

Edgar Filing: Highland Credit Strategies Fund - Form N-2

Highland Credit Strategies Fund  
Form N-2  
March 15, 2006

As filed with the Securities and Exchange Commission on March 15, 2006  
Securities Act Registration No. 333-  
Investment Company Act Registration No. 811-

=====

U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
[GRAPHIC OMITTED]FORM N-2

Registration Statement	
Under the Securities Act of 1933	X
Pre-Effective Amendment No.	_
Post-Effective Amendment No.	_
and/or	
Registration Statement	
Under the Investment Company Act of 1940	X
Amendment No.	_

Highland Credit Strategies Fund  
(Exact Name of Registrant as Specified in Declaration of Trust)  
Two Galleria Tower  
13455 Noel Road, Suite 800  
Dallas, Texas 75240  
(Address of Principal Executive Offices)  
(877) 665-1287  
(Registrant's telephone number, including area code)  
James D. Dondero, President  
Highland Credit Strategies Fund  
Two Galleria Tower  
13455 Noel Road, Suite 800  
Dallas, Texas 75240

(Name and Address of Agent for Service)

Copies to:  
Philip Harris, Esq.  
Skadden, Arps, Slate, Meagher & Flom LLP  
Four Times Square  
New York, New York 10036

Approximate date of proposed public offering:

As soon as practicable after the effective date of this Registration Statement.

CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

=====

Title of Securities Being Registered	Amount Being	Proposed Maximum	Proposed
		Offering	Aggreg

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

	Registered	Price per Unit	Offering
Common Shares, \$0.001 par value.....	100,000 shares	\$20.00	\$2,00

(1) Estimated solely for the purpose of calculating the registration fee.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THE REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(a) OF THE SECURITIES ACT OF 1933 OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATES AS THE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(a), MAY DETERMINE.

### HIGHLAND CREDIT STRATEGIES FUND

#### CROSS REFERENCE SHEET

#### Part A -- Prospectus

	Items in Part A of Form N-2	Location in Pr
Item 1.	Outside Front Cover	Cover Page
Item 2.	Cover Pages; Other Offering Information	Cover Page
Item 3.	Fee Table and Synopsis	Prospectus Summary; Summary o
Item 4.	Financial Highlights	Not Applicable
Item 5.	Plan of Distribution	Cover Page; Prospectus Summar
Item 6.	Selling Shareholders	Not Applicable
Item 7.	Use of Proceeds	Use of Proceeds; The Trust's
Item 8.	General Description of the Registrant	The Trust; The Trust's Invest Description of Shares; Ant in the Agreement and Decla Closed-End Trust Structure
Item 9.	Management	Management of the Trust; Cust Agent; Trust Expenses
Item 10.	Capital Stock, Long-Term Debt, and Other Securities	Description of Shares; Distri Reinvestment Plan; Anti-Ta the Agreement and Declarat Matters
Item 11.	Defaults and Arrears on Senior Securities	Not Applicable
Item 12.	Legal Proceedings	Legal Opinions
Item 13.	Table of Contents of the Statement of Additional Information	Table of Contents for the Sta Information

#### Part B -- Statement of Additional Information

Item 14.	Cover Page	Cover Page
Item 15.	Table of Contents	Cover Page
Item 16.	General Information and History	Not Applicable
Item 17.	Investment Objective and Policies	Investment Objectives and Pol Policies and Techniques; O Policies and Techniques; P

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Item 18.	Management	Management of the Trust; Port Brokerage
Item 19.	Control Persons and Principal Holders of Securities	Not Applicable
Item 20.	Investment Advisory and Other Services	Management of the Trust; Expe
Item 21.	Portfolio Managers	Management of the Trust
Item 22.	Brokerage Allocation and Other Practices	Portfolio Transactions and Br
Item 23.	Tax Status	Tax Matters; Distributions
Item 24.	Financial Statements	Financial Statements; Indepen

### Part C -- Other Information

Items 25-34 have been answered in Part C of this Registration Statement

[flag]

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

PRELIMINARY PROSPECTUS

Subject to Completion , 2006

-----  
Shares  
Highland Credit Strategies Fund  
Common Shares  
-----

Investment Objectives. Highland Credit Strategies Fund (the "Trust") is a newly organized, non-diversified, closed-end management investment company. The Trust's primary investment objective is to deliver attractive risk-adjusted returns to its investors by employing a multi-strategy investment approach to exploit relative value and arbitrage opportunities within the credit markets. Highland Capital Management, L.P., the Trust's investment manager ("Highland" or the "Investment Manager"), will execute, on behalf of the Trust, directional, relative value, capital structure arbitrage and event-driven investment strategies across various credit markets where the Investment Manager holds significant investment experience: primarily the leveraged loan, high yield, structured products, and distressed markets. The Trust will seek to create a portfolio of investments that will maintain low correlation to the broader equity and corporate bond markets, as well as to other alternative investment strategies. A significant portion of the Trust's assets may be invested in securities rated below investment grade, which are commonly referred to as "junk bonds." There can be no assurance that the Trust's investment objectives will be achieved, and the Investment Manager has full discretion regarding the capital markets from which it can access investment opportunities.

