

HARRIS & HARRIS GROUP INC /NY/
Form 10-Q
November 07, 2008

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

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2008

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

For the transition period from _____ to _____

Commission file number: 0-11576

HARRIS & HARRIS GROUP, INC.
(Exact Name of Registrant as Specified in Its Charter)

New York
(State or Other Jurisdiction of
Incorporation or Organization)

13-3119827
(I.R.S. Employer Identification No.)

111 West 57th Street, New York, New York
(Address of Principal Executive Offices)

10019
(Zip Code)

(212) 582-0900
(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 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. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

Edgar Filing: HARRIS & HARRIS GROUP INC /NY/ - Form 10-Q

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

Class	Outstanding at November 7, 2008
Common Stock, \$0.01 par value per share	25,859,573 shares

Harris & Harris Group, Inc.
Form 10-Q, September 30, 2008

Page Number

PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements 1

Consolidated Statements of Assets and Liabilities 2

Consolidated Statements of Operations 3

Consolidated Statements of Cash Flows 4

Consolidated Statements of Changes in Net Assets 5

Consolidated Schedule of Investments 6

Notes to Consolidated Financial Statements 21

Financial Highlights 32

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations 33

Background and Overview 33

Results of Operations 37

Financial Condition 42

Liquidity 44

Capital Resources 45

Critical Accounting Policies 45

Recent Developments - Other 48

Recent Developments - Portfolio Companies 48

Forward-Looking Statements 48

Item 3. Quantitative and Qualitative Disclosures About Market Risk 49

Item 4. Controls and Procedures 51

PART II. OTHER INFORMATION

Item 1A. Risk Factors 52

Item 6. Exhibits 54

Signatures 55

Exhibit Index 56

PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

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

Harris & Harris Group, Inc.[®] (the "Company," "us," "our" and "we"), is an internally managed venture capital company that has elected to operate as a business development company under the Investment Company Act of 1940 (the "1940 Act"). Certain information and disclosures normally included in the consolidated financial statements in accordance with Generally Accepted Accounting Principles have been condensed or omitted as permitted by Regulation S-X and Regulation S-K. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2007, contained in our Annual Report on Form 10-K for the year ended December 31, 2007.

On September 25, 1997, our Board of Directors approved a proposal to seek qualification as a regulated investment company ("RIC") under Subchapter M of the Internal Revenue Code (the "Code"). At that time, we were taxable under Subchapter C of the Code (a "C Corporation"). We filed for the 1999 tax year to elect treatment as a RIC. In order to qualify as a RIC, we must, in general, (1) annually, derive at least 90 percent of our gross income from dividends, interest, gains from the sale of securities and similar sources; (2) quarterly, meet certain investment diversification requirements; and (3) annually, distribute at least 90 percent of our investment company taxable income as a dividend. In addition to the requirement that we must annually distribute at least 90 percent of our investment company taxable income, we may either distribute or retain our taxable net capital gains from investments, but any net capital gains not distributed could be subject to corporate level tax. Further, we could be subject to a four percent excise tax to the extent we fail to distribute at least 98 percent of our annual investment company taxable income and would be subject to income tax to the extent we fail to distribute 100 percent of our investment company taxable income.

Because of the specialized nature of our investment portfolio, we generally can satisfy the diversification requirements under Subchapter M of the Code if we receive a certification from the Securities and Exchange Commission ("SEC") that we are "principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available."

On May 30, 2008, we received SEC certification for 2007, permitting us to qualify for RIC treatment for 2007 (as we had for the years 1999 through 2006) pursuant to Section 851(e) of the Code. Although the SEC certification for 2007 was issued, there can be no assurance that we will qualify for or receive such certification for subsequent years (to the extent we need additional certification as a result of changes in our portfolio) or that we will actually qualify for Subchapter M treatment in subsequent years. In 2007, we qualified for RIC treatment even without certification. In addition, under certain circumstances, even if we qualified for Subchapter M treatment in a given year, we might take action in a subsequent year to ensure that we would be taxed in that subsequent year as a C Corporation, rather than as a RIC. Because Subchapter M does not permit deduction of operating expenses against long-term capital gains, it is not clear that the Company and its shareholders have paid less taxes since 1999 than they would have paid had the Company remained a C Corporation.

HARRIS & HARRIS GROUP, INC. CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES

ASSETS

	September 30, 2008 (Unaudited)	December 31, 2007
Investments, in portfolio securities at value (cost: \$87,913,862 and \$82,677,528, respectively)	\$ 63,942,445	\$ 78,110,384
Investments, in U.S. Treasury obligations at value (cost: \$56,206,231 and \$59,552,933, respectively)	57,032,781	60,193,593
Cash and cash equivalents	937,914	330,009
Restricted funds (Note 9)	124,664	2,667,020
Receivable from portfolio company	0	524
Interest receivable	463,732	647,337
Prepaid expenses	148,515	488,667
Other assets	426,449	455,798
Total assets	\$ 123,076,500	\$ 142,893,332

LIABILITIES & NET ASSETS

Accounts payable and accrued liabilities (Note 9)	\$ 1,953,125	\$ 4,515,463
Deferred rent	9,715	14,525
Total liabilities	1,962,840	4,529,988
Net assets	\$ 121,113,660	\$ 138,363,344

Net assets are comprised of:

Preferred stock, \$0.10 par value, 2,000,000 shares authorized; none issued	\$ 0	\$ 0
Common stock, \$0.01 par value, 45,000,000 shares authorized at 9/30/08 and 12/31/07; 27,688,313 issued at 9/30/08 and 25,143,313 issued at 12/31/07	276,884	251,434
Additional paid in capital (Note 7)	179,619,630	160,927,691
Accumulated net realized loss	(32,232,456)	(15,483,766)
Accumulated unrealized depreciation of investments	(23,144,867)	(3,926,484)
Treasury stock, at cost (1,828,740 shares at 9/30/08 and 12/31/07)	(3,405,531)	(3,405,531)

Edgar Filing: HARRIS & HARRIS GROUP INC /NY/ - Form 10-Q

Net assets	\$	121,113,660	\$	138,363,344
Shares outstanding		25,859,573		23,314,573
Net asset value per outstanding share	\$	4.68	\$	5.93

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

2

HARRIS & HARRIS GROUP, INC. CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

	Three Months Ended Sept. 30		Nine Months Ended Sept. 30	
	2008	2007	2008	2007
Investment income:				
Interest from:				
Fixed-income securities	\$ 585,418	\$ 743,375	\$ 1,626,176	\$ 2,033,574
Miscellaneous income	2,500	39	5,669	39
Total investment income	587,918	743,414	1,631,845	2,033,613
Expenses:				
Salaries, benefits and stock-based compensation (Note 5)	2,205,980	3,230,838	7,101,077	8,409,888
Administration and operations	252,884	311,332	838,100	1,049,375
Professional fees	138,461	155,999	478,559	673,261
Rent	80,358	60,314	197,960	178,634
Directors' fees and expenses	79,318	80,364	263,633	333,717
Depreciation	13,447	16,734	41,251	47,955
Custodian fees	14,209	5,428	26,905	17,163
Total expenses	2,784,657	3,861,009	8,947,485	10,709,993
Net operating loss	(2,196,739)	(3,117,595)	(7,315,640)	(8,676,380)
Net realized (loss) gain from investments:				
Realized (loss) gain from investments	(4,373,124)	14,828	(9,384,082)	5,941
Income tax expense (Note 6)	2,102	4,083	48,968	88,988
Net realized (loss) gain from investments	(4,375,226)	10,745	(9,433,050)	(83,047)
Net (increase) decrease in unrealized depreciation on investments:				
Change as a result of investment sales	4,278,500	0	9,293,153	0
Change on investments held	(31,739,282)	3,711,087	(28,511,536)	(1,120,140)
Net (increase) decrease in unrealized depreciation on investments	(27,460,782)	3,711,087	(19,218,383)	(1,120,140)
Net (decrease) increase in net assets resulting from operations	\$ (34,032,747)	\$ 604,237	\$ (35,967,073)	\$ (9,879,567)
Per average basic and diluted	\$ (1.32)	\$ 0.03	\$ (1.48)	\$ (0.45)

outstanding share

Average outstanding shares	25,859,573	23,235,023	24,271,270	22,084,893
----------------------------	------------	------------	------------	------------

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

3

HARRIS & HARRIS GROUP, INC. CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Cash flows used in operating activities:		
Net decrease in net assets resulting from operations	\$ (35,967,073)	\$ (9,879,567)
Adjustments to reconcile net decrease in net assets resulting from operations to net cash used in operating activities:		
Net realized and unrealized loss on investments	28,602,465	1,114,199
Depreciation of fixed assets, amortization of premium or discount on U.S. government securities, and bridge note interest	(160,283)	31,425
Stock-based compensation expense	4,333,892	5,725,031
Changes in assets and liabilities:		
Restricted funds	2,542,356	(384,144)
Receivable from portfolio company	524	(5,000)
Receivable from broker	0	819,905
Interest receivable	213,520	126,292
Income tax receivable	0	7,209
Prepaid expenses	340,152	(131,514)
Other assets	1,619	25,630
Accounts payable and accrued liabilities	(2,562,338)	122,356
Accrued profit sharing	0	(261,661)
Deferred rent	(4,810)	(5,101)
Net cash used in operating activities	(2,659,976)	(2,694,940)
Cash flows from investing activities:		
Purchase of U.S. government securities	(75,932,334)	(60,744,292)
Sale of U.S. government securities	79,326,692	56,454,594
Investment in private placements and notes	(14,635,185)	(17,480,885)
Proceeds from sale of private placements and notes	140,257	51,669
Purchase of fixed assets	(15,046)	(36,367)
Net cash used in investing activities	(11,115,616)	(21,755,281)
Cash flows from financing activities:		
Proceeds from stock option exercises (Note 5)	0	9,673,662
Proceeds from stock offering (Note 7)	14,383,497	12,993,168
Net cash provided by financing activities	14,383,497	22,666,830
Net increase (decrease) in cash and cash equivalents:		
Cash and cash equivalents at beginning of the period	330,009	2,071,788
Cash and cash equivalents at end of the period	937,914	288,397

Net increase (decrease) in cash and cash equivalents	\$	607,905	\$	(1,783,391)
------------------------------------------------------	----	---------	----	-------------

Supplemental disclosures of cash flow information:

Income taxes paid	\$	48,427	\$	87,920
-------------------	----	--------	----	--------

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

HARRIS & HARRIS GROUP, INC. CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

	Nine Months Ended September 30, 2008 (Unaudited)	Year Ended December 31, 2007
Changes in net assets from operations:		
Net operating loss	\$ (7,315,640)	\$ (11,827,543)
Net realized (loss) gain on investments	(9,433,050)	30,162
Net decrease in unrealized depreciation on investments sold	9,293,153	0
Net (increase) decrease in unrealized depreciation on investments held	(28,511,536)	5,080,936
Net decrease in net assets resulting from operations	(35,967,073)	(6,716,445)
Changes in net assets from capital stock transactions:		
Issuance of common stock upon the exercise of stock options	0	9,996
Issuance of common stock on offering	25,450	13,000
Additional paid-in capital on common stock issued	14,358,047	23,075,683
Stock-based compensation expense	4,333,892	8,050,807
Net increase in net assets resulting from capital stock transactions	18,717,389	31,149,486
Net (decrease) increase in net assets	(17,249,684)	24,433,041
Net assets:		
Beginning of the period	138,363,344	113,930,303
End of the period	\$ 121,113,660	\$ 138,363,344

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

HARRIS & HARRIS GROUP, INC. CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008 (Unaudited)

	Method of Valuation (1)	Shares/ Principal	Value
Investments in Unaffiliated Companies (2)(3) - 13.7% of net assets at value			
Private Placement Portfolio (Illiquid) - 13.7% of net assets at value			
BioVex Group, Inc. (4)(5)(6)(7) -- Developing novel biologics for treatment of cancer and infectious disease			
Series E Convertible Preferred Stock	(M)	2,799,552	\$ 1,250,000
D-Wave Systems, Inc. (4)(5)(6)(8) -- Developing high-performance quantum computing systems			
Series B Convertible Preferred Stock	(M)	1,144,869	1,199,212
Series C Convertible Preferred Stock	(M)	450,450	471,831
Series D Convertible Preferred Stock	(M)	1,533,395	1,606,181
			3,277,224
Exponential Business Development Company (4)(5) - Venture capital partnership focused on early stage companies			
Limited Partnership Interest	(M)	1	2,219
Molecular Imprints, Inc. (4)(5) -- Manufacturing nanoimprint lithography capital equipment			
Series B Convertible Preferred Stock	(M)	1,333,333	1,029,693
Series C Convertible Preferred Stock	(M)	1,250,000	965,337
Warrants at \$2.00 expiring 12/31/11	(I)	125,000	36,875
			2,031,905
Nanosys, Inc. (4)(5) -- Developing zero and one-dimensional inorganic nanometer-scale materials and devices			
Series C Convertible Preferred Stock	(M)	803,428	2,370,113
Series D Convertible Preferred Stock	(M)	1,016,950	3,000,003
			5,370,116
Nantero, Inc. (4)(5)(6) -- Developing a high-density, nonvolatile, random access memory chip, enabled by carbon nanotubes			
Series A Convertible Preferred Stock	(M)	345,070	1,046,908
Series B Convertible Preferred Stock	(M)	207,051	628,172
Series C Convertible Preferred Stock	(M)	188,315	571,329

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

HARRIS & HARRIS GROUP, INC. CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008 (Unaudited)

