; (2) the size of the holding (including percent of outstanding securities of issuer held by the Trust); (3) the initial cost of the security; (4) the existence of any contractual restrictions on the security's disposition and the time to freedom from such restrictions; (5) the price and

extent of public trading in similar securities of the issuer or of comparable companies; (6) quotations or prices from broker-dealers and/or pricing services; (7) information obtained from the issuer, analysts, and/or the appropriate stock exchange (for exchange-traded securities); (8) an analysis of the company's financial statements; (9) an evaluation of the forces that influence the issuer and the market(s) in which the security is purchased and sold (e.g., the existence of pending merger activity, public offerings or tender offers that might affect the value of the security); and (10) with respect to certain Restricted Securities, the price of securities in a subsequent round of financing of an issuer in an arm's-length transaction, if the round includes a new third party investor.

Sometimes a significant valuation event may cause the market value of a security to differ from the fair market value of that security. A significant valuation event is an event that causes or is likely to cause a market quotation to be unavailable or unreliable, and may include: situations relating to a single issue in a market sector; significant fluctuations in U.S. or foreign markets; market disruptions or closings caused by human error, equipment failures, natural disasters, armed conflicts, acts of God, governmental actions or other developments, as well as the same or similar events which may affect specific issues or the securities markets even though not tied directly to the securities markets. A significant valuation event occurring after the close of trading but before the time of valuation may mean that the closing price for the security does not constitute a readily available market quotation. If a significant valuation event has occurred, the security will be valued at fair value as determined in good faith by the Board in accordance with the procedures established by the Board and hereinafter described. Such valuations and procedures will be reviewed periodically by the Board.

The fair value of investments for which no market exists cannot be precisely determined. With respect to securities of a company in its early stage of development, valuation will typically be based upon the original cost to the Trust. This methodology will typically be used until significant developments affecting the portfolio company provide a basis for a change in valuation. The status of portfolio companies is monitored for progress against plan, advancement of the stage of product development, and other factors. When revenues and earnings are present they are monitored. Valuation changes are event driven. When an appropriate event occurs (e.g., the completion of a third party transaction or a significant change in business model) valuation is changed accordingly. In addition the Trust will typically base changes in valuation on actual transactions or on actual firm offers by sophisticated independent investors unaffiliated with the Investment Adviser. Legal or contractual restrictions on the sale of portfolio securities by the Trust will be considered in the valuation of such securities.

Other assets, which include cash, prepaid and accrued items, accounts receivable and income on investments and from the sale of portfolio securities, are carried in accordance with generally accepted accounting principles, as are all liabilities. Liabilities primarily include accrued expenses, sums owed for securities purchased and dividends payable.

PORTFOLIO TRANSACTIONS AND BROKERAGE

Subject to policies established by the Board, the Investment Adviser is primarily responsible for the execution of the Trust's portfolio transactions and the allocation of brokerage. In executing transactions for the portfolio and selecting brokers or dealers (which brokers or dealers may include any affiliate of the Investment Adviser to the extent permitted by the Investment Company Act), the Investment Adviser will use its best efforts to obtain the best price and execution for the Trust. In assessing the best price and execution available for any portfolio transaction, the Investment Adviser will consider all factors it deems relevant including, but not limited to, price (including any applicable brokerage commission or dealer spread), size of order, difficulty of execution, and operational facilities of the firm involved and the firm's risk in positioning a block of securities. The Investment Adviser may cause the Trust to pay a broker-dealer that furnishes brokerage and research services a higher commission than that which might be charged by another broker-dealer for effecting the same transaction, provided that the Investment Adviser determines in good faith that such commission is reasonable in relation to the value of the brokerage and research services provided by such broker-dealer, viewed in terms of either the particular transaction or the overall responsibilities of the Investment Adviser to the Trust. In selecting brokers or dealers to execute a particular transaction and in evaluating the best price and execution available, the Investment Adviser may consider the brokerage and research services (as those terms are defined in Section 28(e) of the Securities Exchange Act of 1934, as amended) provided to the Trust and/or other accounts over which the Investment Adviser exercises investment discretion. Such brokerage and research services might consist of reports and statistics on specific companies or industries, general summaries of groups of bonds

and their comparative earnings and yields, or broad overviews of

the securities markets and the economy. It is further understood that such services may be useful to the Investment Adviser in connection with its services to other clients. While the Investment Adviser generally seeks reasonably competitive commission rates, the Trust will not necessarily pay the lowest commission available.

The Trust has no obligation to deal with any broker or group of brokers in executing transactions in portfolio securities. Brokers who provide supplemental research, market and statistical information to the Investment Adviser may receive orders for transactions by the Trust. The term research, market and statistical information includes advice as to the value of securities, the advisability of purchasing or selling securities and the availability of securities or purchasers or sellers of securities, and furnishing analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts. Information so received will be in addition to and not in lieu of the services required to be performed by the Investment Adviser under the Advisory Agreement and the expenses of the Investment Adviser will not necessarily be reduced as a result of the receipt of such supplemental information. Such information may be useful to the Investment Adviser in providing services to clients other than the Trust, and not all such information may be used by the Investment Adviser in connection with the Trust. Conversely, such information provided to the Investment Adviser by brokers and dealers through whom other clients of the Investment Adviser in the future may affect securities transactions may be useful to the Investment Adviser in providing services to the Trust. To the extent the Investment Adviser receives valuable research, market and statistical information from a broker-dealer, the Investment Adviser intends to direct orders for Trust transactions to that broker-dealer, subject to the foregoing policies, regulatory constraints and the ability of broker dealers to provide competitive prices and commission rates.

The Investment Company Act restricts transactions involving the Trust and its affiliates, including among others, the Trust's Trustees, officers and employees, the Investment Adviser and any affiliates of such affiliates. Subject to any such restrictions, investment companies advised by the Investment Adviser may concurrently invest with the Trust in Restricted Securities, and the Trust may also invest in companies in which directors of the Investment Adviser or Trustees of the Trust have invested or for which they serve as directors or executive officers. The Trust seeks to deal directly with the dealers who make markets in the securities involved, except as limited by applicable law and in those circumstances where better prices and execution are available elsewhere. Under the Investment Company Act, persons affiliated with the Trust are generally prohibited from dealing as principal with the Trust in the purchase and sale of securities. Under certain circumstances, affiliated persons of the Trust are permitted to serve as its broker in over-the-counter transactions conducted on an agency basis.

It is likely that, subject to applicable law, the Trust may invest in securities concurrently being purchased by other investment companies advised by the Investment Adviser. Such purchases would be made on terms no less favorable than those under which such investment companies would be acquiring the securities. In the case of concurrent purchases by the Trust and another investment company or companies managed by the Investment Adviser, such purchases would be made where the Investment Adviser has made an independent decision on behalf of the Trust and such other company that the purchase is appropriate in light of the investment objectives, policies, restrictions, current holdings, available cash and portfolio structure of and other factors affecting each. Such investments will be allocated among clients in a manner believed by the Investment Adviser to be equitable to each. The Trust may also from time to time invest in securities of companies in which affiliated persons of the Trust have invested, subject to the provisions of the Investment Company Act and the rules and regulations promulgated thereunder.