No Prior History. The Trust's shares have no history of public trading. Shares of closed-end investment companies frequently trade at a discount from their net asset value. This risk may be greater for investors expecting to sell their shares in a relatively short period after completion of the public offering. The Trust anticipates that its common shares will be listed on the New York Stock Exchange under the symbol " ."

(continues on next page)

Before buying any common shares you should read the discussion of the material

**Edgar Filing: Highland Credit Strategies Fund - Form N-2**

risks of investing in the Trust in "Principal risks of the Trust" beginning on page of this prospectus. Certain of the risks are summarized in "Prospectus summary--Principal Risks of the Trust" beginning on page .

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Price to Public	Sales Load(2)	Estimated Offering Expenses (
Per Share	\$	\$	\$
Total (1)	\$	\$	\$

- (1) The Trust has granted the underwriters an option to purchase up to additional common shares at the price to public, less the sales load, within 45 days of the date of this prospectus solely to cover over-allotments, if any. If such option is exercised in full, the total price to public, sales load, estimated offering expenses and proceeds to the Trust will be \$ , \$ , \$ and \$ , respectively. See "Underwriting."
- (2) Highland may pay certain qualifying underwriters a sales incentive fee, structuring fee or, alternatively, additional compensation in connection with the offering provided that certain specified sales targets are met. Highland may pay commissions to employees of its affiliates that participate in the marketing of the Trust's common shares. See "Underwriting."
- (3) The Trust will pay offering expenses of the Trust (other than the sales load) up to an aggregate of \$ per share of the Trust's common shares sold in this offering which may include a reimbursement of Highland's expenses incurred in connection with this offering. Highland has agreed to pay such offering expenses of the Trust to the extent they exceed \$ per share of the Trust's common shares. The aggregate offering expenses (other than sales load) to be incurred by the Trust are estimated to be \$ (including amounts incurred by Highland on behalf of the Trust).
- (4) Proceeds to the Trust are calculated after expenses.

The underwriters expect to deliver the common shares to purchasers on or about , 2006.

(continued from previous page)

Investment Policies and Strategy. Under normal market conditions, the Investment Manager will employ, on behalf of the Trust, directional, capital structure arbitrage, relative value, and event-driven investment strategies across various credit markets where the Investment Manager holds significant

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

investment experience; primarily the leveraged loan, high yield, structured products, and distressed markets. The Trust will utilize a multi-strategy investment approach to exploit relative value and arbitrage opportunities within these markets. An objective of the Trust is to maintain low correlation to the broader equity and corporate bond markets, as well as other alternative investment strategies, and to provide high risk-adjusted returns on capital. No assurance can be given that the Trust will achieve its objectives, and the Investment Manager has full discretion regarding the capital markets from which it can access investment opportunities.

The Investment Manager looks to implement selected trading strategies to exploit pricing inefficiencies across the credit markets and within an individual issuer's capital structure. The Trust seeks to achieve diversification by strategy, industry, security type and credit market, but reserves the right to re-position its portfolio toward more concentrated levels depending on market dynamics. Highland manages interest rate, default, currency and systemic risks through a variety of trading methods and market tools, including derivative hedging instruments, as it deems appropriate.

The multi-strategy investment program to be implemented by the Trust will allow the Investment Manager to assess what it considers to be the best risk-adjusted opportunities across multiple markets and to quickly adjust the Trust's trading strategies and market focus to changing conditions. The Investment Manager intends to focus primarily on the U.S. marketplace, but may pursue opportunities in the global credit markets.

You should read this prospectus, which contains important information about the Trust, before deciding whether to invest, and retain it for future reference. A Statement of Additional Information, dated , 2006, containing additional information about the Trust, has been filed with the Securities and Exchange Commission (the "Commission") and is incorporated by reference in its entirety into this prospectus. You can review the table of contents of the Statement of Additional Information on page of this prospectus. You may request a free copy of the Statement of Additional Information by calling (877) 665-1287 or by writing to the Trust, or obtain a copy (and other information regarding the Trust) from the Commission's web site (<http://www.sec.gov>).

The Trust's common shares do not represent a deposit or obligation of, and are not guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board or any other government agency.

Until , 2006 (25 days after the date of this prospectus), all dealers that buy, sell or trade the common shares, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers' obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

ii

### TABLE OF CONTENTS

Prospectus Summary.....	1
Summary of Trust Expenses.....	17
The Trust.....	19
Use of Proceeds.....	19
The Trust's Investments.....	19
Principal risks of the Trust.....	31
Management of the Trust.....	41
Net asset value.....	42

Edgar Filing: Highland Credit Strategies Fund - Form N-2

Distributions.....43  
 Dividend reinvestment plan.....43  
 Description of shares.....44  
 Anti-Takeover provisions in the Agreement and Declaration of Trust.....46  
 Closed-end fund structure.....47  
 Repurchase of common shares.....47  
 Tax matters.....48  
 Underwriting.....49  
 Custodian and transfer agent.....50  
 Legal opinions.....50  
 Privacy principles of the Trust.....50  
 Table of contents for the Statement of Additional Information.....51

You should rely only on the information contained or incorporated by reference in this prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information in this prospectus is accurate only as of the date of this prospectus. Our business, financial condition and prospects may have changed since that date.

iii

PROSPECTUS SUMMARY

This is only a summary. This summary may not contain all of the information that you should consider before investing in our common shares. You should review the more detailed information contained in this prospectus and in the Statement of Additional Information.