	Method of Valuation (1)	Shares/ Principal	Value
Investments in Unaffiliated Companies (2)(3) - 13.7% of net assets at value (cont.)			
Private Placement Portfolio (Illiquid) - 13.7% of net assets at value (cont.)			
NeoPhotonics Corporation (4)(5) -- Developing and manufacturing optical devices and components			
Common Stock	(M)	716,195	\$ 93,106
Series 1 Convertible Preferred Stock	(M)	1,831,256	613,941
Series 2 Convertible Preferred Stock	(M)	741,898	243,932
Series 3 Convertible Preferred Stock	(M)	2,750,000	904,184
Series X Convertible Preferred Stock	(M)	2,000	400,000
Warrants at \$0.15 expiring 01/26/10	(I)	16,364	884
Warrants at \$0.15 expiring 12/05/10	(I)	14,063	760
			2,256,807
Polatis, Inc. (4)(5)(6)(9) -- Developing MEMS-based optical networking components			
Series A-1 Convertible Preferred Stock	(M)	16,775	0
Series A-2 Convertible Preferred Stock	(M)	71,611	0
Series A-4 Convertible Preferred Stock	(M)	4,774	0
Series A-5 Convertible Preferred Stock	(M)	16,438	0
			0
PolyRemedy, Inc. (4)(5)(6)(10) --Developing a robotic manufacturing platform for wound treatment patches			
Series B-1 Convertible Preferred Stock	(M)	287,647	122,250
Starfire Systems, Inc. (4)(5) -- Producing ceramic-forming polymers			
Common Stock	(M)	375,000	0
Series A-1 Convertible Preferred Stock	(M)	600,000	0
			0
Total Unaffiliated Private Placement Portfolio (cost: \$24,854,430)			\$ 16,556,930
Total Investments in Unaffiliated Companies (cost: \$24,854,430)			\$ 16,556,930

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

HARRIS & HARRIS GROUP, INC. CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008 (Unaudited)

	Method of Valuation (1)	Shares/ Principal	Value
Investments in Non-Controlled Affiliated Companies			
(2)(11) -			
33.9% of net assets at value			
Private Placement Portfolio (Illiquid) - 33.9% of net assets at value			
Adesto Technologies Corporation (4)(5)(6) -- Developing semiconductor-related products enabled at the nanoscale			
Series A Convertible Preferred Stock	(M)	6,547,619	\$ 1,100,000
Ancora Pharmaceuticals, Inc. (4)(5)(6) -- Developing synthetic carbohydrates for pharmaceutical applications			
Series B Convertible Preferred Stock	(M)	1,663,808	1,200,000
BridgeLux, Inc. (4)(5)(12) -- Manufacturing high-power light emitting diodes			
Series B Convertible Preferred Stock	(M)	1,861,504	2,792,256
Series C Convertible Preferred Stock	(M)	2,130,699	3,196,050
Series D Convertible Preferred Stock	(M)	666,667	1,000,001
Warrants at \$0.7136 expiring 02/02/17	(I)	98,340	137,184
Warrants at \$0.7136 expiring 04/26/17	(I)	65,560	91,784
			7,217,275
Cambrios Technologies Corporation (4)(5)(6) -- Developing nanowire-enabled electronic materials for the display industry			
Series B Convertible Preferred Stock	(M)	1,294,025	647,013
Series C Convertible Preferred Stock	(M)	1,300,000	650,000
			1,297,013

CFX Battery, Inc. (4)(5)(6)(13) -- Developing batteries
using

nanostructured materials

Series A Convertible Preferred Stock	(M)	1,208,262	946,528
--------------------------------------	-----	-----------	---------

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

8

HARRIS & HARRIS GROUP, INC. CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008 (Unaudited)

	Method of Valuation (1)	Shares/ Principal	Value
Investments in Non-Controlled Affiliated Companies			
(2)(10) -			
33.9% of net assets at value (cont.)			
Private Placement Portfolio (Illiquid) - 33.9% of net assets at value (cont.)			
Crystal IS, Inc. (4)(5) -- Developing single-crystal aluminum nitride substrates for optoelectronic devices			
Series A Convertible Preferred Stock	(M)	391,571 \$	76,357
Series A-1 Convertible Preferred Stock	(M)	1,300,376	253,574
Warrants at \$0.78 expiring 05/05/13	(I)	15,231	4,006
Warrants at \$0.78 expiring 05/12/13	(I)	2,350	618
Warrants at \$0.78 expiring 08/08/13	(I)	4,396	1,187
			335,742
CSwitch Corporation (4)(5)(6)(14) -- Developing next-generation, system-on-a-chip solutions for communications-based platforms			
Series A-1 Convertible Preferred Stock	(M)	6,863,118	0
Unsecured Convertible Bridge Note (including interest)	(M) \$	1,581,202	493,411
			493,411
Ensemble Discovery Corporation (4)(5)(6)(15) -- Developing DNA Programmed Chemistry for the discovery of new classes of therapeutics and bioassays			
Series B Convertible Preferred Stock	(M)	1,449,275	1,000,000
Unsecured Convertible Bridge Note (including interest)	(M)	251,328	251,328
			1,251,328
Innovalight, Inc. (4)(5)(6) -- Developing solar power products enabled by silicon-based nanomaterials			
Series B Convertible Preferred Stock	(M)	16,666,666	4,288,662
Series C Convertible Preferred Stock	(M)	5,810,577	1,495,176
			5,783,838

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

HARRIS & HARRIS GROUP, INC. CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008 (Unaudited)

	Method of Valuation (1)	Shares/ Principal	Value
Investments in Non-Controlled Affiliated Companies			
(2)(10) -			
33.9% of net assets at value (cont.)			
Private Placement Portfolio (Illiquid) - 33.9% of net assets at value (cont.)			
Kereos, Inc. (4)(5)(6) -- Developing emulsion-based imaging agents and targeted therapeutics to image and treat cancer and cardiovascular disease			
Series B Convertible Preferred Stock	(M)	545,456	\$ 0
Kovio, Inc. (4)(5)(6) -- Developing semiconductor products using printed electronics and thin-film technologies			
Series C Convertible Preferred Stock	(M)	2,500,000	3,125,000
Series D Convertible Preferred Stock	(M)	800,000	1,000,000
			4,125,000
Mersana Therapeutics, Inc. (4)(5)(6)(16) -- Developing advanced polymers for drug delivery			
Series A Convertible Preferred Stock	(M)	68,451	68,451
Series B Convertible Preferred Stock	(M)	866,500	866,500
Warrants at \$2.00 expiring 10/21/10	(I)	91,625	37,658
Unsecured Convertible Bridge Note (including interest)	(M)	203,068	203,068
			1,175,677
Metabolon, Inc. (4)(5) -- Discovering biomarkers through the use of metabolomics			
Series B Convertible Preferred Stock	(M)	2,173,913	882,768
Series B-1 Convertible Preferred Stock	(M)	869,565	353,107
Warrants at \$1.15 expiring 3/25/15	(I)	434,783	131,739
			1,367,614

NanoGram Corporation (4)(5) -- Developing solar power products

enabled by silicon-based nanomaterials

Series I Convertible Preferred Stock	(M)	63,210	62,262
Series II Convertible Preferred Stock	(M)	1,250,904	1,232,141
Series III Convertible Preferred Stock	(M)	1,242,144	1,223,512
Series IV Convertible Preferred Stock	(M)	432,179	425,696
			2,943,611

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

HARRIS & HARRIS GROUP, INC. CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008 (Unaudited)

	Method of Valuation (1)	Shares/ Principal	Value
Investments in Non-Controlled Affiliated Companies			
(2)(10) -			
33.9% of net assets at value (cont.)			
Private Placement Portfolio (Illiquid) - 33.9% of net assets at value (cont.)			
Nanomix, Inc. (4)(5) -- Producing nanoelectronic sensors that integrate carbon nanotube electronics with silicon microstructures			
Series C Convertible Preferred Stock	(M)	977,917 \$	23,622
Series D Convertible Preferred Stock	(M)	6,802,397	6,428
			30,050
Nextreme Thermal Solutions, Inc. (4)(5) -- Developing thin-film thermoelectric devices for cooling and energy conversion			
Series A Convertible Preferred Stock	(M)	1,750,000	875,000
Series B Convertible Preferred Stock	(M)	4,870,244	1,327,629
			2,202,629
Questech Corporation (4)(5) -- Manufacturing and marketing proprietary metal and stone decorative tiles			
Common Stock	(M)	655,454	193,846
Warrants at \$1.50 expiring 11/19/08	(I)	5,000	0
Warrants at \$1.50 expiring 11/19/09	(I)	5,000	125
			193,971
Siluria Technologies, Inc. (4)(5)(6) -- Developing next-generation nanomaterials			
Series S-2 Convertible Preferred Stock	(M)	482,218	40,181
Solazyme, Inc. (4)(5)(6) -- Developing algal biodiesel, industrial			

chemicals and special ingredients based on synthetic
biology

Series A Convertible Preferred Stock	(M)	988,204	2,489,088
Series B Convertible Preferred Stock	(M)	495,246	1,247,426
Series C Convertible Preferred Stock	(M)	651,309	1,640,517
			5,377,031

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

HARRIS & HARRIS GROUP, INC. CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008 (Unaudited)

	Method of Valuation (1)	Shares/ Principal	Value
Investments in Non-Controlled Affiliated Companies			
(2)(10) -			
33.9% of net assets at value (cont.)			
Private Placement Portfolio (Illiquid) - 33.9% of net assets at value (cont.)			
Xradia, Inc. (4)(5) -- Designing, manufacturing and selling ultra-high resolution 3D x-ray microscopes and fluorescence imaging systems			
Series D Convertible Preferred Stock	(M)	3,121,099	\$ 4,000,000
Total Non-Controlled Private Placement Portfolio (cost: \$56,974,432)			\$ 41,080,899
Total Investments in Non-Controlled Affiliated Companies (cost: \$56,974,432)			\$ 41,080,899

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

HARRIS & HARRIS GROUP, INC. CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008 (Unaudited)

	Method of Valuation (1)	Shares/ Principal	Value
Investments in Controlled Affiliated Companies			
(2)(17) -			
5.2% of net assets at value			
Private Placement Portfolio (Illiquid) - 5.2% of net assets at value			
Laser Light Engines, Inc. (4)(5)(6)(10) -- Manufacturing solid-state light sources for digital cinema and large-venue projection displays			
Series A Convertible Preferred Stock	(M)	7,499,062	2,000,000
SiOnyx, Inc. (4)(5)(6) -- Developing silicon-based optoelectronic products enabled by its proprietary "Black Silicon"			
Series A Convertible Preferred Stock	(M)	233,499	135,686
Series A-1 Convertible Preferred Stock	(M)	2,966,667	1,723,930
Series A-2 Convertible Preferred Stock	(M)	4,207,537	2,445,000
			4,304,616
Total Controlled Private Placement Portfolio (cost: \$6,085,000)			\$ 6,304,616
Total Investments in Controlled Affiliated Companies (cost: \$6,085,000)			\$ 6,304,616
Total Private Placement Portfolio (cost: \$87,913,862)			\$ 63,942,445

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

HARRIS & HARRIS GROUP, INC. CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008 (Unaudited)

	Method of Valuation (1)	Shares/ Principal	Value
U.S. Government and Agency Securities (18) - 47.1%			
of net assets at value			
U.S. Treasury Bill -- due date 02/12/09	(M)	\$ 4,495,000	\$ 4,477,200
U.S. Treasury Notes -- due date 01/15/09, coupon 3.25%	(M)	3,000,000	3,020,640
U.S. Treasury Notes -- due date 02/15/09, coupon 4.50%	(M)	5,100,000	5,158,956
U.S. Treasury Notes -- due date 04/15/09, coupon 3.125%	(M)	3,000,000	3,024,840
U.S. Treasury Notes -- due date 07/15/09, coupon 3.625%	(M)	3,000,000	3,041,940
U.S. Treasury Notes -- due date 10/15/09, coupon 3.375%	(M)	3,000,000	3,046,410
U.S. Treasury Notes -- due date 01/15/10, coupon 3.625%	(M)	3,000,000	3,068,430
U.S. Treasury Notes -- due date 04/15/10, coupon 4.00%	(M)	3,000,000	3,097,980
U.S. Treasury Notes -- due date 06/30/10, coupon 2.875%	(M)	1,250,000	1,270,600
U.S. Treasury Notes -- due date 07/15/10, coupon 3.875%	(M)	3,000,000	3,108,060
U.S. Treasury Notes -- due date 09/15/10, coupon 3.875%	(M)	2,000,000	2,077,500
U.S. Treasury Notes -- due date 10/15/10, coupon 4.25%	(M)	2,000,000	2,092,660
U.S. Treasury Notes -- due date 12/15/10, coupon 4.375%	(M)	2,000,000	2,102,040
U.S. Treasury Notes -- due date 03/31/11, coupon 4.750%	(M)	2,000,000	2,131,560
U.S. Treasury Notes -- due date 06/30/11, coupon 5.125%	(M)	2,000,000	2,157,960
U.S. Treasury Notes -- due date 09/30/11, coupon 4.500%	(M)	2,000,000	2,126,400
U.S. Treasury Notes -- due date 12/31/11, coupon 4.625%	(M)	2,000,000	2,133,600
U.S. Treasury Notes -- due date 10/31/12, coupon 3.875%	(M)	2,000,000	2,091,880
U.S. Treasury Notes -- due date 02/15/13, coupon 3.875%	(M)	7,500,000	7,804,125
Total Investments in U.S. Government and Agency Securities (cost: \$56,206,231)			\$ 57,032,781