The Trust's portfolio transactions in Restricted Securities are generally subject to Rule 144 under the Securities Act. In general, under Rule 144 as currently in effect, if the Trust has beneficially owned Restricted Securities of a publicly held issuer for a minimum of six months, it will be entitled to sell in any three-month period that number of such securities that will not exceed the greater of 1% of the then outstanding securities of that class or the average weekly trading volume in securities of that class in any national securities exchange and/or in the over-the-counter market during the four calendar weeks immediately preceding the date on which notice of the sale is filed with the Commission. These volume limitations also apply to sales by the Trust of the securities of any issuer as to which it is deemed an affiliate, regardless of whether securities of such issuer are publicly traded. The above-described sales under Rule 144 are subject to certain requirements relating to manner of sale, notice and availability of current public information about the issuer. If the Trust is not deemed to have been an affiliate of the issuer at any time during the 90 days immediately preceding the sale and has beneficially owned Restricted Securities for at least one

year, it is entitled to sell such securities under Rule 144(k) without regard to whether the issuer is publicly-held or to the volume limitations or other requirements described above. When Restricted Securities are sold to the public other than pursuant to Rule 144 or 144A, the Trust may be deemed an underwriter with respect thereto for purposes of the Securities Act and subject to liability as such thereunder.

On occasions when the Investment Adviser deems the purchase or sale of a security to be in the best interest of the Trust as well as other clients, the Investment Adviser, to the extent permitted by applicable laws and regulations, may, but shall be under no obligation to, aggregate the securities to be sold or purchased in order to obtain the most favorable price or lower brokerage commissions and efficient execution. In such event, allocation of the securities so purchased or sold, as well as the expenses incurred in the transaction, will be made by the Investment Adviser in the manner it considers to be the most equitable and consistent with its fiduciary obligations to the Trust and to such other clients.

Allocation of transactions, including their frequency, to various broker-dealers is determined by the Investment Adviser with respect to the Trust, based on its best judgment and in a manner deemed fair and reasonable to Shareholders. The primary consideration is prompt execution of orders in an effective manner at the most favorable price. Certain investments may be appropriate for the Trust and also for other clients advised by the Investment Adviser. Investment decisions for the Trust and for other investment accounts managed by the Investment Adviser are made independently of each other in the light of differing conditions. However, the same investment decision may be made for two or more of such accounts. When a purchase or sale of the same security is made at substantially the same time on behalf of the Trust and one or more other accounts, the transaction will be averaged as to price, and available investments allocated as to amount, in a manner the Investment Adviser believes to be equitable to each such account. Although the Investment Adviser seeks the most favorable overall net results for all of the accounts in any aggregated transaction, in some cases, this practice may adversely affect the price paid or received by the Trust or the size of the position obtained or sold by the Trust. To the extent permitted by law, the Investment Adviser may aggregate the securities to be sold or purchase for the Trust with those to be sold or purchased for other investment companies or accounts in order to obtain best execution.

For the fiscal years ended September 30, 2013, September 30, 2012 and September 30, 2011, the Trust paid \$466,786, \$845,883 and \$740,992, respectively, of brokerage commissions.

As stated in the Prospectus, the Trust's portfolio turnover rate for the fiscal years ended September 30, 2013 and September 30, 2012 was 35.41% and 86.28%, respectively. For a description of the Trust's portfolio turnover policies, see "Portfolio Transactions and Brokerage" in the Prospectus.

QUARTERLY DISTRIBUTION POLICY

The Trust has a managed distribution policy with respect to the Trust's Shares, under which the Trust intends to make quarterly distributions to its Shareholders equal to 2.0% of the Trust's net asset value. The Board adopted the Policy in May, 1999, and since then the Trust has made quarterly distributions at a rate of 2.00% of the Trust's net assets, except for the periods from August 4, 2009, to April 5, 2010 (during which distributions were suspended) and from April 5, 2010 to November 1, 2010 (during which distributions were suspended) and from April 5, to November 1, 2010 (during which the Trust made distributions at a rate of 1.25% of the Trust's net assets). If, for any taxable year, the total distributions required for the Trust's distribution policy exceed the Trust's annual investment company taxable income and net long-term capital gains, the excess will generally be treated as a return of capital (up to the amount of the Shareholder's adjusted tax basis in his or her Shares). The amount treated as a tax-free return of capital will reduce a Shareholder's adjusted basis in his or her own Shares, thereby increasing his or her potential gain or reducing his or her potential loss on the sale of his or her Shares.

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If the Trust's investment company taxable income and net long-term capital gains for any taxable year or calendar year exceed the amount required to be distributed under the distribution policy, the Trust will, at a minimum, make distributions necessary to permit it to qualify for treatment as a regulated investment company under the Internal Revenue Code of 1986, as amended (the "Code"). The Trust has the discretion to retain for reinvestment net long-term capital gains in excess of net short-term capital losses, to the extent that it does not need to distribute these gains to meet its managed distribution obligation or tax requirements. Any retained gains may be subject to taxation, although Shareholders may receive credit for taxes paid by the Trust. It is anticipated that net realized capital gains in excess of the total distributed under this policy would be included in the December distribution.

This distribution policy may, under certain circumstances, have certain adverse consequences to the Trust and its Shareholders. To make such distributions, the Trust may have to sell a portion of its investment portfolio at a time when independent investment judgment might not dictate such action. The Trust's quarterly distribution policy may be changed by the Board without Shareholder approval.

The Trust's most recent distribution of \$0.53 per Share was payable to Shareholders of record on March 3, 2014. That distribution was paid in Shares (except to the extent Shareholders elected to receive cash) on March 31, 2014. For the 2013 calendar year, the Trust distributed a total of \$1.73 per Share.

TAX MATTERS

The following is only a summary of certain U.S. federal income tax considerations generally affecting the Trust and its Shareholders. No attempt is made to present a detailed explanation of the tax treatment of the Trust or its Shareholders, and the following discussion is not intended as a substitute for careful tax planning. Shareholders should consult with their own tax advisers regarding the specific federal, state, local, foreign and other tax consequences of investing in the Trust.

Taxation of the Trust

The Trust intends to qualify and has elected to be treated each taxable year as a regulated investment company under the Code. The principal federal income tax benefits of qualifying as a regulated investment company (RIC), as compared to an ordinary taxable corporation, are that a RIC generally is not itself subject to federal income tax on ordinary investment income and net capital gains that are currently distributed to its shareholders, and that the character of long-term capital gains which are recognized and properly designated by a RIC flows through to its shareholders, who receive (or are deemed to receive) distributions of such income. However, the Trust is subject to corporate income tax (currently at a maximum marginal rate of 35%) on any undistributed income.