The Trust .....	Highland Credit Strategies Fund is a newly organized, management investment company. Throughout this prospectus, we refer to Highland Credit Strategies Fund simply as the "Trust" or as "we" and "our."
The Offering.....	The Trust is offering common shares at an offering price of \$20.00 per share through a group of underwriters led by [redacted]. The common shares of beneficial interest are referred to as "common shares" in the rest of this prospectus. You may purchase common shares (\$2,000) in order to participate in this offering. The Underwriters have given the Underwriters an option to purchase up to [redacted] shares to cover over-allotments. Highland has agreed to pay the offering expenses, and (ii) offering expenses (other than sales commissions) on a common share. See "Underwriting."
Investment Objectives.....	The Trust's primary investment objective is to deliver superior risk-adjusted returns to its investors by employing a multi-strategy approach to exploit relative value and arbitrage opportunities within the fixed income market. Highland will execute, on behalf of the Trust, direct and indirect capital structure arbitrage and event-driven investment strategies in credit markets where the Investment Manager holds significant experience: primarily the leveraged loan, high yield, distressed markets. The Trust will seek to create a portfolio of investments that will maintain low correlation to the broader equity market as well as to other alternative investment strategies. The

Edgar Filing: Highland Credit Strategies Fund - Form N-2

that the Trust's investment objectives will be achieved. The Investment Manager has full discretion regarding the capital market investment opportunities. See "The Trust's investments Policies."

Investment Policies  
And Strategy.....

The Investment Manager looks to implement selected trading and pricing inefficiencies across the credit markets and with respect to capital structure. The Trust seeks to achieve diversification by industry, security type and credit market, but reserves the right to tilt its portfolio toward more concentrated levels depending on market conditions. Highland manages interest rate, default, currency and credit risk through a variety of trading methods and market tools, including derivatives instruments, as it deems appropriate.

The Investment Manager believes that the Trust will benefit from its industry focused investment platform and specialist trading approach. Through relative value and directional opportunities, the Investment Manager leverages its investment platform of approximately sixty investment professionals, which actively monitor approximately 1,000 credits. Their market research and existing positions often leads to a meaningful increase in the timeliness and quality of information that the Investment Manager identifies prospective investments. Additionally, the Investment Manager employs investment professionals that focus on individual credit markets, industry and structured products segments. This broad platform of investment specialists differentiates the Investment Manager from other investment managers on a limited number of investment professionals working within the investment capacity. The Investment Manager believes that credit

1

due-diligence intensive process that requires long-term research and industry and product specialization so that investment decisions are not opposed to reactive in nature.

The multi-strategy investment program to be implemented by the Investment Manager to assess what it considers to be the best investment opportunities across multiple markets and to quickly adjust to changing strategies and market focus to changing conditions. The Investment Manager intends to focus primarily on the U.S. marketplace, but may invest in the global credit markets.

Investment Strategy .....

Under normal market conditions, the Investment Manager will employ the Trust, directional, capital structure arbitrage, market neutral and event-driven investment strategies across various credit markets. The Investment Manager holds significant investment experience in leveraged loan, high yield, structured products, and derivatives. The Trust will utilize a multi-strategy investment approach to identify and arbitrage opportunities within these markets. An objective is to maintain low correlation to the broader equity and credit markets as other alternative investment strategies, and to provide attractive returns on capital. No assurance can be given that the Investment Manager will achieve its objectives, and the Investment Manager has full discretion to invest in markets from which it can access investment opportunities.

Edgar Filing: Highland Credit Strategies Fund - Form N-2

The Investment Manager will select investments from a range of strategies and credit markets in order to create the desired diversification and to optimize the risk-reward parameters. The Investment Manager does not intend to invest the Trust's assets according to any fixed allocations. The investment team and other Highland personnel have a wide range of resources to identify attractive individual investment opportunities for consideration in connection with the Trust. The following is a description of the general types of investments the Trust may invest. This description is merely a summary and the Investment Manager has discretion to cause the Trust to invest in other securities and to follow other investment criteria and guidelines set forth in "The Trust's Investments - Portfolio Composition" for the period. The types of securities and investments the Trust may invest in include:

The Trust will invest and trade in listed and unlisted securities and unrated, debt and equity instruments and other obligations, structured debt and equity instruments as well as financial instruments. Investments may include investments in distressed positions, publicly-traded debt and equity securities, obligations placed with banks, insurance companies and other lending institutions, claims, accounts receivable and any other form of obligation in a bankruptcy or workout process. The Trust may invest in securities denominated in foreign currencies and denominated in foreign currencies.

As part of its investment program, the Trust may invest in debt or synthetic instruments that are sold in direct transactions between their issuers and their purchasers and that are not traded on an exchange, nor traded over the counter. The Trust may also invest in equity-related securities from time to time in connection with a leveraged transaction.