Total Investments (cost: \$144,120,093)	\$ 120,975,226
------------------------------------------------	-----------------------

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

HARRIS & HARRIS GROUP, INC.
CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008
(Unaudited)

Notes to Consolidated Schedule of Investments

- (1) See Footnote to Consolidated Schedule of Investments on page 17 for a description of the Valuation Procedures.
- (2) Investments in unaffiliated companies consist of investments in which we own less than five percent of the voting shares of the portfolio company. Investments in non-controlled affiliated companies consist of investments in which we own five percent or more, but less than 25 percent, of the voting shares of the portfolio company, or where we hold one or more seats on the portfolio company's Board of Directors but do not control the company. Investments in controlled affiliated companies consist of investments in which we own 25 percent or more of the voting shares of the portfolio company or otherwise control the company.
- (3) The aggregate cost for federal income tax purposes of investments in unaffiliated companies is \$24,854,430. The gross unrealized appreciation based on the tax cost for these securities is \$2,035,048. The gross unrealized depreciation based on the tax cost for these securities is \$10,332,548.
- (4) Legal restrictions on sale of investment.
- (5) Represents a non-income producing security. Equity investments that have not paid dividends within the last 12 months are considered to be non-income producing.
- (6) These investments are development stage companies. A development stage company is defined as a company that is devoting substantially all of its efforts to establishing a new business, and either it has not yet commenced its planned principal operations, or it has commenced such operations but has not realized significant revenue from them.
- (7) With our purchase of Series E Convertible Preferred Stock of BioVex, we received a warrant to purchase a number of shares of common stock of BioVex as determined by dividing 624,999.99 by the price per share at which the common stock is offered and sold to the public in connection with the initial public offering. The ability to exercise this warrant is therefore contingent on BioVex completing successfully an initial public offering before the expiration date of the warrant on September 27, 2012. The exercise price of this warrant shall be 110 percent of the initial public offering price.
- (8) D-Wave Systems, Inc., is located and is doing business primarily in Canada. We invested in D-Wave Systems, Inc., through D-Wave USA, a Delaware company. Our investment is denominated in Canadian dollars and is subject to foreign currency translation. See "Note 3. Summary of Significant Accounting Policies."

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

HARRIS & HARRIS GROUP, INC.
CONSOLIDATED SCHEDULE OF INVESTMENTS AS OF SEPTEMBER 30, 2008
(Unaudited)

- (9) Continuum Photonics, Inc., merged with Polatis, Ltd., to form Polatis, Inc.
- (10) Initial investment was made during 2008.
- (11) The aggregate cost for federal income tax purposes of investments in non-controlled affiliated companies is \$56,974,432. The gross unrealized appreciation based on the tax cost for these securities is \$6,545,710. The gross unrealized depreciation based on the tax cost for these securities is \$22,439,243.
- (12) BridgeLux, Inc., was previously named eLite Optoelectronics, Inc.
- (13) On February 28, 2008, Lifco, Inc., merged with CFX Battery, Inc. The surviving entity is CFX Battery, Inc.
- (14) With our investments in secured convertible bridge notes issued by CSwitch, we received two warrants to purchase a number of shares of the class of stock sold in the next financing of CSwitch equal to \$529,322 and \$985,835, respectively, the principal of the notes, divided by the lowest price per share of the class of stock sold in the next financing of CSwitch. The ability to exercise these warrants is, therefore, contingent on CSwitch completing successfully a subsequent round of financing. The warrants will expire five years from the date of the close of the next round of financing. The cost basis of these warrants is \$529 and \$986, respectively.
- (15) With our investment in a convertible bridge note issued by Ensemble Discovery, we received a warrant to purchase a number of shares of the class of stock sold in the next financing of Ensemble Discovery equal to \$125,105.40 divided by the price per share of the class of stock sold in the next financing of Ensemble Discovery. The ability to exercise this warrant is, therefore, contingent on Ensemble Discovery completing successfully a subsequent round of financing. This warrant shall expire and no longer be exercisable on September 10, 2015. The cost basis of this warrant is \$75.20.
- (16) Mersana Therapeutics, Inc., was previously named Nanopharma Corp.
- (17) The aggregate cost for federal income tax purposes of investments in controlled affiliated companies is \$6,085,000. The gross unrealized appreciation based on the tax cost for these securities is \$219,616. The gross unrealized depreciation based on the tax cost for these securities is \$0.
- (18) The aggregate cost for federal income tax purposes of our U.S. government securities is \$56,206,231. The gross unrealized appreciation on the tax cost for these securities is \$941,828. The gross unrealized depreciation on the tax cost of these securities is \$115,278.

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

HARRIS & HARRIS GROUP, INC.
FOOTNOTE TO CONSOLIDATED SCHEDULE OF INVESTMENTS
(Unaudited)

VALUATION PROCEDURES

I. Determination of Net Asset Value

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

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

The Valuation Committee, comprised of all of the independent Board members, is responsible for reviewing and approving the valuation of the Company's assets within the guidelines established by the Board of Directors. The Valuation Committee receives information and recommendations from management.

The values assigned to these investments are based on available information and do not necessarily represent amounts that might ultimately be realized, as such amounts depend on future circumstances and cannot reasonably be determined until the individual investments are actually liquidated or become readily marketable.

II. Approaches to Determining Fair Value

Statement of Financial Accounting Standards No. 157, "Fair Value Measurements," ("SFAS No. 157") defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price).

The main approaches to measuring fair value utilized are the market approach and the income approach.

· Market Approach (M): The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. For example, the market approach often uses market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range each appropriate multiple falls requires judgment considering factors specific to the measurement (qualitative and quantitative).

· **Income Approach (I):** The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present value amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques; and the multi-period excess earnings method, which is used to measure the fair value of certain assets.

SFAS No. 157 classifies the inputs used to measure fair value by these approaches into the following hierarchy:

· **Level 1:** Unadjusted quoted prices in active markets for identical assets or liabilities.

· **Level 2:** Quoted prices in active markets for similar assets or liabilities, or quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.

· **Level 3:** Unobservable inputs for the asset or liability.

Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

III. Investment Categories

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

- Equity-related securities;
- Long-term fixed-income securities;
- Short-term fixed-income securities;
- Investments in intellectual property, patents, research and development in technology or product development; and
- All other securities.

The Company applies the methods for determining fair value discussed above to the valuation of investments in each of these five broad categories as follows:

A. EQUITY-RELATED SECURITIES

Equity-related securities, including warrants, are fair valued using the market or income approaches. The following factors may be considered when the market approach is used to fair value these types of securities:

§ Readily available public market quotations;

§ The cost of the Company's investment;

§ Transactions in a company's securities or unconditional firm offers by responsible parties as a factor in determining valuation;

§ The financial condition and operating results of the company;

§ The company's progress towards milestones.

§ The long-term potential of the business and technology of the company;

§ The values of similar securities issued by companies in similar businesses;

§ Multiples to revenue, net income or EBITDA that similar securities issued by companies in similar businesses receive;

§ The proportion of the company's securities we own and the nature of any rights to require the company to register restricted securities under applicable securities laws; and

§ The rights and preferences of the class of securities we own as compared to other classes of securities the portfolio company has issued.

When the income approach is used to value warrants, the Company uses the Black-Scholes-Merton formula.

B. LONG-TERM FIXED-INCOME SECURITIES

1. **Readily Marketable: Long-term fixed-income securities** for which market quotations are readily available are valued using the most recent bid quotations when available.

2. **Not Readily Marketable: Long-term fixed-income securities** for which market quotations are not readily available are fair valued using the market approach. The factors that may be considered when valuing these types of securities by the market approach include:

Credit quality;
Interest rate analysis;
Quotations from broker-dealers;
Prices from independent pricing services that the Board believes are reasonably reliable; and
Reasonable price discovery procedures and data from other sources.

C. SHORT-TERM FIXED-INCOME SECURITIES

Short-term fixed-income securities are valued using the market approach in the same manner as long-term fixed-income securities until the remaining maturity is 60 days or less, after which time such securities may be valued at amortized cost if there is no concern over payment at maturity.

D. INVESTMENTS IN INTELLECTUAL PROPERTY, PATENTS, RESEARCH AND DEVELOPMENT IN TECHNOLOGY OR PRODUCT DEVELOPMENT

Such investments are fair valued using the market approach. The Company may consider factors specific to these types of investments when using the market approach including:

- The cost of the Company's investment;
- Investments in the same or substantially similar intellectual property or patents or research and development in technology or product development or offers by responsible third parties;
- The results of research and development;
- Product development and milestone progress;
- Commercial prospects;
- Term of patent;
- Projected markets; and
- Other subjective factors.

E. ALL OTHER SECURITIES

All other securities are reported at fair value as determined in good faith by the Valuation Committee using the approaches for determining valuation as described above.

For all other securities, the reported values shall reflect the Valuation Committee's judgment of fair values as of the valuation date using the outlined basic approaches of valuation discussed in Section III. They do not necessarily represent an amount of money that would be realized if we had to sell such assets in an immediate liquidation. Thus, valuations as of any particular date are not necessarily indicative of amounts that we may ultimately realize as a result of future sales or other dispositions of investments we hold.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. THE COMPANY

Harris & Harris Group, Inc. (the "Company," "us," "our" and "we"), is a venture capital company operating as a business development company ("BDC") under the Investment Company Act of 1940 ("1940 Act"). We operate as an internally managed company whereby our officers and employees, under the general supervision of our Board of Directors, conduct our operations.

We elected to become a BDC on July 26, 1995, after receiving the necessary shareholder approvals. From September 30, 1992, until the election of BDC status, we operated as a closed-end, non-diversified investment company under the 1940 Act. Upon commencement of operations as an investment company, we revalued all of our assets and liabilities in accordance with the 1940 Act. Prior to September 30, 1992, we were registered and filed under the reporting requirements of the Securities Exchange Act of 1934 (the "1934 Act") as an operating company and, while an operating company, operated directly and through subsidiaries.

Harris & Harris Enterprises, Inc.,SM is a 100 percent wholly owned subsidiary of the Company. Harris & Harris Enterprises, Inc., is a partner in Harris Partners I, L.P.,SM and is taxed under Subchapter C of the Code (a "C Corporation"). Harris Partners I, L.P. is a limited partnership and is used to hold certain interests in portfolio companies. The partners of Harris Partners I, L.P., are Harris & Harris Enterprises, Inc., (sole general partner) and Harris & Harris Group, Inc., (sole limited partner). Harris & Harris Enterprises, Inc., pays taxes on any non-passive investment income generated by Harris Partners I, L.P. For the period ended September 30, 2008, there was no non-passive investment income. The Company consolidates the results of its subsidiaries for financial reporting purposes.

NOTE 2. INTERIM FINANCIAL STATEMENTS

Our interim financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and in conformity with generally accepted accounting principles applicable to interim financial information. Accordingly, they do not include all information and disclosures necessary for a presentation of our financial position, results of operations and cash flows in conformity with generally accepted accounting principles in the United States of America. In the opinion of management, these financial statements reflect all adjustments, consisting of valuation adjustments and normal recurring accruals, necessary for a fair presentation of our financial position, results of operations and cash flows for such periods. The results of operations for any interim period are not necessarily indicative of the results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Principles of Consolidation. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for investment companies and include the accounts of the Company and its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates. The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and contingent assets and liabilities as of September 30, 2008, and December 31, 2007, and the reported amounts of revenues and expenses for the three months and nine months ended September 30, 2008, and 2007. Actual results could differ from these estimates, and the differences could be material. The most significant estimates relate to the fair valuations of certain of our investments.

Cash and Cash Equivalents. Cash and cash equivalents includes demand deposits and money market instruments with maturities of less than three months. Cash and cash equivalents are carried at cost which approximates value.

Portfolio Investment Valuations. Investments are stated at "value" as defined in the 1940 Act and in the applicable regulations of the SEC. Value, as defined in Section 2(a)(41) of the 1940 Act, is (i) the market price for those securities for which a market quotation is readily available and (ii) the fair value as determined in good faith by, or under the direction of, the Board of Directors for all other assets. (See "Valuation Procedures" in the "Footnote to Consolidated Schedule of Investments.") At September 30, 2008, our financial statements include private venture capital investments valued at \$63,942,445, the fair values of which were determined in good faith by, or under the direction, of the Board of Directors. Upon sale of investments, the values that are ultimately realized may be different from what is presently estimated. The difference could be material. Effective January 1, 2008, the Company adopted SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The adoption of SFAS No. 157 did not have a material impact on the fair value measurements of the Company's investments.

Foreign Currency Translation. The accounting records of the Company are maintained in U.S. dollars. All assets and liabilities denominated in foreign currencies are translated into U.S. dollars based on the rate of exchange of such currencies against U.S. dollars on the date of valuation. For the nine months ended September 30, 2008, included in the net decrease in unrealized depreciation on investments was a \$186,684 loss resulting from foreign currency translation.

Securities Transactions. Securities transactions are accounted for on the date the transaction for the purchase or sale of the securities is entered into by the Company (i.e., trade date).

Interest Income Recognition. Interest income, adjusted for amortization of premium and accretion of discount, is recorded on accrual basis. The Company ceases accruing interest when securities are determined to be non-income producing and writes off any previously accrued interest.