To qualify as a RIC, the Trust must, among other things, (a) derive in each taxable year at least 90% of its gross income from dividends, interest, payments with respect to securities loans, gains from the sale or other disposition of stock, securities or foreign currencies, net income derived from an interest in a qualified publicly traded partnership and other income derived with respect to its business of investing in such stock, securities or currencies (the Qualifying Income Requirement); (b) diversify its holdings so that, at the end of each quarter of the taxable year, (1) at least 50% of the market value of the Trust's assets is represented by cash and cash items, U.S. Government Securities, the securities of other RICs and other securities, with such other securities of any one issuer limited for the purposes of this calculation to an amount not greater than 5% of the value of the Trust's total assets and not greater than 10% of the outstanding voting securities of such issuer, and (2) not more than 25% of the value of its total assets is invested in the securities of (i) any one issuer (other than U.S. Government Securities or the securities of other RICs), (ii) two or more issuers (other than the securities of other RICs) which the RIC controls and which are determined to be in the same or similar trades or businesses, and (iii) one or more qualified publicly traded partnerships; and (c) distribute at least 90% of its investment company taxable income (which includes, among other items, dividends, interest and net short-term capital gains in excess of net long-term capital losses) each taxable year. The U.S. Treasury Department has authority to promulgate regulations pursuant to which gains from foreign currency (and options, futures and forward contracts on foreign currency) not directly related to a RIC's business of investing in stocks and securities would not be treated as qualifying income for purposes of the Qualifying Income Requirement. To date, such regulations have not been promulgated.

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If for any taxable year the Trust were to fail to qualify as a RIC, all of the Trust's taxable income would be subject to federal income tax at the rates applicable to corporations (with no deduction for distributions to Shareholders), and Trust distributions would be taxable to Shareholders as dividends to the extent of the Trust's earnings and profits.

Amounts not distributed on a timely basis in accordance with a calendar year distribution requirement are subject to a nondeductible 4% excise tax. To avoid the excise tax, the Trust must generally distribute during each calendar year an amount at least equal to the sum of (1) 98% of its ordinary income (taking into account certain deferrals and elections) for the calendar year, (2) 98% of its capital gains in excess of its capital losses (adjusted for certain ordinary losses) for the one-year period ending on October 31 of the calendar year, and (3) all ordinary income and capital gains for previous years that were not distributed during such years. To avoid application of the excise tax,

the Trust intends to make its distributions in accordance with the calendar year distribution requirement. A dividend will be treated as paid on December 31 of the calendar year if it is declared by the Trust in October, November or December of the year, payable to Shareholders of record on a date in such a month and paid by the Trust during January of the following year. Such dividends will be taxable to Shareholders as of December 31 of the calendar year in which the dividends are declared, rather than during the calendar year in which the dividends are received. If the Trust elects to retain net capital gains and treat such gains as having been distributed, all or a portion of such gains may not be treated as having been timely distributed for purposes of satisfying the excise tax calendar year distribution requirement.

Distributions

Dividends paid from investment company taxable income generally will be taxable to Shareholders as ordinary income whether paid in cash or reinvested in the Trust's Shares. The Trust intends to distribute to its Shareholders substantially all of its investment company taxable income, if any, for each year. It is anticipated that the Trust's income distributions will be paid annually in additional Shares unless the Shareholder elects payment in cash.

A portion of the dividends paid by the Trust may be treated as qualified dividend income which is taxable to individuals at the same rates that are applicable to long-term capital gains. A Trust distribution is treated as qualified dividend income to the extent that the Trust receives dividend income from taxable domestic corporations and certain qualified foreign corporations, provided that certain holding period and other requirements are met by both the Trust and the Shareholder. Trust distributions generally will not qualify as qualified dividend income to the extent attributable to interest, capital gains, REIT distributions and distributions from certain non-U.S. corporations.

Distributions of the excess, if any, of net long-term capital gains over net short-term capital losses (net capital gains) designated by the Trust as capital gain dividends will be taxable to Shareholders as long-term capital gains, whether paid in cash or reinvested in the Trust's Shares, regardless of how long the Shareholders have held the Trust's Shares, and will not be eligible for the dividends received deduction for corporations. The Trust may elect to retain net capital gains. In such event, the Trust will be required to pay federal income taxes on the undistributed net capital gains, but intends to elect to treat such capital gains as having been distributed to Shareholders. As a result, such amounts will be included in the gross income of the Shareholders as long-term capital gains and Shareholders will be able to claim their proportionate share of federal income taxes paid by the Trust on such gains as a credit against their own federal income tax liabilities, and will be entitled to increase the adjusted tax basis of their Shares of the Trust by an amount equal to approximately 65% of the amount of the undistributed capital gains included in their gross income. Organizations or persons not subject to federal income tax on such capital gains (such as, generally, qualified pension and profit-sharing funds, including Individual Retirement Accounts and Keogh plans, and certain trusts, nonresident aliens and foreign corporations) will be entitled to a refund of their pro rata share of such taxes paid by the Trust upon filing appropriate returns or claims for refund with the Internal Revenue Service (IRS). Even if the Trust makes such an election, it is possible that the Trust may incur an excise tax as a result of not having distributed sufficient net capital gains.

A distribution of an amount in excess of the Trust's current and accumulated earnings and profits will be treated by a Shareholder as a return of capital which is applied against and reduces the Shareholder's basis in his or her Shares. To the extent that the amount of any such distribution exceeds the Shareholder's basis in his or her Shares, the excess will be treated by the Shareholder as gain from a sale or exchange of the Shares.

If the value of the Trust's Shares is reduced below a Shareholder's cost as a result of a distribution of investment company taxable income or net capital gains by the Trust, such distribution will be taxable to the Shareholder. The price of Shares purchased at this time may reflect the amount of the forthcoming distribution. Those purchasing just prior to a distribution of investment company taxable income or net capital gains will receive a distribution which will nevertheless be taxable to them.

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Dividends (not including capital gain dividends) received by corporate Shareholders from the Trust qualify for the dividends received deduction for corporate Shareholders to the extent the Trust designates the amount distributed as eligible for the deduction. The aggregate amount designated by the Trust cannot exceed the aggregate amount of dividends received by the Trust from domestic corporations for the taxable year, and the designation of dividend income must generally be the same for all Shares.

The dividends received deduction for corporate Shareholders may be further reduced if the Shares with respect to which dividends are received are treated as debt-financed or if either those Shares or the Shares of the Trust are deemed to have been held by the Trust or its Shareholders, respectively, for less than 46 days.

In addition to furnishing any other required tax statements, the Trust intends to report in written notices to Shareholders regarding the tax status of all distributions made during such taxable year, the amount qualifying for the dividends received deduction for corporations and the amount of undistributed net capital gains and related tax credits.

Sale of Shares

Generally, gain or loss realized upon the sale or exchange of Shares will be capital gain or loss if the Shares are capital assets in the Shareholder's hands and generally will be long-term or short-term, depending upon the Shareholder's holding period for the Shares. Investors should be aware that any loss realized upon the sale or exchange of Shares held for six months or less will be treated as a long-term capital loss to the extent of any distributions or deemed distributions of long-term capital gain to the Shareholder with respect to such Shares. In addition, any loss realized on a sale or exchange of Shares will be disallowed to the extent the Shares disposed of are replaced within a period of 61 days beginning 30 days before and ending 30 days after the Shares are disposed of, such as pursuant to the Plan. In such case, the basis of Shares acquired will be adjusted to reflect the disallowed loss.