The Trust may employ currency hedges (either in the form of derivatives) in certain circumstances to reduce currency risk. The Trust may also use leverage in the form of preferred shares, and the Trust may invest in securities of companies whose capital structures are highly leveraged.

2

From time to time, the Investment Manager may also invest the Trust's assets in short-term U.S. Government obligations, bank deposits, commercial paper and other money market instruments. The Investment Manager may enter into repurchase agreements with respect to such obligations to make investments quickly and to serve as collateral with respect to its investments. A greater percentage of Trust assets may be invested in obligations if the Investment Manager believes that a greater percentage is appropriate because of expected economic or business conditions or for security prices. From time to time cash balances in connection with the account may be placed in a money-market fund.

Investment Manager.....

Highland will be the Trust's investment manager. Highland will receive a management fee, payable monthly, in an amount equal to a percentage of the Trust's Managed Assets (the "Management Fee"). The Management Fee will be an amount equal to the total assets of the Trust attributable to any Preferred Shares of the Trust issued or otherwise attributable to the use of leverage) minus the Trust's liabilities (other than the aggregate indebtedness connected with the use of leverage). The Management Fee is comprised of two components:



Edgar Filing: Highland Credit Strategies Fund - Form N-2

Management Fee is paid to Highland as compensation for services it provides to the Trust, and % of to Highland as compensation for the administrative ser Trust. See "Management of the Trust."

Borrowings And Preferred Shares.....

The Trust intends to use leverage through the issuance beneficial interest ("Preferred Shares"), commercial p an aggregate amount of up to % of the Trust's Man issuance or borrowing. The Trust may borrow from banks institutions.

The Trust currently intends to issue Preferred Shares months following the completion of this offering. The Shares will leverage your investment in common shares. Preferred Shares, costs of that offering will be borne shareholders and result in a reduction of the net asse shares. Any issuance of Preferred Shares, commercial p of borrowing will have seniority over the common share

Any Preferred Shares issued by the Trust will pay divi rates, which will be reset frequently. Borrowings may rate and generally will be based on short-term rates. return, net of applicable Trust expenses, on the Trust purchased with leverage exceeds the Preferred Share di periodically, or the interest rate on any borrowings, return or income than will be needed to pay such divid In this event, the excess will be available to pay hig common shares. When leverage is employed, the net asse the common shares and the yield to holders of common s Leverage creates a greater risk of loss, as well as a the common shares than if leverage is not used. The Tr may not be successful. See "Principal Risks of the Tru

Distributions.....

Commencing with the Trust's initial dividend, the Trus monthly cash distributions of all or a portion of its income to common shareholders. We expect to declare t on the Trust's common shares within approximately 45 d offering and to pay that initial monthly dividend appr after completion of this offering. The Trust expects

annually at least 90% of its investment company taxabl

Various factors will affect the level of the Trust's c gains, such as its asset mix. To permit the Trust to distributions, the Trust may from time to time distrib amount of income and gains earned in a particular peri income and gains would be available to supplement futu result, the distributions paid by the Trust for any pa or less than the amount of income and gains actually e that month. Undistributed income and gains will add to value and, correspondingly, distributions from undistr from capital, if any, will deduct from the Trust's net "Distributions." Shareholders will automatically have distributions reinvested in common shares issued by th

Edgar Filing: Highland Credit Strategies Fund - Form N-2

the Trust purchased in the open market in accordance with the reinvestment plan unless an election is made to receive the Reinvestment Plan."

Listing.....

The Trust anticipates that its common shares will be listed on the Exchange under the symbol "....."

Custodian And Transfer Agent.....

ALPS Mutual Trusts Services, Inc. ("ALPS"), located at Denver, Colorado 80202, will serve as custodian for the Trust in its capacity, will maintain certain financial and accounting records pursuant to an agreement with the Trust. ALPS will also serve as transfer agent. See "Custodian and Transfer Agent."

Market Price Of Shares.....

Common shares of closed-end investment companies frequently trade at prices higher than their net asset value. Common shares of closed-end investment companies like the Trust that invest primarily in equity securities have frequently traded at prices higher than their net asset value and at prices lower than their net asset value. The Trust's common shares will trade at a price higher than or equal to the Trust's net asset value will be reduced immediately following the sales load and the amount of the offering costs paid by the Trust. Proceeds." In addition to net asset value, the market price of the Trust's shares may be affected by such factors as dividend level, interest rates, affected by expenses, dividend stability, liquidity and other factors. See "Principal Risks of the Trust," "Description of Shares," and "Statement of Additional Information with the heading 'Market Price of Shares.'" The common shares are designed primarily for long-term investors and should not purchase common shares of the Trust if you are not prepared to hold them after purchase.

Principal Risks Of The Trust.....

The following is a summary of some of the risks associated with the Trust's common shares. Investors should also refer to the Trust's Prospectus for a more detailed explanation of the risks associated with investing in the Trust's common shares.

No Operating History

The Trust is a non-diversified, closed-end management investment company with no operating history.