Realized Gain or Loss and Unrealized Appreciation or Depreciation of Portfolio Investments. Realized gain or loss is recognized when an investment is disposed of and is computed as the difference between the Company's cost basis in the investment at the disposition date and the net proceeds received from such disposition. Realized gains and losses on investment transactions are determined by specific identification. Unrealized appreciation or depreciation is computed as the difference between the fair value of the investment and the cost basis of such investment.

Stock-Based Compensation. The Company has a stock-based employee compensation plan. The Company accounts for the plan in accordance with the provisions of Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment," ("SFAS No. 123(R)"). See "Note 5. Stock-Based Compensation" for further discussion.

Income Taxes. As we intend to qualify as a RIC under Subchapter M of the Internal Revenue Code, the Company does not provide for income taxes. Our taxes are accounted for in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," and FIN 48, "Accounting for Uncertainty in Income Taxes." The Company recognizes interest and penalties in income tax expense.

We pay federal, state and local income taxes on behalf of our wholly owned subsidiary, Harris & Harris Enterprises, Inc., which is a C corporation. See "Note 6. Income Taxes."

Restricted Funds. The Company maintains a rabbi trust for the purposes of accumulating funds to satisfy the obligations incurred by us for the Supplemental Executive Retirement Plan ("SERP") under the employment agreement with Charles E. Harris.

Property and Equipment. Property and equipment are included in "Other Assets" and are carried at cost, less accumulated depreciation of \$377,454. Depreciation is provided using the straight-line method over the estimated useful lives of the premises and equipment.

Concentration of Credit Risk. The Company places its cash and cash equivalents with financial institutions and, at times, cash held in checking accounts may exceed the Federal Deposit Insurance Corporation insured limit.

NOTE 4. FAIR VALUE MEASUREMENTS

At September 30, 2008, our financial assets were categorized as follows in the fair value hierarchy for SFAS No. 157 purposes:

Fair Value Measurement at Reporting Date Using:

Description	September 30, 2008	Fair Value Measurement at Reporting Date Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Government Securities	\$ 57,032,781	\$ 0	\$ 57,032,781	\$ 0
Portfolio Companies	\$ 63,942,445	\$ 0	\$ 0	\$ 63,942,445
Total	\$ 120,975,226	\$ 0	\$ 57,032,781	\$ 63,942,445

The following chart shows the components of change in the financial assets categorized as Level 3, for the three months ended September 30, 2008.

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)

Portfolio Companies	
Beginning Balance, July 1, 2008	\$ 92,335,524
Total realized losses included in changes in net assets	(4,371,987)
Total unrealized losses included in changes in net assets	(27,847,181)
Purchases and interest on bridge notes	3,832,612
Disposals	(6,523)
Ending Balance, September 30, 2008	\$ 63,942,445

The amount of total losses for the period included in changes in net assets attributable to the change in unrealized gains or losses relating to assets still held at the reporting date

\$ (32,125,681)

The following chart shows the components of change in the financial assets categorized as Level 3, for the nine months ended September 30, 2008.

**Fair Value Measurements Using Significant
Unobservable Inputs (Level 3)**

Portfolio Companies	
Beginning Balance, January 1, 2008	\$ 78,110,384
Total realized losses included in changes in net assets	(9,386,640)
Total unrealized losses included in changes in net assets	(19,404,273)
Purchases and interest on bridge notes	14,756,711
Disposals	(133,737)
Ending Balance, September 30, 2008	\$ 63,942,445

The amount of total losses for the period included in changes in net assets attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	\$ (28,697,427)
------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	-----------------

NOTE 5. STOCK-BASED COMPENSATION

On March 23, 2006, the Board of Directors of the Company voted to terminate the Employee Profit-Sharing Plan and to establish the Harris & Harris Group, Inc. 2006 Equity Incentive Plan (the "Stock Plan"), subject to shareholder approval. This proposal was approved at the May 4, 2006, Annual Meeting of Shareholders. The Stock Plan provides for the grant of equity-based awards of stock options to our officers, employees and directors (subject to receipt of an exemptive order described below) and restricted stock (subject to receipt of an exemptive order described below) to our officers and employees who are selected by our Compensation Committee for participation in the plan and subject to compliance with the 1940 Act.

On July 11, 2006, the Company filed an application with the SEC regarding certain provisions of the Stock Plan, and on June 29, 2007, the Company responded to comments from the SEC on the application. In the event that the SEC provides the exemptive relief requested by the application, and we receive any additional stockholder approval required, the Compensation Committee may, in the future, authorize awards of stock options under the Stock Plan to non-employee directors of the Company and authorize grants of restricted stock to employees, subject to shareholder approval.

A maximum of 20 percent of our total shares of our common stock issued and outstanding are available for awards under the Stock Plan. Under the Stock Plan, no more than 25 percent of the shares of stock reserved for the grant of the awards under the Stock Plan may be restricted stock awards at any time during the term of the Stock Plan. If any shares of restricted stock are awarded, such awards will reduce on a percentage basis the total number of shares of stock for which options may be awarded. If the Company does not receive exemptive relief from the SEC to issue restricted stock, all shares granted under the Stock Plan may be subject to stock options. No more than 1,000,000 shares of our common stock may be made subject to awards under the Stock Plan to any individual in any year.

On March 19, 2008, the Compensation Committee of the Board of Directors and the full Board of Directors of the Company approved a grant of individual Non-Qualified Stock Option ("NQSO") awards for certain officers and employees of the Company. The terms and conditions of the stock options granted were set forth in award agreements between the Company and each award recipient entered into on that date. Options to purchase a total of 348,032 shares of stock were granted with vesting periods ranging from March 2009 to March 2012 and with an exercise price of \$6.18, which was the closing volume weighted average price of our shares of common stock on March 19, 2008. Upon exercise, the shares would be issued from our previously authorized but unissued shares.

On August 13, 2008, the Compensation Committee of the Board of Directors and the full Board of Directors of the Company approved a grant of individual Non-Qualified Stock Option ("NQSO") awards for certain officers and employees of the Company. The terms and conditions of the stock options granted were set forth in award agreements between the Company and each award recipient entered into on that date. Options to purchase a total of 1,163,724 shares of stock were granted with vesting periods ranging from December 2008 to August 2012 and with an exercise price of \$6.92, which was the closing volume weighted average price of our shares of common stock on August 13, 2008. Upon exercise, the shares would be issued from our previously authorized but unissued shares.

The Company accounts for the Stock Plan in accordance with the provisions of SFAS No. 123(R), which requires that we determine the fair value of all share-based payments to employees, including the fair value of grants of employee stock options, and record these amounts as an expense in the Statement of Operations over the vesting period with a corresponding increase to our additional paid-in capital. At September 30, 2008, and December 31, 2007, the increase to our operating expenses was offset by the increase to our additional paid-in capital, resulting in no net impact to our net asset value. Additionally, the Company does not record the tax benefits associated with the expensing of stock options, because the Company currently intends to qualify as a RIC under Subchapter M of the Code.

An option's expected term is the estimated period between the grant date and the exercise date of the option. As the expected term period increases, the fair value of the option and the non-cash compensation cost will also increase. The expected term assumption is generally calculated using historical stock option exercise data. The Company does not have historical exercise data to develop such an assumption. In cases where companies do not have historical data and where the options meet certain criteria, SEC Staff Accounting Bulletin 107 ("SAB 107") provides the use of a simplified expected term calculation. Accordingly, the Company calculated the expected terms using the SAB 107 simplified method.

Expected volatility is the measure of how the stock's price is expected to fluctuate over a period of time. An increase in the expected volatility assumption yields a higher fair value of the stock option. Expected volatility factors for the stock options were based on the historical fluctuations in the Company's stock price over a period commensurate with the expected term of the option, adjusted for stock splits and dividends.

The expected dividend yield assumption is traditionally calculated based on a company's historical dividend yield. An increase to the expected dividend yield results in a decrease in the fair value of option and resulting compensation cost. Although the Company has declared deemed dividends in previous years, most recently in 2005, the amounts and timing of any future dividends cannot be reasonably estimated. Therefore, for purposes of calculating fair value, the Company has assumed an expected dividend yield of zero percent.

The risk-free interest rate assumptions are based on the annual yield on the measurement date of a zero-coupon U.S. Treasury bond the maturity of which equals the option's expected term. Higher assumed interest rates yield higher fair values.

The amount of non-cash, stock-based compensation expense recognized in the Consolidated Statements of Operations is based on the fair value of the awards the Company expects to vest, recognized over the vesting period on a straight-line basis for each award, and adjusted for actual options vested and pre-vesting forfeitures. The forfeiture rate is estimated at the time of grant and revised, if necessary, in subsequent periods if the actual forfeiture rate differs from the estimated rate and is accounted for in the current period and prospectively.

The fair value of each stock option award is estimated on the date of grant using the Black-Scholes-Merton option pricing model as permitted by SFAS No. 123(R). The assumptions used in the calculation of fair value of the stock options granted on March 19, 2008, using the Black-Scholes-Merton model for the contract term was as follows:

Type of Award	Term	Number of Options Granted	Expected Term in Yrs	Expected Volatility Factor	Expected Dividend Yield	Risk-free Interest Rates	Weighted Average Fair Value Per Share
Non-qualified stock options	9.78 Years	348,032	6.14	57.1%	0%	2.62%	\$ 3.45
Total		348,032					\$ 3.45

The assumptions used in the calculation of fair value of the stock options granted on August 13, 2008, using the Black-Scholes-Merton model for the contract term was as follows:

Type of Award	Term	Number of Options Granted	Expected Term in Yrs	Expected Volatility Factor	Expected Dividend Yield	Risk-free Interest Rates	Weighted Average Fair Value Per Share
Non-qualified stock options	9.38 Years	976,685	5.94%	55.1%	0%	3.40%	\$ 3.79
Non-qualified stock options	9.38 Years	187,039	4.88%	50.6%	0%	3.24%	\$ 3.25
Total		1,163,724					

For the three months and nine months ended September 30, 2008, the Company recognized \$1,367,567 and \$4,333,892 of compensation expense in the Consolidated Statements of Operations. As of September 30, 2008, there was approximately \$9,206,698 of unrecognized compensation cost related to unvested stock option awards. This cost is expected to be recognized over a weighted-average period of approximately two years.

For the three months and nine months ended September 30, 2008, no stock options were exercised.

For the three months and nine months ended September 30, 2008, the calculation of the net decrease in net assets resulting from operations per share excludes the stock options because such options were anti-dilutive. The options may be dilutive in future periods in which there is a net increase in net assets resulting from operations, in the event that there is a significant increase in the average stock price in the stock market or in the event of significant decreases in the amount of unrecognized compensation cost.

A summary of the changes in outstanding stock options is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (Yrs)	Aggregate Intrinsic Value
Options Outstanding at January 1, 2008	3,967,744	\$ 10.54	\$ 4.77		
Granted	1,511,756	\$ 6.75	\$ 3.64	9.25	
Exercised	0	\$ 0	\$ 0		
Forfeited or Expired	(465,087)	\$ 10.15	\$ 2.70		
Options Outstanding at September 30, 2008	5,014,413	\$ 9.43	\$ 4.62	5.82	\$ 69,357
Options Exercisable at September 30, 2008	1,760,544	\$ 10.42	\$ 5.34	4.89	\$ 0
Options Exercisable and Expected to be Exercisable at September 30, 2008	4,943,565	\$ 9.42	\$ 4.59	5.80	\$ 69,357

The aggregate intrinsic value in the table above with respect to options outstanding, exercisable and expected to be exercisable, is calculated as the difference between the Company's closing stock price of \$6.38 on the last trading day of the third quarter of 2008 and the exercise price, multiplied by the number of in-the-money options. This represents the total pre-tax intrinsic value that would have been received by the option holders had all options been fully vested and all option holders exercised their awards on September 30, 2008.

Unless earlier terminated by our Board of Directors, the Stock Plan will expire on May 4, 2016. The expiration of the Stock Plan will not by itself adversely affect the rights of plan participants under awards that are outstanding at the time the Stock Plan expires. Our Board of Directors may terminate, modify or suspend the plan at any time, provided that no modification of the plan will be effective unless and until any required shareholder approval has been obtained. The Compensation Committee may terminate, modify or amend any outstanding award under the Stock Plan at any time, provided that in such event, the award holder may exercise any vested options prior to such termination of the Stock Plan or award.

NOTE 6. INCOME TAXES

We filed for the 1999 tax year to elect treatment as a regulated investment company ("RIC") under Subchapter M of the Internal Revenue Code of 1986 (the "Code") and qualified for the same treatment for the years 2000 through 2007. However, there can be no assurance that we will qualify as a RIC for 2008 or subsequent years.

In the case of a RIC which furnishes capital to development corporations, there is an exception to the rule relating to the diversification of investments required to qualify for RIC treatment. This exception is available only to registered management investment companies which the SEC determines to be principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available ("SEC Certification"). We have received SEC Certification since 1999, including for 2007, but it is possible that we may not receive SEC Certification in future years.

In addition, under certain circumstances, even if we qualified for Subchapter M treatment for a given year, we might take action in a subsequent year to ensure that we would be taxed in that subsequent year as a C Corporation, rather than as a RIC. As a RIC, we must, among other things, distribute at least 90 percent of our investment company taxable income and may either distribute or retain our realized net capital gains on investments.

Provided that a proper election is made, a corporation taxable under Subchapter C of the Code or a C Corporation that elects to qualify as a RIC continues to be taxable as a C Corporation on any gains realized within 10 years of its qualification as a RIC (the "Inclusion Period") from sales of assets that were held by the corporation on the effective date of the RIC election ("C Corporation Assets"), to the extent of any gain built into the assets on such date ("Built-In Gain"). If the corporation fails to make a proper election, it is taxable on its Built-In Gain as of the effective date of its RIC election. We had Built-In Gains at the time of our qualification as a RIC and made the election to be taxed on any Built-In Gain realized during the Inclusion Period.