Legislation passed by Congress requires reporting of adjusted cost basis information for covered securities, which generally include shares of a regulated investment company acquired after January 1, 2012, to the IRS and to taxpayers. Shareholders should contact their financial intermediaries with respect to reporting of cost basis and available elections for their accounts.

The Trust may invest in shares of foreign corporations which may be classified under the Code as passive foreign investment companies (PFICs). In general, a foreign corporation is classified as a PFIC if at least one-half of its assets constitute investment-type assets, or 75% or more of its gross income is investment-type income. If the Trust receives a so-called excess distribution with respect to PFIC stock, the Trust itself may be subject to a tax on a portion of the excess distribution, whether or not the corresponding income is distributed by the Trust to Shareholders. In general, under the PFIC rules, an excess distribution is treated as having been realized ratably over the period during which the Trust held the PFIC shares. The Trust itself will be subject to tax on the portion, if any, of an excess distribution that is so allocated to prior Trust taxable years and an interest factor will be added to the tax, as if the tax had been payable in such prior taxable years. Gain from the sale of PFIC shares is treated in the same manner as an excess distribution. Excess distributions and gain from the sale of PFIC shares are characterized as ordinary income even though, absent application of the PFIC rules, such gains and certain excess distributions might have been classified as capital gain.

The Trust may elect to mark to market any PFIC shares in lieu of being subject to U.S. federal income taxation. At the end of each taxable year to which the election relates, the Trust would report as ordinary income the amount by which the fair market value of the PFIC stock exceeds the Trust's adjusted basis in the stock. Any mark-to-market losses and any loss from an actual disposition of shares would be deductible as ordinary losses to the extent of any net mark-to-market gains included in income in prior years. The effect of the election would be to treat excess distributions and gain on dispositions as ordinary income which is not subject to a Trust-level tax when distributed to Shareholders as a dividend. Alternatively, the Trust may elect to include as income and gain its share of the ordinary earnings and net capital gain of certain PFICs in lieu of being taxed in the manner described above.

Under the Code, the gains or losses attributable to fluctuations in exchange rates which occur between the time the Trust accrues receivables or liabilities denominated in a foreign currency and the time the Trust actually collects such receivables or pays such liabilities generally are treated as ordinary income or ordinary loss. Similarly, on disposition of foreign currency or debt securities denominated in a foreign currency and on disposition of certain futures and forward contracts, gains or losses attributable to fluctuations in the value of foreign currency between the date of acquisition of the currency, security or contract and the date of disposition also are treated as ordinary

gain or loss. These gains or losses, referred to under the Code as Section 988 gains or losses, may increase or decrease the amount of the Trust's investment company taxable income to be distributed to its Shareholders as ordinary income.

Hedging Transactions

Certain futures and foreign currency contracts in which the Trust may invest are section 1256 contracts. While gains or losses on section 1256 contracts are considered 60% long-term and 40% short-term capital gains or losses, certain foreign currency futures and foreign currency contracts may give rise to ordinary income or loss, as described above. Also, section 1256 contracts held by the Trust at the end of each taxable year (and, generally, for purposes of the 4% excise tax, on October 31 of each year) are marked-to-market with the result that unrealized gains or losses are treated as though they were realized.

Generally, the hedging transactions undertaken by the Trust may result in straddles for U.S. federal income tax purposes. The straddle rules may affect the character of gains (or losses) realized by the Trust. In addition, losses realized by the Trust on positions that are part of a straddle may be deferred under the straddle rules, rather than being taken into account in calculating the taxable income for the taxable year in which the losses are realized. Because only a few regulations implementing the straddle rules have been promulgated, the tax consequences to the Trust of engaging in hedging transactions are not entirely clear.

The Trust may make one or more of the elections available under the Code which are applicable to straddles. If the Trust makes any of the elections, the amount, character and timing of the recognition of gains or losses from the affected straddle positions will be determined under the rules that vary according to the election(s) made. The rules applicable under certain of the elections may operate to accelerate the recognition of gains or losses from the affected straddle positions.

Notwithstanding any of the foregoing, the Trust may recognize gain (but not loss) from a constructive sale of certain appreciated financial positions if the Trust enters into a short sale, offsetting notional principal contract, futures or forward contract transaction with respect to the appreciated position or substantially identical property. Appreciated financial positions subject to this constructive sale treatment are interests (including options, futures and forward contracts and short sales) in stock, partnership interests, certain actively traded trust instruments and certain debt instruments. Constructive sale treatment does not apply to certain transactions closed before the end of the thirtieth day after the close of the taxable year, if certain conditions are met.

Foreign Withholding Taxes

Income received by the Trust from non-U.S. sources may be subject to withholding and other taxes imposed by other countries. Because it is not expected that more than 50% of the value of the Trust's total assets at the close of its taxable year will consist of stock and securities of non-U.S. corporations, it is not expected that the Trust will be eligible to elect to pass-through to the Trust's Shareholders the amount of foreign income and similar taxes paid by the Trust. In the absence of such an election, the foreign taxes paid by the Trust will reduce its investment company taxable income, and distributions of investment company taxable income received by the Trust from non-U.S. sources will be treated as U.S. source income.

Backup Withholding

The Trust may be required to withhold U.S. federal income tax at the rate of 28% of all taxable distributions payable to Shareholders who fail to provide the Trust with their correct taxpayer identification number or to make required certifications, or who have been notified by the IRS that they are subject to backup withholding. Backup withholding is not an additional tax. Any amounts withheld may be credited against a Shareholder's U.S. federal income tax liability. Certain persons are exempt from the backup withholding requirements. Questions relating to backup withholding should be directed to your tax adviser.

Foreign Shareholders

U.S. taxation of a Shareholder who, as to the U.S., is a non-resident alien individual, a foreign trust or estate, a foreign corporation or foreign partnership (Foreign Shareholder) depends on whether the income from the Trust is effectively connected with a U.S. trade or business carried on by such Shareholder.

Income Not Effectively Connected

If the income from the Trust is not effectively connected with a U.S. trade or business carried on by the Foreign Shareholder, distributions of investment company taxable income will be subject to a U.S. tax of 30% (or lower treaty rate), which tax is generally withheld from such distributions.