Investment And Market Discount Risk

An investment in the Trust's common shares is subject to market discount risk, including the possible loss of the entire amount that you invest. If shares are sold, the price received may be less than the original investment. Net asset value will be reduced immediately following the initial offering by the amount of the sales load and other expenses of the Trust. Common shares are designed for long-term investors and are not intended to be treated as trading vehicles. Shares of closed-end management investment companies frequently trade at a discount from their net asset value and may trade at a price that is less than the initial offering price.

factors. If shares are sold, the price received may be less than the original investment. Net asset value will be reduced immediately following the initial offering by the amount of the sales load and other expenses of the Trust. Common shares are designed for long-term investors and are not intended to be treated as trading vehicles. Shares of closed-end management investment companies frequently trade at a discount from their net asset value and may trade at a price that is less than the initial offering price.

greater for investors who sell their shares in a relation to the offering after completion of the initial offering.

#### Concentration of the Trust's Portfolio

While the Investment Manager will invest in a number of instruments issued by different institutions and plans investment strategies with respect to the Trust's portfolio, a significant amount of the Trust's investments could be in instruments of only a few companies or that at any particular time the investment strategy could be more heavily weighted than the concentration of the Trust's portfolio in any one obligation, resulting in a greater degree of risk with respect to defaults by the issuer. The concentration of the portfolio in any one industry would result in a greater degree of risk with respect to economic downturns in that industry. The concentration of the Trust's portfolio in any one industry would subject the Trust to a greater degree of risk if the portfolio was diversified with respect to several industries.

#### Illiquidity of Investments

The investments made by the Trust may be very illiquid. The Trust may not be able to sell such investments at prices that reflect the Investment Manager's assessment of their fair value or to liquidate investments by the Trust. Illiquidity may result from the absence of an established market for the investments as well as legal restrictions on their resale by the Trust and other factors. The nature of the Trust's investments, especially those in private companies, may require a long holding period prior to their sale, whether the investment will be profitable or not.

#### Bank Loans

A portion of the Trust investments may consist of loans, including those therein originated by banks and other financial institutions, referred to as "bank loans." The Trust investments may include loans incurred by borrowers in connection with highly leveraged operations, finance internal growth, acquisitions, mergers or stock repurchases. As a result of the additional debt incurred by the borrower in the course of the transaction, the borrower's creditworthiness may be such that rating agencies to be below investment-grade. Such loans may include corporate loans which are negotiated by one or more commercial banks, institutions and syndicated among a group of commercial banks or institutions. In order to induce the lenders to extend loans at a favorable interest rate, the borrower often provides the lender with information about its business which is not generally available to the public.

Bank loans are typically at the most senior level of the borrower's debt and are often secured by specific collateral, including, but not limited to, real estate, trademarks, patents, accounts receivable, inventory, equipment, franchises and common and preferred stock of the borrower and its affiliates. Bank loans often contain restrictive covenants that restrict the activities of the borrower in an effort to protect the lender's ability to receive timely payments of principal and interest. Such covenants may include restrictions on dividend payments, specific

mandatory minimum financial ratios, limits on total debt, and other tests. Bank loans usually have shorter terms than subordinated debt.

may require mandatory prepayments from excess cash flow from offerings of debt and/or equity securities. The bank loans and obligations to be acquired by the Trust are likely to

The Trust may acquire interests in bank loans and other debt securities directly (by way of sale or assignment) or indirectly through the purchase of an assignment. The purchaser of an assignment typically succeeds to all the obligations of the assigning institution and becomes a party to an agreement with respect to the debt obligation; however, the purchaser's obligations are restricted than those of the assigning institution. A partial purchase of a portion of a debt obligation typically results in a co-obligation with the institution participating out the interest, not in the purchasing participations, the Trust generally will have no control over compliance by the borrower with the terms of the loan, and the right of set off against the borrower, and the Trust may not have access to collateral supporting the debt obligation in which it has a participation. As a result, the Trust will be exposed to the credit risk of the borrower and the institution selling the participation.

Purchasers of bank loans are predominantly commercial banks and investment banks. As secondary market trading volume increases, bank loans frequently adopt standardized documentation to facilitate trading which should improve market liquidity. There can be no assurance of future levels of supply and demand in bank loan trading, the degree of liquidity or that the current level of liquidity will be maintained. The provision to holders of such loans of confidence in the borrower, the unique and customized nature of the loan, the private syndication of the loan, bank loans are not as liquid as a publicly traded security, and historically the trading volume in the bank loan market has been small relative to the high-yield

#### Distressed Debt

The Trust is authorized to invest in the securities of distressed and bankrupt issuers, including debt obligations that are in default or payment default. Such investments generally trade at a discount and are considered speculative. The repayment of defaulted obligations is subject to significant uncertainties. Defaulted obligations might require a lengthy workout or bankruptcy proceedings, during which the Trust may not receive any interest or other payments. Typically such workouts result in only partial recovery of cash payments or other payments on the obligation for other debt or equity securities of the issuer, which may in turn be illiquid or speculative.