For federal tax purposes, the Company's 2004 through 2007 tax years remain open for examination by the tax authorities under the normal three year statute of limitations. Generally, for state tax purposes, the Company's 2003 through 2007 tax years remain open for examination by the tax authorities under a four year statute of limitations.

For the nine months ended September 30, 2008, and 2007, our income tax expense was \$48,968 and \$88,988, respectively.

Continued qualification as a RIC requires us to satisfy certain investment asset diversification requirements in future years. Our ability to satisfy those requirements may not be controllable by us. There can be no assurance that we will qualify as a RIC in subsequent years.

NOTE 7. CAPITAL TRANSACTIONS

On June 25, 2007, we completed the sale of 1,300,000 shares of our common stock for gross proceeds of \$14,027,000; net proceeds of this offering, after placement agent fees and offering costs of \$1,033,832, were \$12,993,168.

On June 20, 2008, we completed the sale of 2,545,000 shares of our common stock for gross proceeds of \$15,651,750; net proceeds of this offering, after placement agent fees and offering costs of \$1,268,253, were \$14,383,497.

NOTE 8. CHANGE IN NET ASSETS PER SHARE

The following table sets forth the computation of basic and diluted per share net increases in net assets resulting from operations for the three and nine months ended September 30, 2008, and September 30, 2007.

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
	2008	2007	2008	2007
Numerator for (decrease) increase in net assets per share	\$ (34,032,747)	\$ 604,237	\$ (35,967,073)	\$ (9,879,567)
Denominator for basic and diluted weighted average shares	25,859,573	23,235,023	24,271,270	22,084,893
Basic and diluted net (decrease) increase in net assets per share resulting from operations	\$ (1.32)	\$ 0.03	\$ (1.48)	\$ (0.45)

NOTE 9. EMPLOYEE BENEFITS

We have established a rabbi trust for the purpose of accumulating funds to satisfy the obligations incurred by us under Mr. Harris's Supplemental Executive Retirement Plan ("SERP"), which amounted to \$124,664 and \$2,667,020 at September 30, 2008, and December 31, 2007, respectively, and is included in accounts payable and accrued liabilities. The restricted funds for the SERP Account totaled \$124,664 and \$2,667,020 at September 30, 2008, and December 31, 2007, respectively. Mr. Harris's rights to benefits pursuant to this SERP will be no greater than those of a general creditor of us.

During the nine months ended September 30, 2008, Mr. Harris received a \$2,889,717 distribution from the SERP Account. Any subsequent balance of the SERP Account will be paid on July 31, 2009.

NOTE 10. COMMITMENTS AND CONTINGENCIES

On July 1, 2008, we signed a five-year lease for office space in Palo Alto, California. The lease expires on August 31, 2013. Future minimum lease payments in each of the following years are: 2009 - \$125,206; 2010 - \$128,962; 2011 - \$132,831; 2012 - \$136,816 and 2013 - \$93,135.

NOTE 11. SUBSEQUENT EVENTS

The Proxy Statement for the 2008 Annual Meeting of Shareholders stated that if the named executive officers, exclusive of our Chief Executive Officer, Charles E. Harris, as he is scheduled to retire on December 31, 2008, do not receive sufficient cash from the exercise and sale of stock options in a year to provide market-competitive total compensation, as determined by the Compensation Committee, based on advice from the independent compensation consultant, the Committee will pay the named executive officers cash bonuses. Accordingly, should sufficient stock option exercises fail to occur prior to December 31, 2008, and based on market information provided by the independent compensation consultant, on October 30, 2008, the Compensation Committee of the Company resolved to award bonuses on December 31, 2008, totaling \$395,000. Mr. Harris will not receive a bonus owing to his scheduled retirement.

On October 7, 2008, we made a \$240,000 new investment in a privately held tiny technology portfolio company.

On October 8, 2008, we made a \$250,000 new investment in a privately held tiny technology portfolio company.

On October 31, 2008, we made a \$250,000 follow-on investment in a privately held tiny technology portfolio company.

On November 7, 2008, we made a \$42,542 follow-on investment in a privately held tiny technology portfolio company.

HARRIS & HARRIS GROUP, INC. FINANCIAL HIGHLIGHTS (Unaudited)

	Three Months Ended Sept. 30		Nine Months Ended Sept. 30	
	2008	2007	2008	2007
Per Share Operating Performance				
Net asset value per share, beginning of period	\$ 5.95	\$ 5.54	\$ 5.93	\$ 5.42
Net operating (loss)*	(0.09)	(0.13)	(0.30)	(0.39)
Net realized income (loss) on investments*(1)	(0.17)	0.00	(0.36)	(0.01)
Net (increase) decrease in unrealized depreciation as a result of sales*(1)	0.17	0.00	0.41	(0.00)
Net decrease (increase) in unrealized depreciation on investments held*	(1.23)	0.16	(1.17)	(0.05)
Total from investment operations*	(1.32)	0.03	(1.42)	(0.45)
Net increase as a result of stock-based compensation*	0.05	0.10	0.18	0.26
(Decrease) Increase as a result of offering, net of offering expenses	0.00	0.00	(0.01)	0.26
Net increase as a result of proceeds from exercise of options	0.00	0.02	0.00	0.20
Total increase from capital stock transactions	0.05	0.12	0.17	0.72
Net asset value per share, end of period	\$ 4.68	\$ 5.69	\$ 4.68	\$ 5.69
Stock price per share, end of period	\$ 6.38	\$ 10.64	\$ 6.38	\$ 10.64
Total return based on stock price (2)	6.33%	(5.00)%	(27.42)%	(11.99)%

Supplemental Data:

Net assets, end of period	\$ 121,113,660	\$ 132,442,597	\$ 121,113,660	\$ 132,442,597
---------------------------	----------------	----------------	----------------	----------------

Ratio of expenses to average net assets ⁽²⁾							
		2.0%		3.0%		6.5%	8.8%
Ratio of net operating income (loss) to average net assets ⁽²⁾							
		(1.6)%		(2.4)%		(5.3)%	(7.1)%
Cash dividend paid per share	\$	0.00	\$	0.00	\$	0.00	\$ 0.00
Deemed dividend per share	\$	0.00	\$	0.00	\$	0.00	\$ 0.00
Number of shares outstanding, end of period							
		25,859,573		23,271,858		25,859,573	23,271,858

*Based on Average Shares Outstanding

⁽¹⁾ Net realized and unrealized gains (losses) include rounding adjustments to reconcile change in net asset value per share. See Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a description of realized and unrealized gains and losses.

⁽²⁾ Not annualized

The accompanying notes are an integral part of this schedule.

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

The information contained in this section should be read in conjunction with the Company's unaudited September 30, 2008 Consolidated Financial Statements and the Company's audited 2007 Consolidated Financial Statements and notes thereto.

Background and Overview

We incorporated under the laws of the state of New York in August 1981. In 1983, we completed an initial public offering and invested \$406,936 in Otisville BioTech, Inc., which also completed an initial public offering later that year. In 1984, Charles E. Harris purchased a controlling interest in us which also made him the control person of Otisville. We then divested our other assets and became a financial services company, with the investment in Otisville as the initial focus of our business activity.

In 1992, we registered as an investment company under the 1940 Act, commencing operations as a closed-end, non-diversified investment company. In 1995, we elected to become a business development company subject to the provisions of Sections 55 through 65 of the 1940 Act.

Throughout our corporate history, we have made early stage venture capital investments in a variety of industries. We define venture capital investments as investments in start-up firms and small businesses with exceptional growth potential. We have invested a substantial portion of our assets in venture capital investments of private, development stage or start-up companies. These private businesses tend to be thinly capitalized, unproven, small companies that lack management depth, have little or no history of operations and are developing unproven technologies. At September 30, 2008, \$63,942,445, or 52.8 percent, of our net assets at fair value consisted of private venture capital investments, net of unrealized depreciation of \$23,971,417. At December 31, 2007, \$78,110,384, or 56.5 percent, of our net assets at fair value consisted of private venture capital investments, net of unrealized depreciation of \$4,567,144.

Since our investment in Otisville in 1983 through September 30, 2008, we have made a total of 82 venture capital investments, including four private placement investments in securities of publicly traded companies. We have exited 50 of these 82 investments, realizing total proceeds of \$143,923,354 on our invested capital of \$60,549,559. As measured from first dollar in to last dollar out, the average and median holding periods for these 50 investments were 3.68 years and 3.20 years, respectively. As measured by the 173 separate rounds of investment within these 50 investments, the average and median holding periods for the 173 separate rounds of investment were 2.86 years and 2.53 years, respectively.

In 1994, we made our first investment in a tiny technology company developing nanotechnology, Nanophase Technologies Corporation. From August 2001 through September 30, 2008, all 40 of our initial investments have been in tiny technology. From August 2001 through September 30, 2008, we have invested a total (before any subsequent write-ups, write-downs or dispositions) of \$101,270,435 in tiny technology.

We currently have 31 active tiny technology companies in our portfolio, including one tiny technology investment made prior to 2001. At September 30, 2008, from first dollar in, the average and median holding periods for these 31 active tiny technology investments were 3.64 years and 3.37 years, respectively.

In our Form 10-Q for the quarter ended March 31, 2008, we stated, "Two of our portfolio companies have been considering with their advisors the possibility of filing for initial public offerings (IPOs) in 2008. There can be no assurance that either of them will file for an IPO in 2008, and a variety of factors, including stock market and general business conditions, could lead either or both of them to terminate such considerations." In the quarter ended September 30, 2008, there was only one venture capital-backed IPO in the United States, and there have been only seven thus far in 2008. We believe that until stock market conditions for IPOs improve, it is unlikely that any of our portfolio companies will file for IPOs. Additionally, we believe until such time that conditions improve, the recent substantial decrease in the general availability of capital has greatly increased the risk that companies that need to raise money to reach cash-flow breakeven or complete an exit (i.e., complete an IPO or be acquired) will either have to pay a higher price than heretofore for capital or not be able to raise additional capital at all.

The following is a summary of our initial and follow-on investments in tiny technology from 2001 to the present. We consider a "round led" to be a round where we issued the term sheet, were the new investor or led a set of new investors in an investee company. Typically, but not always, the lead investor negotiates the price and terms of a deal with the investee company.

	2001	2002	2003	2004	2005	2006	2007	YTD 9/30/08
Total Incremental Investments	\$ 489,999	\$ 6,240,118	\$ 3,812,600	\$ 14,837,846	\$ 16,251,339	\$ 24,408,187	\$ 20,595,161	\$ 14,635,185
No. of New Investments	1	7	5	8	4	6	7	2
No. of Follow-On Investment Rounds	0	1	5	21	13	14	20	19
No. of Rounds Led	0	1	0	2	0	7	3	3
Average Dollar Amount - Initial	\$ 489,999	\$ 784,303	\$ 437,156	\$ 911,625	\$ 1,575,000	\$ 2,383,424	\$ 1,086,441	\$ 1,122,250
Average Dollar Amount - Follow-On	N/A	\$ 750,000	\$ 325,364	\$ 359,278	\$ 765,488	\$ 721,974	\$ 649,504	\$ 652,141

We value our private venture capital investments each quarter as determined in good faith by our Valuation Committee, a committee of independent directors, within guidelines established by our Board of Directors in accordance with the 1940 Act. (See "Footnote to Consolidated Schedule of Investments" contained in "Consolidated Financial Statements.")

In the years 2001 through September 30, 2008, the Company recorded the following gross write-ups in privately held securities as a percentage of net assets at the beginning of the year ("BOY"), gross write-downs in privately held securities as a percentage of net assets at the beginning of the year, and net write-ups/(write-downs) in privately held securities as a percentage of net assets at the beginning of the year.

	2001	2002	2003	2004	2005	2006	2007
Net Asset Value, BOY	\$ 31,833,475	\$ 24,334,770	\$ 27,256,046	\$ 40,682,738	\$ 74,744,799	\$ 117,987,742	\$ 113,987,742
Gross Write-Downs During Year	\$ (2,532,730)	\$ (5,400,005)	\$ (1,256,102)	\$ (5,711,229)	\$ (3,450,236)	\$ (4,211,323)	\$ (7,811,323)
Gross Write-Ups During Year	\$ 1,528,866	\$ 285	\$ 847,578	\$ 6,288,397	\$ 23,485,176	\$ 279,363	\$ 11,685,176
Gross Write-Downs as a Percentage of Net Asset Value, BOY	-7.96%	-22.19%	-4.61%	-14.04%	-4.62%	-3.57%	-6.86%
Gross Write-Ups as a Percentage of Net Asset Value, BOY	4.80%	0.00%	3.11%	15.46%	31.42%	0.24%	26.24%
Net Write-Downs/Write-Ups as a Percentage of Net Asset Value, BOY	-3.15%	-22.19%	-1.49%	1.42%	26.8%	-3.33%	-10.62%

During the nine months ended September 30, 2008, we recorded gross write-downs of \$29,518,963. These write-downs are owing primarily to the non-performance risk associated with our portfolio companies in the current economic environment and secondarily to adjustments of valuation to reflect specific fundamental developments unique to particular portfolio companies. We define non-performance risk as the risk that a negative cash flow portfolio company will be: (a) unable to raise capital, will need to be shut down and will not return our invested capital; or (b) able to raise capital, but at a valuation significantly lower than the implied post-money valuation. Our best estimate of the non-performance risk of our portfolio companies has been quantified and included in the valuation of the companies at September 30, 2008.