Distributions of capital gain dividends and amounts retained by the Trust which are designated as undistributed capital gains will not be subject to U.S. tax at the rate of 30% (or lower treaty rate) unless the Foreign Shareholder is a non-resident alien individual and is physically present in the U.S. for more than 182 days during the taxable year and meets certain other requirements. However, this 30% tax on capital gains of non-resident alien individuals who are physically present in the U.S. for more than the 182-day period only applies in exceptional cases, because any individual present in the U.S. for more than 182 days during the taxable year is generally treated as a resident for U.S. federal income tax purposes; in that case, he or she would be subject to U.S. federal income tax on his or her worldwide income at the graduated rates applicable to U.S. citizens, rather than the 30% U.S. tax. In the case of a Foreign Shareholder who is a non-resident alien individual, the Trust may be required to withhold U.S. federal income tax at a rate of 28% of distributions of net capital gains unless the Foreign Shareholder certifies his or her non-U.S. status under penalties of perjury or otherwise establishes an exemption. See Backup Withholding above. If a Foreign Shareholder is a non-resident alien individual, any gain such Shareholder realizes upon the sale or exchange of such Shareholder's Shares of the Trust in the U.S. will ordinarily be exempt from U.S. tax unless such Shareholder is physically present in the U.S. for more than 182 days during the taxable year and meets certain other requirements.

However, subject to certain limitations and the receipt of further guidance from the U.S. Treasury, dividends paid to certain Foreign Shareholders may be exempt from U.S. tax through 2007 to the extent such dividends are attributable to qualified interest and/or net short-term capital gains, provided that the Trust elects to follow certain procedures. The Trust does not anticipate following the procedures and as a result, the full amount of distributions of ordinary dividends, including distributions of any interest or short-term gains will be subject to withholding at a rate of 30 percent or any applicable lower treaty rate.

Income Effectively Connected

If the income from the Trust is effectively connected with a U.S. trade or business carried on by a Foreign Shareholder, then distributions of investment company taxable income and capital gain dividends, amounts retained by the Trust which are designated as undistributed capital gains and any gains realized upon the sale or exchange of Shares of the Trust will be subject to U.S. federal income tax at the graduated rates applicable to U.S. citizens, residents and domestic corporations. Such Foreign Shareholders that are corporations may also be subject to the branch profits tax imposed by the Code.

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Effective July 1, 2014, the Trust will be required to withhold U.S. tax (at a 30% rate) on payments of taxable dividends and (effective January 1, 2017) redemption proceeds and certain capital gain dividends made to certain non-U.S. entities that fail to comply (or be deemed compliant) with extensive new reporting and withholding requirements designed to inform the U.S. Department of the Treasury of U.S.-owned foreign investment accounts. Shareholders may be requested to provide additional information to the Trust to enable the Trust to determine whether withholding is required.

The tax consequences to a Foreign Shareholder entitled to claim the benefits of an applicable tax treaty may be different from those described herein. Foreign Shareholders may also be subject to U.S. estate tax with respect to their Trust shares. Foreign Shareholders are advised to consult their own tax advisers with respect to the particular tax consequences to them of an investment in the Trust.

Other Taxes

Distributions may also be subject to state, local and foreign taxes and/or the alternative minimum tax depending on each Shareholder's particular situation. Shareholders should consult their own tax advisers with respect to their particular situation.

ADMINISTRATOR, CUSTODIAN, TRANSFER AGENT, DIVIDEND DISBURSING AGENT AND REGISTRAR

The Trust's securities and cash are held under a custodian contract by State Street Bank and Trust Company (the Custodian), whose principal business address is One Lincoln Street, Boston, Massachusetts 02111. Rules adopted under the Investment Company Act permit the Trust to maintain its securities and cash in the custody of certain eligible banks and securities depositories. Pursuant to those Rules, the Trust's portfolio of securities and cash, when invested in Foreign Securities, will be held by sub-custodians who have been approved by the Board in accordance with the rules and regulations of the Commission following consideration of a number of factors, including, but not limited to, the relationship of the institution with the Custodian, the reliability and financial stability of the institution, the ability of the institution to perform capably custodial services for the Trust, the reputation of the institution in its national market, the political and economic stability of the countries in which the sub-custodians will be located and the risks of potential nationalization or expropriation of Trust assets. The Custodian also performs certain accounting related functions for the Trust, including calculation of NAV and net income.

State Street Bank and Trust Company (the Administrator) also serves as administrator to the Trust pursuant to an Administration Agreement. Under the Administration Agreement the Trust's assets are combined with assets of H&Q Life Science Investors, another closed-end mutual fund managed by the Investment Adviser. The combined assets are charged a fee computed and payable monthly at an annual rate of (i) .034% of the first \$150 million; (ii) .024% of the next \$150 million; (iii) .014% on assets in excess of \$300 million, subject to annual minimum fee of \$77,500. The Administrative Agreement covers administrative costs, including out-of-pocket expenses incurred in the ordinary course of providing services under the Administration Agreement.

Computershare Inc. serves as Dividend Disbursing Agent for the Trust. Computershare Trust Company, N.A., a fully owned subsidiary of Computershare Inc., serves as (1) the Plan Agent for the Trust's Dividend Reinvestment Plan and (2) the Transfer Agent and Registrar for Shares of the Trust. Computershare Trust Company, N.A. and Computershare Inc. have their principal business at 250 Royall Street, Canton, MA 02021.

FINANCIAL STATEMENTS

The Trust's financial statements as of and for the fiscal year ended September 30, 2013, together with the report thereon of Deloitte & Touche LLP, an independent registered public accounting firm, given on the authority of such firm as experts in auditing and accounting, are incorporated in this SAI by reference to the Trust's September 30, 2013 Annual Report to Shareholders, including the Schedule of Investments, the Statement of Assets and Liabilities, the Statement of Operations, the Statement of Changes in Net Assets, the Statement of Cash Flows and the five-year Financial Highlights. A copy of the Trust's 2013 Annual Report to Shareholders is available at the SEC's website (www.sec.gov). Copies may also be obtained free of charge upon request from the Trust's Information Agent at [] or from the Trust at (617) 772-8500. It is expected that the unaudited financial statements included in the Trust's Semi-Annual Report to Shareholders for the six months ended March 31, 2014 will be mailed to Shareholders on or around May 30, 2014, and available on the Trust's website (www.teklacap.com) on or around June 10, 2014.

Any statement contained in the Trust's annual report that is incorporated by reference in this SAI shall be deemed modified or superseded for purposes of the Prospectus and this SAI to the extent a statement contained in the Prospectus or this SAI varies from such statement. Any such statement so modified or superseded shall not, except as modified or superseded, be deemed to constitute a part of the Prospectus or this SAI.

APPENDIX A

PROXY VOTING POLICIES AND PROCEDURES

Policy

The following are the policies and procedures adopted and implemented by Tekla Capital Management LLC (TCM) for voting proxies with respect to portfolio securities held by H&Q Healthcare Investors and H&Q Life Sciences Investors (each a Fund and collectively the Funds). The policies and procedures are reasonably designed to ensure that proxies are voted in the best interest of the Funds and the Funds' shareholders, in accordance with TCM's fiduciary duties and Rule 206(4)-6 under the Investment Advisers Act of 1940 (the Investment Advisers Act). TCM considers the best interests of the Funds and their shareholders to mean their best long-term economic interests.