There are a number of significant risks inherent in the investment in distressed debt. First, many events in a bankruptcy are the product of circumstances beyond the adversary proceedings and are beyond the control of the issuer. Creditors are generally given an opportunity to object to the plan of reorganization; there can be no assurance that a bankruptcy court in the issuer's jurisdiction would not approve actions that would be contrary to the interests of the Trust. Second, the effect of a bankruptcy filing on an issuer can permanently affect the issuer. The issuer may lose its ability to operate, its employees and otherwise become incapable of restoring its ability to pay. If for this or any other reason the proceeding is converted to a liquidation, the value of the issuer may not equal the liquidation value. Third, the duration of a bankruptcy proceeding is difficult to predict. A creditor's return on investment may be adversely affected by delays while the plan of

reorganization is being negotiated, approved by the court in the bankruptcy court and until it ultimately becomes effective, administrative costs in connection with a bankruptcy proceeding may be high and would be paid out of the debtor's estate prior to the claims of other creditors. For example, if a proceeding involves protracted litigation, or turns into a liquidation, substantial additional administrative costs. Fifth, bankruptcy law permits the inclusion of "substantially similar" claims in determining the classification of claims in a reorganization. Because the standard for classification is broad, the risk that the Trust's influence with respect to the classification of other obligations it owns can be lost by increases in the number of claims in that class or by different classification of claims in the early stages of the bankruptcy process it is often difficult to identify, or even to identify, any contingent claims. Seventh, especially in the case of investments made prior to the commencement of bankruptcy proceedings, creditors can lose their ranking if they exercise "domination and control" over a debtor and other creditors demonstrate that they have been harmed by such actions. Claims that have priority by law (for example, claims for tax

In any investment involving distressed debt obligations, there is a risk that the transaction involving such debt obligations will require a considerable time or will result in a distribution of the proceeds of the obligation in exchange for the distressed debt obligations that may be less than the Trust's purchase price of such debt obligations. Furthermore, if an anticipated transaction does not occur, the Trust may be required to sell its investment at a loss. Given the size of the Trust's investments concerning transactions involving distressed debt obligations, there is a potential risk of loss by the Trust in any particular investment.

Investments in companies operating in workout modes or under Chapter 11 of the Bankruptcy Code are also, in certain circumstances, subject to the claims of liabilities which may exceed the value of the Trust's investment in the company. For example, under certain circumstances, creditors who have inappropriately exercised control over the management of a company may have their claims subordinated or disallowed or may be liable for damages suffered by parties as a result of such actions. An active management style may present a greater risk in such circumstances than a passive approach. In addition, under certain circumstances, distributions by the Trust or payments on the debt obligations may be such payment is later determined to have been a fraudulent or preferential payment.

The Investment Manager on behalf of the Trust may participate in committees formed by creditors to negotiate with the management of companies that may or may not be in bankruptcy or may be involved with debtors with respect to restructuring issues. If the Trust is a member of the committee, the Trust would likely be only one of many creditors who would be interested in obtaining an outcome that is in its best interests. There can be no assurance that the Trust would be able to obtain results most favorable to it in such proceedings and that it may incur significant legal and other expenses in attending to its duties as a result of participation by the Trust on such committees. The Trust also has duties to other creditors represented by the committee and thereby expose the Trust to liability to such other creditors as a result of the Trust's actions. Participation by the Trust on such committees may expose the Trust to be subject to certain restrictions on its ability to participate in a particular investment and may also make the Trust an "unsecured

the federal securities laws. Either circumstance will ability to trade in or acquire additional positions in

7

particular investment when it might otherwise desire t

#### High-Yield Securities

A portion of the Trust's investments will consist of i generally be characterized as "high-yield securities." typically rated below investment grade by one or more statistical rating organizations or are unrated but of to obligations rated below investment grade, and have liquidity risk than more highly rated obligations. Hig generally unsecured and may be subordinate to other ob The lower rating of high-yield securities reflects a g adverse changes in the financial condition of the issu conditions (including, for example, a substantial peri or declining earnings) or both may impair the ability payment of principal and interest. Many issuers of hig highly leveraged, and their relatively high debt to eq increased risks that their operations might not genera service their obligations. Overall declines in the bel and other markets may adversely affect such issuers by to refinance their obligations at maturity.

High-yield securities are often issued in connection w or recapitalizations in which the issuers incur a subs indebtedness than the level at which they had previous securities that are debt instruments have historically default rates than has been the case for investment gr may also invest in equity securities issued by entitie unrated or are rated below investment grade.

The Trust is authorized to invest in obligations of is trading at significantly higher yields than had been h applicable issuer's obligations. Such investments may that have a heightened probability of being in covenan future. Such investments generally are considered spec defaulted obligations is subject to significant uncert obligations might be repaid only after lengthy workout during which the issuer might not make any interest or such workout or bankruptcy proceedings result in only payments or an exchange of the defaulted security for securities of the issuer or its affiliates, which may speculative.

High-yield securities purchased by the Trust will be s additional risks to the extent that such obligations m subordinated to substantial amounts of senior indebted portion of which may be secured. Moreover, such obliga Trust may not be protected by financial covenants or l indebtedness.