The increase or decrease in the value of our venture capital investments does not affect the day-to-day operations of the Company, as we have no debt and fund our venture capital investments and daily operating expenses from interest earned and proceeds from the sales of our investments in U.S. government securities.

We have discretion in the investment of our capital. However, we invest primarily in illiquid equity securities of private companies. Generally, these investments take the form of preferred stock, are subject to restrictions on resale and have no established trading market. Our principal objective is to achieve long-term capital appreciation. Therefore, a significant portion of our investment portfolio provides little or no income in the form of dividends or interest. We earn interest income from fixed-income securities, including U.S. government and agency securities. The amount of interest income we earn varies with the average balance of our fixed-income portfolio and the average yield on this portfolio. Interest income is secondary to capital gains and losses in our results of operations.

We present the financial results of our operations utilizing accounting principles generally accepted in the United States for investment companies. On this basis, the principal measure of our financial performance during any period is the net increase/(decrease) in our net assets resulting from our operating activities, which is the sum of the following three elements:

Net Operating Income / (Loss) - the difference between our income from interest, dividends, and fees and our operating expenses.

Net Realized Income / (Loss) on Investments - the difference between the net proceeds of sales of portfolio securities and their stated cost, plus income from interests in limited liability companies.

Net Increase / (Decrease) in Unrealized Appreciation or Depreciation on Investments - the net unrealized change in the value of our investment portfolio.

Owing to the structure and objectives of our business, we generally expect to experience net operating losses and seek to generate increases in our net assets from operations through the long-term appreciation of our venture capital investments. We have relied, and continue to rely, on proceeds from sales of investments, rather than on investment income, to defray a significant portion of our operating expenses. Because such sales are unpredictable, we attempt to maintain adequate working capital to provide for fiscal periods when there are no such sales.

Results of Operations

Three months ended September 30, 2008, as compared with the three months ended September 30, 2007

In the three months ended September 30, 2008, we had a net decrease in net assets resulting from operations of \$(34,032,747). In the three months ended September 30, 2007, we had a net increase in net assets resulting from operations of \$604,237.

Investment Income and Expenses:

We had net operating losses of \$2,196,739 and \$3,117,595 for the three months ended September 30, 2008, and September 30, 2007, respectively. The variation in these results is primarily owing to the changes in investment income and operating expenses, including non-cash expenses of \$1,367,567 in 2008 and \$2,302,394 in 2007 associated with amortization of stock options. During the three months ended September 30, 2008, and 2007, total investment income was \$587,918 and \$743,414, respectively. During the three months ended September 30, 2008, and 2007, total operating expenses were \$2,784,657 and \$3,861,009, respectively, including the non-cash expense of \$1,367,567 in 2008 and \$2,302,394 in 2007 associated with amortization of stock options.

During the three months ended September 30, 2008, as compared with the same period in 2007, investment income decreased, reflecting a decrease in our average holdings of U.S. government securities. During the three months ended September 30, 2008, our average holdings of such securities were \$58,057,162, as compared with \$67,656,776 during the three months ended September 30, 2007.

Operating expenses were \$2,784,657 and \$3,861,009 for the three months ended September 30, 2008, and September 30, 2007, respectively, including non-cash, stock option-based compensation expense of \$1,367,567 in 2008 and \$2,302,394 in 2007. The decrease in operating expenses for the three months ended September 30, 2008, as compared with the three months ended September 30, 2007, was primarily owing to decreases in salaries, benefits and stock-based compensation expense, administration and operations expense and professional fees, partially offset by an increase in our rent expense. Salaries, benefits and stock-based compensation expense decreased by \$1,024,858, or 31.7 percent, through September 30, 2008, as compared with September 30, 2007, primarily as a result of a decrease in non-cash expense of \$934,827 associated with the Stock Plan. Although the non-cash, stock-based compensation expense for the Stock Plan was \$1,367,567, this expense was offset by a corresponding increase to our additional paid-in capital, resulting in no net impact to our net asset value. The non-cash, stock-based compensation expense and corresponding increase to our additional paid-in capital may increase in future quarters. Administration and operations expense decreased by \$58,448, or 18.8 percent, through September 30, 2008, as compared with September 30, 2007, primarily as a result of a decrease in our directors' and officers' liability insurance expense and decreases in the cost of the annual report and proxy-related expenses. Professional fees decreased by \$17,538, or 11.2 percent, for the three months ended September 30, 2008, as compared with the same period in 2007, primarily as a result of a reduction in certain legal, accounting and consulting fees. Rent expense increased by \$20,044, or 33.2 percent, through September 30, 2008, as compared to September 30, 2007, as a result of the lease of new office space in Palo Alto, CA.

Realized Income and Losses From Investments:

During the three months ended September 30, 2008, we realized net losses on investments of \$4,373,124, as compared with realized net gains on investments of \$14,828 during the three months ended September 30, 2007.

During the three months ended September 30, 2008, we realized net losses of \$4,373,124, consisting primarily of realized losses on Evolved Nanomaterial Sciences, Inc., of \$2,800,000, on Phoenix Molecular Corporation of \$93,487 and on Zia Laser, Inc., of \$1,478,500.

During the three months ended September 30, 2007, we realized net gains of \$14,828, consisting primarily of realized gains on the sale of U.S. government and agency securities and a gain realized from a distribution from Exponential Business Development Company.

Net Unrealized Appreciation and Depreciation of Portfolio Securities:

During the three months ended September 30, 2008, net unrealized depreciation on total investments increased by \$27,460,782, or 636.3 percent, from net unrealized appreciation of \$4,315,915 at June 30, 2008, to net unrealized depreciation of \$23,144,867 at September 30, 2008, owing primarily to the non-performance risk associated with our portfolio companies in the current economic environment. During the three months ended September 30, 2007, net unrealized depreciation on total investments decreased by \$3,711,087, or 26.8 percent, from net unrealized depreciation of \$13,838,647 at June 30, 2007, to net unrealized depreciation of \$10,127,560 at September 30, 2007.

During the three months ended September 30, 2008, net unrealized depreciation on our venture capital investments increased by \$27,847,181, from net unrealized appreciation of \$3,875,764 at June 30, 2008, to net unrealized depreciation of \$23,971,417 at September 30, 2008, owing primarily to decreases in the valuations of the following investments held, offset by an increase in the valuation of Questech Corporation of \$54,693:

<u>Investment</u>	<u>Amount of Write-Down</u>
Adesto Technologies Corporation	\$1,100,000
Ancora Pharmaceuticals, Inc.	400,000
BioVex Group, Inc.	1,250,000
BridgeLux, Inc.	983
Cambrios Technologies Corporation	1,297,012
Crystal IS, Inc.	997,401
CSwitch Corporation	4,519,350
D-Wave Systems, Inc.	8,397
Ensemble Discovery Corporation	1,000,000
Exponential Business Development Company	168
Innovalight, Inc.	1,927,946
Kereos, Inc.	90,371
Mersana Therapeutics, Inc.	1,006,602
Metabolon, Inc.	1,395,874
Molecular Imprints, Inc.	2,296,178
NanoGram Corporation	2,943,611
Nanomix, Inc.	691,090
Neophotonics Corporation	2,364,458
Nextreme Thermal Solutions, Inc.	2,182,233
Polatis, Inc.	276,526
PolyRemedy, Inc.	122,250
Siluria Technologies, Inc.	120,542
Solazyme, Inc.	5,378,325
Starfire Systems, Inc.	690,000

We also had decreases in unrealized depreciation attributable to the reversal of unrealized depreciation owing to realization of net losses on Evolved Nanomaterial Sciences, Inc., of \$2,800,000 and on Zia Laser, Inc., of \$1,478,500. We had a decrease owing to foreign currency translation of \$121,057 on our investment in D-Wave Systems, Inc. Unrealized appreciation on our U.S. government securities portfolio increased from \$440,151 at June 30, 2008, to \$826,550 at September 30, 2008.

During the three months ended September 30, 2007, net unrealized depreciation on our venture capital investments decreased by \$3,028,058, from \$13,320,521 to \$10,292,463, owing primarily to increases in the valuations of our investments in AlphaSimplex Group, LLC, of \$113,964, CSwitch Corporation of \$48,935, Exponential Business Development Company of \$1,973, Innovalight, Inc., of \$3,218,216 and SiOnyx, Inc., of \$899,566, partially offset by decreases in the valuations of our investments in BridgeLux, Inc., of \$41,605, Chlorogen, Inc., of \$23,122, Evolved Nanomaterial Sciences, Inc., of \$438,042, Nanomix, Inc., of \$549,774, NanoOpto Corporation of \$60,000, Polatis, Inc., of \$184,323 and Questech Corporation of \$85,210. We also had an increase in the value of our investment in D-Wave Systems, Inc., of \$127,480 owing to foreign currency translation. Unrealized depreciation on our U.S. government and agency securities portfolio decreased from \$518,126 at June 30, 2007, to an unrealized appreciation of \$164,903 at September 30, 2007.

Nine months ended September 30, 2008, as compared with the nine months ended September 30, 2007

In the nine months ended September 30, 2008, and September 30, 2007, we had net decreases in net assets resulting from operations of \$35,967,073 and \$9,879,567, respectively.

Investment Income and Expenses:

We had net operating losses of \$7,315,640 and \$8,676,380 for the nine months ended September 30, 2008, and September 30, 2007, respectively. The variation in these results is primarily owing to the changes in investment income and operating expenses, including non-cash expenses of \$4,333,892 in 2008 and \$5,725,031 in 2007 associated with amortization of stock options. During the nine months ended September 30, 2008, and 2007, total investment income was \$1,631,845 and \$2,033,613, respectively. During the nine months ended September 30, 2008, and 2007, total operating expenses were \$8,947,485 and \$10,709,993, respectively.

During the nine months ended September 30, 2008, as compared with the same period in 2007, investment income decreased, reflecting a decrease in our average holdings throughout the period of U.S. government securities. During the nine months ended September 30, 2008, our average holdings of such securities were \$56,089,836, as compared with \$62,541,791 at September 30, 2007.

Operating expenses, including non-cash, stock-based compensation expense, were \$8,947,485 and \$10,709,993 for the nine months ended September 30, 2008, and September 30, 2007, respectively. The decrease in operating expenses for the nine months ended September 30, 2008, as compared with the nine months ended September 30, 2007, was primarily owing to decreases in salaries, benefits and stock-based compensation expense and to decreases in administration and operations expense, professional fees and directors' fees and expenses. Salaries, benefits and stock-based compensation expense decreased by \$1,308,811, or 15.6 percent, through September 30, 2008, as compared with September 30, 2007, primarily as a result of a decrease in non-cash expense of \$1,391,139 associated with the Stock Plan, offset by an increase in salaries and benefits owing to an increase in our head count as compared with that of the same period in 2007. While the non-cash, stock-based compensation expense for the Stock Plan increased our operating expenses by \$4,333,892, this increase was offset by a corresponding increase to our additional paid-in capital, resulting in no net impact to our net asset value. The non-cash, stock-based compensation expense and corresponding increase to our additional paid-in capital may increase in future quarters. Administration and operations expense decreased by \$211,275, or 20.1 percent, through September 30, 2008, as compared with September 30, 2007, primarily as a result of a decrease in our directors' and officers' liability insurance expense, decreases in the cost of the annual report and proxy-related expenses, and decreases in fees associated with the exercise of stock options. Professional fees decreased by \$194,702, or 28.9 percent, for the nine months ended September 30, 2008, as compared with the same period in 2007, primarily as a result of a reduction in the cost of our annual compliance program audit and a reduction in certain legal and accounting fees.

Realized Income and Losses from Investments:

During the nine months ended September 30, 2008, we realized net losses on investments of \$9,384,082, as compared with realized net gains on investments of \$5,941 during the nine months ended September 30, 2007.

During the nine months ended September 30, 2008, we realized net losses of \$9,384,082, consisting primarily of realized losses on our investments in Chlorogen, Inc., of \$1,326,072, on Evolved Nanomaterial Sciences, Inc., of \$2,800,000, on NanoOpto Corporation of \$3,688,581, on Phoenix Molecular Corporation of \$93,487 and on Zia Laser of \$1,478,500. During the nine months ended September 30, 2008, we received a payment of \$105,714 from the NanoOpto Corporation bridge note.

During the nine months ended September 30, 2007, we realized net gains of \$5,941, consisting primarily of net realized losses on the sale of U.S. government and agency securities, offset by income from our investments in AlphaSimplex Group, LLC and Exponential Business Development Company.

Net Unrealized Appreciation and Depreciation of Portfolio Securities:

During the nine months ended September 30, 2008, net unrealized depreciation on total investments increased by \$19,218,383, or 489.5 percent, from net unrealized depreciation of \$3,926,484 at December 31, 2007, to net unrealized depreciation of \$23,144,867 at September 30, 2008, owing primarily to the non-performance risk associated with our portfolio companies in the current economic environment. During the nine months ended September 30, 2007, net unrealized depreciation on total investments increased by \$1,120,140, or 12.4 percent, from net unrealized depreciation of \$9,007,420 at December 31, 2006, to net unrealized depreciation of \$10,127,560 at September 30, 2007.