TCM shall vote proxies for the exclusive benefit, and in the best economic interest, of the Funds and their shareholders. Such exercise of voting rights shall be subject to the same standard of care as is generally applicable to TCM's performance of its duties, as set forth in the advisory agreements with the Funds. The policies and procedures contained herein are designed to be guidelines, however each vote is ultimately cast on a case-by-case basis, taking into consideration the relevant facts and circumstances at the time of the vote. Any material conflicts that may arise will be resolved in the best interests of the Funds and their shareholders.

A proxy committee has been designated and is responsible for administering and overseeing the proxy voting process. The committee consists of the President of TCM, TCM's Chief Compliance Officer (CCO), and the analyst responsible for oversight of the company that is the subject of the proxy. The committee considers proxy questions and determines the vote on behalf of the Funds.

Procedures

Logistics

TCM's CCO shall be responsible for maintaining the proxy log, monitoring corporate actions and confirming the timely voting of proxies. The proxy log shall contain the following information, in accordance with Form N-PX:

- the name of the issuer;
- the exchange ticker symbol, if available;

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- the CUSIP number, if available;
- the shareholder meeting date;
- a brief identification of the matter voted on;
- whether the matter was proposed by the issuer or a security holder;
- whether TCM cast its vote on the matter;
- how TCM cast its vote on the matter (for, against, abstain; for or withhold regarding the election of directors); and
- whether TCM cast its vote for or against management.

TCM's CCO shall also record whether any conflicts of interest have been identified and, if so, what action was taken to resolve the conflict with respect to each vote cast and each abstention.

Substantive Voting Decisions

TCM's substantive voting decisions turn on the particular facts and circumstances of each proxy vote. The following is a list of common proxy vote issues and TCM's standard considerations when determining how to vote such proxies.

Routine Matters/Corporate Administrative Items. After an initial review, TCM generally votes with management on routine matters related to the operation of the issuer that are not expected to have a significant economic impact on the issuer and/or its shareholders.

Potential for Major Economic Impact. TCM may review and analyze on a case-by-case basis, non-routine proposals that are more likely to affect the structure and operation of the issuer and to have a greater impact on the value of the investment.

Corporate Governance. TCM may review and consider corporate governance issues related to proxy matters and generally supports proposals that foster good corporate governance practices.

Special Interest Issues. TCM may consider: (i) the long-term benefit to shareholders of promoting corporate accountability and responsibility on social issues; (ii) management's responsibility with respect to special interest issues; (iii) any economic costs and restrictions on management; and (iv) the responsibility of TCM to vote proxies for the greatest long-term shareholder value.

Limitations on Director Tenure and Retirement. TCM may consider: (i) a reasonable retirement age for directors, *e.g.* 70 or 72; (ii) the introduction of new perspectives on the board; and (iii) the arbitrary nature of such limitations and the possibility of detracting from the board's stability and continuity.

Directors' Minimum Stock Ownership. TCM may consider: (i) the benefits of additional vested interest; (ii) the ability of a director to serve a company well regardless of the extent of his or her share ownership; and (iii) the impact of limiting the number of persons qualified to be directors.

D&O Indemnification and Liability Protection. TCM may consider: (i) indemnifying directors for acts conducted in the normal course of business; (ii) limiting liability for monetary damages for violating the duty of care; (iii) expanding coverage beyond legal expenses to acts that represent more serious violations of fiduciary obligation than carelessness (*e.g.* negligence); and (iv) providing expanded coverage in cases when a director's legal defense was unsuccessful if the director was found to have acted in good faith and in a manner that he or she reasonably believed was in the best interests of the issuer.

Director Nominations in Contested Elections. TCM may consider: (i) long-term financial performance of the issuer relative to its industry; (ii) management's track record; (iii) background to proxy contest; (iv) qualifications of both slates of nominees; (v) evaluations of what each side is offering shareholders as well as the likelihood that the proposed objectives and goals can be met; and (vi) stock ownership positions.

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Cumulative Voting. TCM may consider: (i) the ability of significant stockholders to elect a director of their choosing; (ii) the ability of minority shareholders to concentrate their support in favor of a director or directors of their choosing; and (iii) the potential to limit the ability of directors to work for all shareholders.

Classified Boards. TCM may consider: (i) providing continuity; (ii) promoting long-term planning; and (iii) guarding against unwanted takeovers.

Poison Pills. TCM may consider: (i) TCM's position on supporting proposals to require a shareholder vote on other shareholder rights plans; (ii) ratifying or redeeming a poison pill in the interest of protecting the value of the issuer; and (iii) other alternatives to prevent a takeover at a price demonstrably below the true value of the issuer.

Fair Price Provisions. TCM may consider: (i) the vote required to approve the proposed acquisition; (ii) the vote required to repeal the fair price provision; (iii) the mechanism for determining fair price; and (iv) whether these provisions are bundled with other anti-takeover measures (*e.g.*, supermajority voting requirements) that may entrench management and discourage attractive tender offers.

Equal Access. TCM may consider: (i) the opportunity for significant shareholders of the issuer to evaluate and propose voting recommendations on proxy proposals and director nominees, and to nominate candidates to the board; and (ii) the added complexity and burden.

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Charitable Contributions. TCM may consider: (i) the potential benefits to shareholders; (ii) the potential to detract the issuer's resources from more direct uses of increasing shareholder value; and (iii) the responsibility of shareholders to make individual contributions.

Stock Authorizations. TCM may consider: (i) the need for the increase; (ii) the percentage increase with respect to the existing authorization; (iii) voting rights of the stock; and (iv) overall capitalization structures.

Preferred Stock. TCM may consider: (i) whether the new class of preferred stock has unspecified voting, conversion, dividend distribution, and other rights; (ii) whether the issuer expressly states that the stock will not be used as a takeover defense or carry superior voting rights; (iii) whether the issuer specifies the voting, dividend, conversion, and other rights of such stock and the terms of the preferred stock appear reasonable; and (iv) whether the stated purpose is to raise capital or make acquisitions in the normal course of business.

Director Compensation. TCM may consider: (i) whether director shares are at the same market risk as those of the shareholders; and (ii) how option programs for outside directors compare with the standards of internal programs.

Golden and Tin Parachutes. TCM may consider: (i) whether they will be submitted for shareholder approval; and (ii) the employees covered by the plan and the quality of management.

Compensation. TCM may consider: (i) Whether the company has an independent compensation committee; (ii) whether the compensation committee engaged independent consultants; (iii) whether the compensation committee has lapsed or waived equity vesting restrictions; and (iv) whether the company has adopted or extended a Golden Parachute without shareholder approval. TCM will generally support annual advisory votes on executive compensation.

Limitations

TCM may abstain from voting a proxy if it concludes that the effect on shareholders' economic interests or the value of the portfolio holding is indeterminable or insignificant. TCM may abstain from voting a proxy if it concludes that the cost of voting is disproportionate to the economic impact the vote would have on the portfolio holdings. With respect to certain privately held companies, TCM may not have the opportunity to vote or may have a limitation on its ability to vote. For example, in certain cases a company may be permitted by its charter or other governing documents to take action without a shareholder meeting and with written consent of fewer than all shareholders.