Insolvency Considerations with Respect to Issuers of Debt Securities. Various laws enacted for the protection of creditors may apply to the obligations held by the Trust. The information in this section is provided with respect to U.S. issuers subject to United States insolvency considerations may differ with respect to other issuers. The rights brought by an unpaid creditor or representative of a creditor of a debt obligation, such as a trustee in bankruptcy, where the creditor did not receive fair consideration or reasonably equivalent value for the indebtedness constituting the debt obligation and, in such indebtedness, the issuer (i) was insolvent, (ii) was unable to pay its capital or (iii) intended to incur, or believed that it would incur, its ability to pay such debts as they mature, such as the creditor's right to invalidate, in whole or in part, such indebtedness as to the creditor, subordinate such indebtedness to existing or future debts of the issuer, to recover amounts previously paid by such issuer in satisfaction of such indebtedness. The measure of insolvency for purposes of this section. Generally, an issuer would be considered insolvent at the time the sum of its debts were then greater than all of its property, or if the present fair saleable value of its assets was less than the amount that would be required to pay its probable liabilities as they became absolute and matured. There can be no assurance that a court would apply in order to determine whether the issuer's giving effect to the incurrence of the indebtedness constitutes a breach of obligation or that, regardless of the method of valuation, a court would determine that the issuer was "insolvent" upon giving effect to the obligation. In addition, in the event of the insolvency of an issuer, the issuer's payments made on such debt obligation could be subject to the issuer's "preference" if made within a certain period of time (generally one year) before insolvency. Similarly, a court might apply the doctrine of subordination to subordinate the claim of a lender or creditor of the issuer, to claims of other creditors of the borrower, such as a lender, institution, another investor, or any of their transferees, if the issuer engaged in unfair, inequitable, or fraudulent conduct. Payments on a debt obligation are avoidable, whether as fraudulent conveyances or preferences, such payments can be recaptured either from the issuer (such as the Trust) or from subsequent transferees of the issuer (such as investors in the Trust). To the extent that any such payments to the Trust the resulting loss will be borne by the investor. In the event of a bankruptcy or insolvency proceeding would be able to recover any such payment from a holder of notes only to the extent of the issuer's jurisdiction over such holder or its assets. Moreover, payments that are avoidable payments could not be recaptured directly from the issuer for value in exchange for its note, in good faith and with no knowledge that such payments were avoidable. The Investment Manager does not intend to conduct that would form the basis for a successful cause of action for fraudulent conveyance, preference or equitable subordination. The Investment Manager assures, however, as to whether any lending institution or issuer, which the issuer acquired the debt obligations engaged in any other conduct that would subject the debt obligations to the issuer's insolvency laws) and, if it did, as to whether such conduct would be asserted in a U.S. court (or in the courts of any other country) against the issuer.

Analysis of Troubled, Distressed or Bankrupt Companies  
The Trust may invest in companies that are troubled, in such, they are subject to a multitude of legal, industrial, and governmental forces that make analysis of these companies difficult. Further, the Investment Manager relies on company management, analyst reports, market participants, and personal experience to analyze the Trust. There can be no assurance that any of these sources are credible, or that the Investment Manager's analysis will lead to profitable investments.

#### Leverage

The use of leverage, which can be described as exposure to debt with a ratio greater than the amount of equity invested, either through Preferred Shares, borrowing or other forms of market exposure, may have favorable and unfavorable effects of price movements in the Trust. Insofar as the Trust employs leverage in its investments, the Trust will be subject to substantial risks of loss.

#### Common Stock Risk

The Trust will have exposure to common stocks. Although common stocks have historically generated higher average total returns than fixed income securities over the long-term, common stocks also have experienced significant volatility in those returns and may significantly underperform fixed income securities during certain periods. An adverse event, such as an unfavorable earnings report, may depress the value of common stocks held by the Trust. Also, the price of common stocks is subject to significant price movements in the stock market and a drop in the stock market may cause the price of common stocks to which the Trust has exposure to fluctuate for several reasons, including changes in the financial condition of an issuer or the general condition of the stock market, or when political or economic events affecting the market. In addition, common stock prices may be particularly sensitive to changes in interest rates, as the cost of capital rises and borrowing costs increase.

#### Dividend Risk

Dividends on common stock are not fixed but are declared at the discretion of the issuer's board of directors. There is no guarantee that the common stocks in which the Trust invests will declare dividends. If dividends are declared they will remain at current levels or increase or decrease. Further in "Tax Matters," "qualified dividend income" generally will be eligible for the reduced tax rate applicable to qualified dividend income for taxable years beginning before January 1, 2009. Higher tax rates will apply to dividend income beginning in 2009, unless further legislation is passed by Congress. There is no assurance as to what portion of the Trust's income will constitute qualified dividend income. See "Principal Risks--Dividend Risk."