During the nine months ended September 30, 2008, net unrealized depreciation on our venture capital investments increased by \$19,404,273, from net unrealized depreciation of \$4,567,144 at December 31, 2007, to net unrealized depreciation of \$23,971,417 at September 30, 2008, owing primarily to decreases in the valuations of the following investments held:

<u>Investment</u>	<u>Amount of Write-Down</u>
Adesto Technologies Corporation	\$1,100,000
Ancora Pharmaceuticals, Inc.	299,439
BioVex Group, Inc.	1,250,000
BridgeLux, Inc.	2,721
Cambrios Technologies Corporation	1,297,012
Crystal IS, Inc.	997,796
CSwitch Corporation	4,519,350
	1,000,000

Ensemble Discovery Corporation	
Innovalight, Inc.	1,927,946
Kereos, Inc.	159,743
Mersana Therapeutics, Inc.	1,015,673
Metabolon, Inc.	2,132,386
Molecular Imprints, Inc.	2,468,095
NanoGram Corporation	2,943,611
Nanomix, Inc.	980,418
Neophotonics Corporation	3,401,952
Nextreme Thermal Solutions, Inc.	2,182,133
Polatis, Inc.	276,526
PolyRemedy, Inc.	122,250
Questech Corporation	398,283
Siluria Technologies, Inc.	120,542
Starfire Systems, Inc.	750,000

We also had decreases in unrealized depreciation attributable to the reversal of depreciation owing to net realized losses on Chlorogen, Inc., of \$1,326,072, on Evolved Nanomaterial Sciences, Inc., of \$2,800,000, on NanoOpto Corporation of \$3,688,581 and on Zia Laser, Inc., of \$1,478,672. For the nine months ended September 30, 2008, we had increases in the valuations of our investments in D-Wave Systems, Inc., of \$5,199, Exponential Business Development Company of \$25 and Solazyme, Inc., of \$821,340. We had a decrease owing to foreign currency translation of \$178,286 on our investment in D-Wave Systems, Inc. Unrealized appreciation on our U.S. government securities portfolio increased from \$640,660 at December 31, 2007, to \$826,550 at September 30, 2008.

During the nine months ended September 30, 2007, net unrealized depreciation on our venture capital investments increased by \$1,841,494, from \$8,450,969 to \$10,292,463, owing primarily to decreases in the valuations of our investments in Chlorogen, Inc., of \$1,326,073, Evolved Nanomaterial Sciences, Inc., of \$2,800,000, Nanomix, Inc., of \$1,009,546, NanoOpto Corporation of \$1,475,599, Polatis, Inc., of \$9,534 and Questech Corporation of \$249,749, offset partially by increases in the valuation of our investments in AlphaSimplex Group, LLC, of \$113,964, BridgeLux, Inc., of \$328,369, CSwitch Corporation of \$48,935, Exponential Business Development Company of \$1,973, Innovalight, Inc., of \$3,218,216, Kovio, Inc., of \$125,000 and SiOnyx, Inc., of \$899,566. We also had an increase owing to foreign currency translation of \$291,796 on our investment in D-Wave Systems, Inc. Unrealized depreciation on our U.S. government and agency securities portfolio decreased from \$556,451 at December 31, 2006, to unrealized appreciation of \$164,903 at September 30, 2007.

Financial Condition

September 30, 2008

At September 30, 2008, our total assets and net assets were \$123,076,500 and \$121,113,060, respectively. At December 31, 2007, they were \$142,893,332 and \$138,363,344, respectively.

At September 30, 2008, net asset value per share ("NAV") was \$4.68, as compared with \$5.93 at December 31, 2007. At September 30, 2008, our shares outstanding increased to 25,859,573, from 23,314,573 at December 31, 2007.

Significant developments in the nine months ended September 30, 2008, included a decrease in the value of our venture capital investments of \$14,167,939 and a decrease in the value of our investment in U.S. government obligations of \$3,160,812. The decrease in the value of our venture capital investments, from \$78,110,384 at December 31, 2007, to \$63,942,445 at September 30, 2008, resulted primarily from two new and 19 follow-on investments of \$14,635,185, offset by a decrease in the net value of our venture capital investments of \$19,404,273. The decrease in the net value of our venture capital investments is owing primarily to the non-performance risk associated with our portfolio companies in the current economic environment and secondarily to adjustments of valuation to reflect specific fundamental developments unique to particular portfolio companies. The decrease in the value of our U.S. government obligations, from \$60,193,593 at December 31, 2007, to \$57,032,781 at September 30, 2008, is primarily owing to the investment of net proceeds of \$14,383,497 received through the registered direct stock offering, offset by net operating expenses and by new and follow-on venture capital investments, totaling \$14,635,185.

The following table is a summary of additions to our portfolio of venture capital investments made during the nine months ended September 30, 2008:

<u>New Investment</u>	<u>Amount</u>
PolyRemedy, Inc.	\$ 244,500
Laser Light Engines, Inc.	\$ 2,000,000
<u>Follow-on Investment</u>	
Adesto Technologies Corporation	\$ 1,052,174
Ancora Pharmaceuticals Inc.	\$ 800,000
BridgeLux, Inc.	\$ 1,000,001
CSwitch Corporation	\$ 986,821
D-Wave Systems, Inc.	\$ 736,019
D-Wave Systems, Inc.	\$ 487,804
Ensemble Discovery Corporation	\$ 250,286
Mersana Therapeutics, Inc.	\$ 200,000
Metabolon, Inc.	\$ 1,000,000
NeoPhotonics Corporation	\$ 200,000
Nextreme Thermal Solutions, Inc.	\$ 377,580
Nextreme Thermal Solutions, Inc.	\$ 200,000
Nextreme Thermal Solutions, Inc.	\$ 200,000
Nextreme Thermal Solutions, Inc.	\$ 800,000
Nextreme Thermal Solutions, Inc.	\$ 1,050,000
Phoenix Molecular Corporation	\$ 25,000
Phoenix Molecular Corporation	\$ 25,000
Solazyme, Inc.	\$ 2,000,000
Solazyme, Inc.	\$ 1,000,000
Total	\$ 14,635,185

The following tables summarize the values of our portfolios of venture capital investments and U.S. government obligations, as compared with their cost, at September 30, 2008, and December 31, 2007:

	September 30, 2008	December 31, 2007
Venture capital investments, at cost	\$ 87,913,862	\$ 82,677,528
Net unrealized depreciation ⁽¹⁾	23,971,417	4,567,144
Venture capital investments, at fair value	\$ 63,942,445	\$ 78,110,384
	September 30, 2008	December 31, 2007
U.S. government obligations, at cost	\$ 56,206,231	\$ 59,552,933
Net unrealized appreciation ⁽¹⁾	826,550	640,660
U.S. government obligations, at value	\$ 57,032,781	\$ 60,193,593

⁽¹⁾At September 30, 2008, and December 31, 2007, the net accumulated unrealized depreciation on investments was \$23,144,867 and \$3,926,484, respectively.

The following table summarizes the fair value composition of our venture capital investment portfolio at September 30, 2008, and December 31, 2007.

	September 30, 2008	December 31, 2007
Category		
Tiny Technology	99.9%	99.9%
Other Venture Capital Investments	0.1%	0.1%
Total Venture Capital Investments	100.0%	100.0%

Liquidity

Our primary sources of liquidity are cash, receivables and freely marketable securities, net of short-term indebtedness. Our secondary sources of liquidity are restricted securities of companies that are publicly traded.

At September 30, 2008, and December 31, 2007, our total net primary liquidity was \$58,446,900 and \$61,183,136, respectively, and our secondary liquidity was \$0 and \$0, respectively.

The decrease in our primary liquidity from December 31, 2007, to September 30, 2008, is primarily owing to the use of funds for investments and payment of net operating expenses, partially offset by the proceeds received through the registered direct stock offering.

We fund our day-to-day operations using interest earned and proceeds from the sales of our investments in U.S. government securities. The increase or decrease in the valuations of our portfolio companies does not impact our daily liquidity. At September 30, 2008, and December 31, 2007, we had no investments in money market mutual funds. We have no debt outstanding, and, therefore, are not subject to credit agency downgrades.

Capital Resources

On June 20, 2008, we completed the sale of 2,545,000 shares of our common stock, for total gross proceeds of \$15,651,750; net proceeds of this offering, after placement agent fees and offering costs of \$1,268,253, were \$14,383,497. We intend to use, and have been using, the net proceeds of this offering to make new investments in tiny technology, as well as for follow-on investments in our existing venture capital investments and for working capital. Through September 30, 2008, we have used \$6,483,163 of the net proceeds from this offering for these purposes.

On June 25, 2007, we completed the sale of 1,300,000 shares of our common stock from our shelf registration statement for gross proceeds of \$14,027,000; net proceeds of this offering, after placement agent fees and offering costs of \$1,033,832, were \$12,993,168. We used the net proceeds of this offering to make new investments in tiny technology, as well as for follow-on investments in our existing venture capital investments and for working capital. Through September 30, 2008, we have used all of the net proceeds from this offering for these purposes.

Critical Accounting Policies

The Company's significant accounting policies are described in Note 3 to the Consolidated Financial Statements and in the Footnote to the Consolidated Schedule of Investments. Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and those that require management's most difficult, complex or subjective judgments. The Company considers the following accounting policies and related estimates to be critical:

Valuation of Portfolio Investments

The most significant estimate inherent in the preparation of our consolidated financial statements is the valuation of investments and the related amounts of unrealized appreciation and depreciation of investments recorded. As a business development company, we invest in primarily illiquid securities that generally have no established trading market.

Investments are stated at "value" as defined in the 1940 Act and in the applicable regulations of the SEC. Value, as defined in Section 2(a)(41) of the 1940 Act, is (i) the market price for those securities for which a market quotation is readily available and (ii) the fair value as determined in good faith by, or under the direction of, the Board of Directors for all other assets. (See "Valuation Procedures" in the "Footnote to Consolidated Schedule of Investments.") At September 30, 2008, our financial statements include private venture capital investments valued at \$63,942,445, the fair values of which were determined in good faith by, or under the direction of, the Board of Directors. At September 30, 2008, approximately 51.9 percent of our total assets represent investments in portfolio companies valued at fair value by the Board of Directors.

Determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment, although our valuation policy is intended to provide a consistent basis for determining fair value of the portfolio investments. Factors that may be considered include, but are not limited to, readily available public market quotations; the cost of the Company's investment; transactions in the portfolio company's securities or unconditional firm offers by responsible parties; the financial condition and operating results of the company; the long-term potential of the business and technology of the company; the values of similar securities issued by companies in similar businesses; multiples to revenues, net income or EBITDA that similar securities issued by companies in similar businesses receive; the proportion of the company's securities we own and the nature of any rights to require the company to register restricted securities under the applicable securities laws; the achievement of milestones; and the rights and preferences of the class of securities we own as compared with other classes of securities the portfolio has issued.

The ongoing credit crisis, decline in the stock market and decline in economic activity (and evidence of a recession) have made it extremely difficult for many companies to raise capital. Moreover, the cost of capital has increased substantially. Historically, difficult venture capital environments have resulted in weak companies not receiving financing and being subsequently closed down with a loss of investment to venture investors, and/or strong companies receiving financing but at significantly lower valuations than the preceding venture rounds. This economic and financing environment has caused an increase in the non-performance risk for venture-backed companies. We define non-performance risk as the risk that a negative cash flow portfolio company will be: (a) unable to raise capital, will need to be shut down and will not return our invested capital; or (b) able to raise capital, but at a valuation significantly lower than the implied post-money valuation. Our best estimate of the non-performance risk of our portfolio companies has been quantified and included in the valuation of the companies at September 30, 2008.

All investments recorded at fair value are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels, defined by SFAS No. 157 and directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets, are as follows:

· Level 1: Unadjusted quoted prices in active markets for identical assets or liabilities.

· Level 2: Quoted prices in active markets for similar assets or liabilities, or quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.

· Level 3: Unobservable inputs for the asset or liability.

At September 30, 2008, all of our private portfolio investments were classified as Level 3 in the hierarchy, indicating a high level of judgment required in their valuation.

The values assigned to our assets are based on available information and do not necessarily represent amounts that might ultimately be realized, as these amounts depend on future circumstances and cannot be reasonably determined until the individual investments are actually liquidated or become readily marketable. Upon sale of investments, the values that are ultimately realized may be different from what is presently estimated. This difference could be material.

Stock-Based Compensation

Determining the appropriate fair-value model and calculating the fair value of share-based awards at the date of grant requires judgment. We use the Black-Scholes-Merton option pricing model to estimate the fair value of employee stock options, consistent with the provisions of SFAS No. 123(R). Management uses the Black-Scholes-Merton option pricing model because of the lack of the historical option data that is required for use in other, more complex models. Other models may yield fair values that are significantly different from those calculated by the Black-Scholes-Merton option pricing model.

Option pricing models, including the Black-Scholes-Merton model, require the use of subjective input assumptions, including expected volatility, expected life, expected dividend rate, and expected risk-free rate of return. In the Black-Scholes-Merton model, variations in the expected volatility or expected term assumptions have a significant impact on fair value. As the volatility or expected term assumptions increase, the fair value of the stock option increases. In the Black-Scholes-Merton model, the expected dividend rate and expected risk-free rate of return are not as significant to the calculation of fair value. A higher assumed dividend rate yields a lower fair value, whereas higher assumed interest rates yield higher fair values for stock options.

We use the simplified calculation of expected life described in the SEC's Staff Accounting Bulletin 107 because of the lack of historical information about option exercise patterns. Future exercise behavior could be materially different than that which is assumed by the model.

Expected volatility is based on the historical fluctuations in the Company's stock. The Company's stock has historically been volatile, which increases the fair value.