Conflicts of Interest

The Proxy Committee identifies any potential conflicts of interest. Each potential conflict must be addressed in a manner which will be in the best interest of the Funds and their shareholders. If any potential conflict is identified the Proxy Committee consults with the Funds' counsel. Where conflicts of interest arise between clients and TCM, TCM may convene an ad-hoc committee to debate the conflict and to give a ruling on a preferred course of action. If the ad-hoc committee determines that TCM has a conflict of interest in any instance, TCM's CCO shall disclose the conflict to the Board and seek voting instructions.

TCM may cause the proxies to be voted in accordance with the recommendations of an independent third party service provider that TCM may use to assist in voting proxies.

Disclosure

The following disclosure shall be provided in connection with these policies and procedures:

- TCM shall provide a description or a copy of these policies and procedures to the Boards of Trustees of the Funds annually and upon request.
- TCM shall make available to the Funds its proxy voting records, for inclusion on the Funds' Form N-PX.
- TCM shall include its proxy voting policies and procedures in its annual filing on Form N-CSR.
- TCM shall cause the Funds' shareholder reports to include a statement that a copy of these policies and procedures is available upon request (i) by calling a toll-free number; (ii) on the Funds' website, (if the Funds choose); and (iii) on the SEC's website.

- TCM shall cause the Funds' annual and semi-annual reports to include a statement that information is available regarding how the Funds voted proxies during the most recent twelve-month period (i) without charge, upon request, either by calling a toll-free number or on or through the Funds' website, or both; and (ii) on the SEC's website.

Recordkeeping

TCM shall maintain records of proxies voted in accordance with Section 204-2 of the Advisers Act, including proxy statements, a record of each vote cast, and a copy of any document created by TCM that was material to making a decision of how to vote the proxy, or that memorializes the basis for TCM's decision on how to vote the proxy. TCM shall also maintain a copy of its policies and procedures and each written request from a client for proxy voting records and TCM's written response to any client request, either written or oral, for such records. Proxy statements that are filed on EDGAR shall be considered maintained by TCM. All such records shall be maintained for a period of five years in an easily accessible place, the first two years in the offices of TCM.

PART C

OTHER INFORMATION

Item 25. Financial Statements and Exhibits

1. Financial Statements (incorporated by reference to Form N-CSR filed on December 5, 2013):

- (i) Schedule of Investments as of September 30, 2013
- (ii) Statement of Assets and Liabilities as of September 30, 2013
- (iii) Statement of Operations for the fiscal year ended September 30, 2013
- (iv) Statement of Changes in Net Assets as of September 30, 2013
- (v) Statement of Cash Flows as of September 30, 2013
- (vi) Financial Highlights
- (vii) Notes to Financial Statements
- (viii) Report of Independent Public Accountants dated November 25, 2013

2. Exhibits:

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- a. (i) Amended and Restated Declaration of Trust of the Registrant, dated as of April 21, 1987, is incorporated by reference to Exhibit (a) to Registrant's registration statement on Form N-2 (File No. 333-19247), filed July 21, 1997
- (ii) Notice of Change of Trustee, dated June 2, 2003, is incorporated by reference to Exhibit (a)(ii) to Registrant's registration statement on Form N-2 (File No. 333-114322), filed April 8, 2004
- (iii) Notice of Change of Trustee, dated September 20, 2006, is filed herewith
- (iv) Notice of Change of Trustee, dated July 2, 2007, is filed herewith
- (v) Notice of Change of Trustee, dated June 8, 2010, is filed herewith
- (vi) Notice of Change of Trustee, dated June 29, 2011, is filed herewith
- (vii) Amendment Relating to Repurchase of Shares, dated July 8, 2011, is incorporated by reference to Exhibit (a)(iii) from Form N-2/A Registration Statement (File No. 811-04889), filed July 21, 2011
- (viii) Notice of Change of Trustee, dated December 14, 2011, is filed herewith
- (ix) Notice of Change of Trustee, dated May 2, 2012, is filed herewith
- b. By-Laws of the Registrant, as amended, are incorporated by reference to Exhibit (b)(iii) from Form N-2/A Registration Statement (File No. 333-19247), filed December 28, 2012
- c. Not Applicable
- d. (i) Specimen certificate for Shares of Beneficial Interest is incorporated by reference to Exhibit (d)(i) to Registrant's registration statement on Form N-2/A (File No. 333-114322), filed May 26, 2004

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- (ii) Form of Notice of Guaranteed Delivery to be filed by pre-effective amendment

- (iii) Form of Exercise Form to be filed by pre-effective amendment

- (iv) Form of Beneficial Owner Certification to be filed by pre-effective amendment

- e. Dividend Reinvestment Plan of the Registrant dated May 1995 is incorporated by reference to Exhibit (e) to Registrant's registration statement on Form N-2 (File No. 333-19247), filed January 3, 1997

- f. Not Applicable

- g. Investment Advisory Agreement, dated as of July 1, 2009, between the Registrant and Tekla Capital Management LLC (formerly known as Hambrecht & Quist Capital Management, LLC), is filed herewith

- h. Not Applicable

- i. Not Applicable

- j. Custodian Agreement, dated September 30, 2004, between the Registrant and State Street Bank and Trust Company, is filed herewith

- k. (i) Administration Agreement between Registrant and State Street Bank and Trust Company, dated as of July 1, 2005, is filed herewith

- (ii) Transfer Agency and Service Agreement between Registrant, Computershare Trust Company, N.A. and Computershare Shareholder Services, Inc. (formerly known as EquiServe, Inc.), dated as of March 1, 2006 is filed herewith

- (iii) Information Agent Agreement between the Registrant and [] to be filed by pre-effective amendment

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(iv) Subscription Agent Agreement between the Registrant and [] dated [] to be filed by pre-effective amendment

l. Opinion and Consent of Dechert LLP to be filed by pre-effective amendment

m. Not Applicable

n. (i) Consent of Deloitte and Touch LLP is filed herewith

n. (ii) Powers of Attorney are filed herewith

o. Not Applicable

p. Not Applicable

q. Not Applicable

r. Code of Ethics of Registrant and its Investment Adviser is filed herewith

Item 26. Marketing Arrangements

Not Applicable

Item 27. Other Expenses of Issuance and Distribution

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

Information Agent Fees and Expenses	\$	15,000
Printing and mailing	\$	160,000
Legal Fees and Expenses	\$	300,000
Auditing Fees and Expenses	\$	5,000
New York Stock Exchange Listing Fees	\$	22,000
Subscription Agent Fees and Expenses	\$	28,000
Securities and Exchange Commission Filing Fees	\$	15,000
Miscellaneous	\$	5,000
Total	\$	535,000

Item 28. Persons Controlled by or under Common Control with Registrant

Not Applicable

Item 29. Number of Holders of Securities

As of March 31, 2014, the number of record holders of each class of securities of Registrant was as follows:

Title of Class	Number of Record Holders
Shares of beneficial interest, \$.01 par value	456

Item 30. Indemnification

Under Article V of the Registrant's Amended and Restated Declaration of Trust dated April 21, 1987, as amended, any past or present Trustee or officer of Registrant will be indemnified by the Registrant to the fullest extent permitted by law against liability and against all expenses reasonably incurred by him in connection with any claim, action, suit or proceeding in which he becomes involved as a party or otherwise by reason of his being or having been a Trustee or officer of Registrant, and against amounts paid and incurred by him in the settlement thereof. This provision does not authorize indemnification when it is determined, in the manner specified in the Amended and Restated Declaration of Trust, that the Trustee or officer would otherwise be liable to Registrant or its shareholders by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of his duties. Expenses of a Trustee or officer may be paid by Registrant in advance of the final disposition of any claim, action, suit or proceeding upon receipt of an undertaking by the Trustee or officer to repay the expenses to Registrant in the event that it is ultimately determined that indemnification of the Trustee or officer is not authorized under the Amended and Restated Declaration of Trust.

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The Registrant will purchase insurance insuring its Trustees and officers against certain liabilities incurred in their capacity as such, and insuring the Registrant against any payments which it is obligated to make to such persons under the foregoing indemnification provisions.

Insofar as indemnification for liability arising under the Securities Act of 1933, as amended (" 1933 Act "), may be permitted to Trustees, officers and controlling persons of the Registrant pursuant to the foregoing provisions, or otherwise, the Registrant has been advised that, in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the 1933 Act, and is, therefore, unenforceable. In the event

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that a claim for indemnification against such liabilities (other than the payment by the Registrant of expenses incurred or paid by a Trustee, officer or controlling person of the Registrant in the successful defense of any action, suit or proceeding) is asserted by such Trustee, officer or controlling person in connection with the securities being registered, the Registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the 1933 Act and will be governed by the final adjudication of such issue.

Under the Investment Advisory Agreement between the Registrant and Hambrecht & Quist Capital Management, LLC (the Investment Adviser) dated July 1, 2002, the Registrant has agreed to certain limitations on the liability of the Investment Adviser and has agreed to provide certain indemnification. Section 9 of the Investment Advisory Agreement provides as follows:

The Investment Adviser shall not be held responsible for any loss incurred by any act or omission of any broker. The Investment Adviser also shall not be liable to the Fund or to any shareholder of the Fund for any error or judgment or for any loss suffered by the Fund in connection with rendering services hereunder except (a) a loss resulting from a breach of fiduciary duty with respect to the receipt of compensation for services (in which case any award of damages shall be limited to the period and the amount set forth in Section 36(b)(3) of the [Investment Company Act of 1940]) or (b) a loss resulting from willful misfeasance, bad faith or gross negligence on the part of the Investment Adviser, or reckless disregard of its obligations and duties hereunder. Subject to the foregoing, the Fund also shall indemnify the Investment Adviser, and any officer, director and employee thereof to the maximum extent permitted by Article V of the Fund's Declaration of Trust.

Item 31. Business and Other Connections of Investment Adviser

Tekla Capital Management LLC was organized in June 2002 for the purpose of providing investment advisory services to H&Q Healthcare Investors and H&Q Life Sciences Investors (File Nos. 811-04889 and 811-06565). Reference is made to Trustees and Officers in the Statement of Additional Information and to Schedule A of Part 1 of Form ADV, Uniform Application for Investment Adviser Registration, as amended from time to time, (File No. 801-61018) filed with the Commission for information concerning the business and other connections of Daniel R. Omstead, Eng.ScD., Trustee and President of the Trust and President and CEO of the Investment Adviser.

Item 32. Location of Accounts and Records

Records are located at:

1. Tekla Capital Management LLC
2 Liberty Square, 9th Floor
Boston, MA 02109

(Registrant's corporate records and records relating to its function as Investment Adviser to Registrant)

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2. State Street Bank and Trust Company
200 Newport Avenue
North Quincy, MA 02171

(Records relating to its function as Custodian to Registrant; and most of Registrant's accounting and all records relating to its function as Registrant's accounting agent)

3. State Street Bank and Trust Company

100 Huntington Avenue

Boston, MA 02116

(Records relating to its function as Administrator to Registrant)

4. Computershare Trust Company, N.A.
250 Royall Street
Canton, MA 02021

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(Records relating to its function as Registrar and Transfer Agent to Registrant)

5. Computershare Inc.
250 Royall Street
Canton, MA 02021

(Records relating to its function as Dividend Disbursing Agent to Registrant)

Item 33. Management Service

Not Applicable

Item 34. Undertakings

1. Registrant hereby undertakes to suspend offering of the shares covered hereby until it amends its prospectus contained herein if (1) subsequent to the effective date of this Registration Statement, its net asset value per share declines more than 10 percent from its net asset value per share as of the effective date of this Registration Statement, or (2) its net asset value increases to an amount greater than its net proceeds as stated in such prospectus.

2. Not Applicable.

3. Not Applicable.

4. Not Applicable.

5. (a) For the purpose of determining any liability under the Securities Act, the information omitted from the form of prospectus filed as part of this Registration Statement in reliance upon Rule 430A and contained in a form of prospectus filed by the Registrant under Rule 497(h) under the Securities Act shall be deemed to be part of this Registration Statement as of the time it was declared effective; and (b) Registrant hereby undertakes that for the purposes of determining any liability under the Securities Act of 1933, each post-effective amendment that contains a form of prospectus shall be deemed to be a new Registration Statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

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

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SIGNATURES

Pursuant to the requirements of the Securities Act of 1933 and the Investment Company Act of 1940, the Registrant has duly caused this Pre-Effective Amendment No. 2 to its Registration Statement on Form N-2 to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Boston and Commonwealth of Massachusetts on the 16th day of April, 2014.

H&Q HEALTHCARE INVESTORS

By: /s/ Daniel R. Omstead
Daniel R. Omstead, President

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed by the following persons in the capacities and on the dates indicated:

Signature	Title	Date
/s/ Daniel R. Omstead Daniel R. Omstead	Trustee and President (Principal Executive Officer)	April 16, 2014
/s/ Laura Woodward Laura Woodward	Treasurer (Principal Financial Officer)	April 16, 2014
/s/ Oleg M. Pohotsky* Oleg M. Pohotsky	Trustee and Chairman of the Board	April 16, 2014
/s/ Michael W. Bonney* Michael W. Bonney	Trustee	April 16, 2014
/s/ Rakesh K. Jain* Rakesh K. Jain	Trustee	April 16, 2014
/s/ William S. Reardon* William S. Reardon	Trustee	April 16, 2014
/s/ Uwe E. Reinhardt* Uwe E. Reinhardt	Trustee	April 16, 2014
/s/ Lucinda H. Stebbins* Lucinda H. Stebbins	Trustee	April 16, 2014

*By: Daniel R. Omstead as attorney-in-fact of each person so indicated and pursuant to the power of attorney filed herewith.