SFAS No. 123(R) requires us to develop an estimate of the number of share-based awards that will be forfeited owing to employee turnover. Quarterly changes in the estimated forfeiture rate can have a significant effect on reported share-based compensation, as the effect of adjusting the rate for all expense amortization after the grant date is recognized in the period the forfeiture estimate is changed. If the actual forfeiture rate proves to be higher than the estimated forfeiture rate, then an adjustment will be made to increase the estimated forfeiture rate, which would result in a decrease to the expense recognized in the financial statements. If the actual forfeiture rate proves to be lower than the estimated forfeiture rate, then an adjustment will be made to decrease the estimated forfeiture rate, which would result in an increase to the expense recognized in the financial statements. Such adjustments would affect our operating expenses and additional paid-in capital, but would have no effect on our net asset value.

Pension and Post-Retirement Benefit Plan Assumptions

The Company provides a Retiree Medical Benefit Plan for employees who meet certain eligibility requirements. Several statistical and other factors that attempt to anticipate future events are used in calculating the expense and liability values related to our post-retirement benefit plans. These factors include assumptions we make about the discount rate, the rate of increase in healthcare costs, and mortality, among others.

The discount rate reflects the current rate at which the post-retirement benefit liabilities could be effectively settled considering the timing of expected payments for plan participants. In estimating this rate, we consider rates of return on high quality fixed-income investments included in published bond indexes. We consider the Moody's Aa Corporate Bond Index and the Citigroup Pension Liability Index in the determination of the appropriate discount rate assumptions. The weighted average rate we utilized to measure our post retirement benefit obligation as of December 31, 2007, and to calculate our 2008 expense was 6.55 percent, which is an increase from the 5.75 percent rate used in determining the 2007 expense.

Recent Developments — Other

The Proxy Statement for the 2008 Annual Meeting of Shareholders stated that if the named executive officers, exclusive of our Chief Executive Officer, Charles E. Harris, as he is scheduled to retire on December 31, 2008, do not receive sufficient cash from the exercise and sale of stock options in a year to provide market-competitive total compensation, as determined by the Compensation Committee, based on advice from the independent compensation consultant, the Committee will pay the named executive officers cash bonuses. Accordingly, should sufficient stock option exercises fail to occur prior to December 31, 2008, and based on market information provided by the independent compensation consultant, on October 30, 2008, the Compensation Committee of the Company resolved to award bonuses on December 31, 2008, totaling \$395,000. Mr. Harris will not receive a bonus owing to his scheduled retirement.

Recent Developments — Portfolio Companies

On October 7, 2008, we made a \$240,000 new investment in a privately held tiny technology portfolio company.

On October 8, 2008, we made a \$250,000 new investment in a privately held tiny technology portfolio company.

On October 31, 2008, we made a \$250,000 follow-on investment in a privately held tiny technology portfolio company.

On November 7, 2008, we made a \$42,542 follow-on investment in a privately held tiny technology portfolio company.

Forward-Looking Statements

The information contained herein may contain "forward-looking statements" based on our current expectations, assumptions and estimates about us and our industry. These forward-looking statements involve risks and uncertainties. Words such as "believe," "anticipate," "estimate," "expect," "intend," "plan," "will," "may," "might," "could," "continue" and other similar expressions identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of several factors more fully described in "Risk Factors" and elsewhere in this Form 10-Q, and in our Form 10-K for the year ended December 31, 2007. The forward-looking statements made in this Form 10-Q relate only to events as of the date on which the statements are made. We undertake no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the

future.

48

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our business activities contain elements of risk. We consider the principal types of market risk to be valuation risk and the risk associated with fluctuations in interest rates. Although we are risk-seeking rather than risk-averse in our investments, we consider the management of risk to be essential to our business.

Value, as defined in Section 2(a)(41) of the 1940 Act, is (i) the market price for those securities for which market quotations are readily available and (ii) fair value as determined in good faith by, or under the direction of, the Board of Directors for all other assets. (See the "Valuation Procedures" in the "Footnote to Consolidated Schedule of Investments" contained in "Item 1. Consolidated Financial Statements.")

Neither our investments nor an investment in us is intended to constitute a balanced investment program.

We have invested a substantial portion of our assets in private development stage or start-up companies. These private businesses tend to be based on new technology and to be thinly capitalized, unproven, small companies that lack management depth and have not attained profitability or have no history of operations. Because of the speculative nature and the lack of a public market for these investments, there is significantly greater risk of loss than is the case with traditional investment securities. We expect that some of our venture capital investments will be a complete loss or will be unprofitable and that some will appear to be likely to become successful but never realize their potential. Even when our private equity investments complete initial public offerings (IPOs), we are normally subject to lock-up agreements for a period of time, and thereafter, the market for the unseasoned publicly traded securities may be relatively illiquid.

Because there is typically no public market for our interests in the small privately held companies in which we invest, the valuation of the equity interests in that portion of our portfolio is determined in good faith by our Valuation Committee, comprised of the independent members of our Board of Directors, in accordance with our Valuation Procedures. In the absence of a readily ascertainable market value, the determined value of our portfolio of equity interests may differ significantly from the values that would be placed on the portfolio if a ready market for the equity interests existed. Any changes in valuation are recorded in our consolidated statements of operations as "Net increase (decrease) in unrealized appreciation on investments." Changes in valuation of any of our investments in privately held companies from one period to another may be volatile.

Investments in privately held, early-stage companies are inherently more volatile than investments in more mature businesses. Such immature businesses are inherently fragile and easily affected by both internal and external forces. Our investee companies can lose much or all of their value suddenly in response to an internal or external adverse event. Conversely, these immature businesses can gain suddenly in value in response to an internal or external positive development. During the nine months ended September 30, 2008, we recorded gross write-downs of \$29,518,963. These write-downs are owing primarily to the non-performance risk associated with our portfolio companies in the current economic environment and secondarily to adjustments of valuation to reflect specific fundamental developments unique to particular portfolio companies.

We also invest in short-term money market instruments, and both short and long-term U.S. government and agency securities. To the extent that we invest in short and long-term U.S. government and agency securities, changes in interest rates result in changes in the value of these obligations which result in an increase or decrease of our net asset value. The level of interest rate risk exposure at any given point in time depends on the market environment, the expectations of future price and market movements, and the quantity and duration of long-term U.S. government and agency securities held by the Company, and it will vary from period to period. If the average interest rate on U.S. government securities at September 30, 2008, were to increase by 25, 75 and 150 basis points, the weighted average value of these securities held by us at September 30, 2008, would decrease by approximately \$256,033, \$768,099 and \$1,536,197, respectively, and our net asset value would decrease correspondingly.

Most of our investments are denominated in U.S. dollars. We currently have one investment denominated in Canadian dollars. We are exposed to foreign currency risk related to potential changes in foreign currency exchange rates. The potential loss in fair value on this investment resulting from a 10 percent adverse change in quoted foreign currency exchange rates is \$306,962 at September 30, 2008.

In addition, in the future, we may from time to time opt to borrow money to make investments. Our net investment income will be dependent upon the difference between the rate at which we borrow funds and the rate at which we invest such funds. As a result, there can be no assurance that a significant change in market interest rates and the current credit crisis will not have a material adverse effect on our net investment income in the event we choose to borrow funds for investing purposes.

Item 4. Controls and Procedures

(a) *Disclosure Controls and Procedures.* As of the end of the period covered by this report, the Company's management, under the supervision and with the participation of our chief executive officer and chief financial officer, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as required by Rules 13a-15 of the 1934 Act). Disclosure controls and procedures means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the 1934 Act is recorded, processed, summarized and reported, within time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the issuer's management, as appropriate, to allow timely decisions regarding required disclosures. As of September 30, 2008, based upon this evaluation of our disclosure controls and procedures, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective.

(b) *Changes in Internal Control Over Financial Reporting.* There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the third quarter of 2008 to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

Investing in our common stock involves significant risks relating to our business and investment objective. You should carefully consider the risks and uncertainties described in our Annual Report on Form 10-K for the year ended December 31, 2007, before you purchase any of our common stock. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Unknown additional risks and uncertainties, or ones that we currently consider immaterial, may also impair our business. If any of these risks or uncertainties materialize, our business, financial condition or results of operations could be materially adversely affected. In this event, the trading price of our common stock could decline, and you could lose all or part of your investment. In addition to the risks described in our Annual Report on Form 10-K, you should consider the following risks:

Unstable credit markets could adversely affect our portfolio companies.

Although our portfolio companies rely primarily on equity financing, some of them borrow funds as well. Given the current credit environment, there can be no assurance that portfolio companies will be able to borrow money on a timely basis or on reasonable terms, which could have a negative impact on their operating performance, raise their cost of capital, or even jeopardize their existence. Furthermore, certain of our portfolio companies manage their cash positions by investing in money-market funds, auction-rate securities, or other short-term securities that are vulnerable to current credit conditions. Lack of liquidity in such investments, or even defaults by issuers of such securities, could restrict the amount of cash available to such portfolio companies. These events could lead to financial losses in our portfolio.

A continuing lack of initial public offering opportunities may cause companies to stay in our portfolio longer, leading to lower returns, write-downs and write-offs.

Beginning in about 2001, many fewer venture capital-backed companies per annum have been able to complete initial public offerings (IPOs) than in the years of the previous decade, and for the first time in a quarter since 1978, no venture capital-backed companies completed IPOs in the quarter ended June 30, 2008, according to the National Venture Capital Association and Thomson Reuters. In the quarter ended September 30, 2008, there was only one venture capital-backed IPO in the United States, and there have been only seven thus far in 2008. Moreover, in 2007, according to the National Venture Capital Association, the venture capital-backed companies that completed IPOs had a median age of about 8.6 years, which was older than the median age of venture capital-backed IPOs in any period since 2001-2002. Now that some of our companies are becoming more mature, a continuing lack of IPO opportunities for venture capital-backed companies could lead to companies staying longer in our portfolio as private entities still requiring funding. This situation may adversely affect the amount of available funding for early-stage companies in particular as, in general, venture-capital firms are being forced to provide additional financing to late-stage companies that cannot complete an IPO. In the best case, such stagnation would dampen returns, and in the worst case, could lead to write-downs and write-offs as some companies run short of cash and have to accept lower valuations in private fundings or are not able to access additional capital at all. A continuing lack of IPO opportunities for venture capital-backed companies is also causing some venture capital firms to change their strategies, leading some of them to reduce funding of their portfolio companies and making it more difficult for such companies to access capital and to fulfill their potential, which can result in write-downs and write-offs of such companies by other venture capital firms, such as ourselves, who are co-investors in such companies.

Changes in valuations of our privately held, early stage companies tend to be more volatile than changes in prices of publicly traded securities.

Investments in privately held, early-stage companies are inherently more volatile than investments in more mature businesses. Such immature businesses are inherently fragile and easily affected by both internal and external forces. Our investee companies can lose much or all of their value suddenly in response to an internal or external adverse event. Conversely, these immature businesses can gain suddenly in value in response to an internal or external positive development. These events and their effect on valuation may not be measurable until they occur. Moreover, because our ownership interests in such investments are generally valued only at quarterly intervals by our Valuation Committee, a committee made up of all the independent members of our Board of Directors, changes in valuations from one valuation point to another tend to be larger than changes in valuations of marketable securities, which are revalued in the marketplace much more frequently. Information pertinent to our portfolio companies is not always known immediately by us, and, therefore, its availability for use in determining value may not always coincide with the time frame of our valuations.

Fluctuations in the price of oil may affect our alternative energy companies.

We have investments in securities of companies that are developing alternative solutions for energy and chemical production to those that rely on the use of oil. These alternative solutions are viable economically at varying prices of barrels of oil. As such, the recent decline and any future declines in the price of oil may adversely affect the business prospects and the value of our securities of these alternative energy companies.

Because we do not choose investments based on a strategy of diversification, nor do we rebalance the portfolio should one or more investments increase in value substantially relative to the rest of the portfolio, the value of our portfolio is subject to greater volatility than the value of companies with more broadly diversified investments.

We do not choose investments based on a strategy of diversification. We also do not rebalance the portfolio should one of our portfolio companies increase in value substantially relative to the rest of the portfolio. Therefore, the value of our portfolio may be more vulnerable to events affecting a single sector or industry and, therefore, subject to greater volatility than a company that follows a diversification strategy. Accordingly, an investment in our common stock may present greater risk to you than an investment in a diversified company.

Item 6. Exhibits

- | | |
|--------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1* | Lease dated July 1, 2008 by and between Jack Rominger, Tommie Plemons and Dale Denson as Lessor and Harris & Harris Group, Inc., a New York corporation, as Lessee. |
| 10.2 | Nonsolicitation and Noncompetition Agreement between the Company and Charles E. Harris, dated July 31, 2008, incorporated by reference as Exhibit 10 to the Company's Form 8-K (File No. 814-00176) filed on August 1, 2008. |
| 31.01* | Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.02* | Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32* | Certification of CEO and CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

*filed herewith

SIGNATURES

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

Harris & Harris Group, Inc.

/s/ Daniel B. Wolfe
By: Daniel B. Wolfe
Chief Financial Officer

/s/ Patricia N. Egan
By: Patricia N. Egan
Chief Accounting Officer
and Vice President

Date: November 7, 2008

EXHIBIT INDEX

ExhibitDescription

No.

- 10.1 Lease dated July 1, 2008 by and between Jack Rominger, Tommie Plemons and Dale Denson as Lessor and Harris & Harris Group, Inc., a New York corporation, as Lessee.
- 31.01 Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.02 Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification of CEO and CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.