#### Small And Mid-Cap Stock Risk

The Trust may invest in companies with small or medium capitalization. Small and medium company stocks can be more volatile than, and may have higher trading volume than, larger company stocks. There may be less trading volume for a company's stock, which means that buy and sell transactions may have a larger impact on the stock's price than is the case for larger company stocks. Smaller and medium companies may have fewer buyers and sellers. Any one line of business, therefore, may have a greater impact on a medium company's stock price than is the case for a large company. Smaller or medium company stocks may not be well known



Non-U.S. Securities Risk

The Trust anticipates that it will invest a portion of securities of non-

10

U.S. issuers. When the Trust acquires securities of non-U.S. issuers, the Trust is subject to risks not usually associated with owning securities of U.S. issuers. These risks can include fluctuations in foreign currency exchange rates, exchange controls, political and economic instability, nationalization, differences in financial reporting, differences in regulation and trading, and foreign taxation issues.

Emerging Markets Risk

Investing in securities of issuers based in underdeveloped countries entails all of the risks of investing in securities of developed countries to a heightened degree. Emerging market countries generally include countries throughout the world except the United States, Canada, Japan, Australia, and the most countries located in Western Europe. These heightened risks include greater risks of expropriation, confiscatory taxation, political, social, political and economic stability; (ii) the smaller market size for such securities and a lower volume of trading, resulting in greater price and in price volatility; and (iii) certain national policies that may limit the Trust's investment opportunities including restrictions on the types of issuers or industries deemed sensitive to relevant national policies.

Foreign Currency Risk

Because the Trust may invest in securities denominated in currencies other than the U.S. dollar, changes in foreign currency exchange rates affect the value of securities owned by the Trust, the unrealized gains or depreciation of investments and gains on and income from the sale of securities of certain countries may be volatile and therefore may affect the value of securities denominated in such currencies, which means the value of such securities could decline as a result of changes in the exchange rates of such currencies and the U.S. dollar. In addition, the Trust's foreign currency transactions in an attempt to enhance total return may also expose the Trust to the risks of foreign currency movements.

Securities Lending Risk

The Trust may lend its portfolio securities to banks or other financial institutions on creditworthiness standards established by the board of directors. Securities lending is subject to the risk that loaned securities may not be available to the Trust on a timely basis and the Trust may lose the opportunity to sell the securities at a desirable price. The risk of a decline in price of securities loaned by the Trust that occurs during the term of the loan would be borne by the Trust and would adversely affect the Trust's performance. Also, there may be delays in recovery, or no recovery, of the loaned securities, even a loss of rights in the collateral should the borrower fail financially while the loan is outstanding. These risks are more pronounced for non-U.S. securities.

Risks Associated With Options On Securities

There are several risks associated with transactions involving options on securities. For example, there are significant differences between the volatility of options markets that could result in an imperfect correlation between the price of the underlying securities and the price of the options, causing a given transaction not to achieve its objective.

whether, when and how to use options involves the exercise of judgment and even a well conceived transaction may be unsuccessful because of market behavior or unexpected events.

As the writer of a covered call option, the Trust forgoes the opportunity to profit from increases in the price of the underlying security covering the call option above the sum of the price of the call, but has retained the risk of loss if the price of the underlying security declines. As the Trust writes covered call options on its portfolio, its ability to benefit from

11

capital appreciation becomes more limited. The writer of a covered call option over the time when it may be required to fulfill its obligation under the option. Once an option writer has received an exercise notice, it must effect a closing purchase transaction in order to terminate the option and must deliver the underlying security at the exercise price.

When the Trust writes covered put options, it bears the risk that if the price of the underlying stock declines below the exercise price, the option will be exercised. If the option is exercised, the Trust could incur a loss equal to the price paid to purchase the stock underlying the put option at a price above the current price of the stock at the time of exercise plus the put premium received when it wrote the option. While the Trust's potential loss on a covered put option is limited to distributions earned on the underlying security securing the put option plus the premium received from the option, the Trust risks a loss equal to the entire exercise price of the option minus the put premium.

#### Interest Rate Risk

Interest rate risk is the risk that debt securities, and the value of the Trust's debt security holdings, will decline in value because of changes in interest rates. The value of debt securities will decrease in value when interest rates rise and increase in value when interest rates decline. This means that the net asset value of the Trust's shares will fluctuate with interest rate changes and that the value of the Trust's debt security holdings.

#### Prepayment Risk

If interest rates fall, the principal on bonds held by the Trust may be repaid earlier than expected. If this happens, the proceeds from the early payment will be reinvested by the Trust in securities bearing lower interest rates, which could result in a possible decline in the Trust's income and distributions. The Trust may invest in pools of mortgages issued or guaranteed by mortgage issuers or U.S. government agencies and instrumentalities. These securities are especially sensitive to prepayment risk because borrowers may refinance their mortgages when interest rates drop.

#### Non-Investment Grade Securities Risk

The Trust may invest in securities that are below investment grade. Non-investment grade securities are commonly referred to as high yield securities. Investments in lower grade securities will expose the Trust to more risk than if the Trust owned only higher grade debt securities. Because of the risks associated with lower grade securities, you could experience a loss on your investment in common shares of the Trust, both in the short-term and the long-term. Lower grade securities, though high yielding, are also high risk. They may be subject to certain risks with r

entity and to greater market fluctuations than certain rated securities. The retail secondary market for lower rated securities may be less liquid than that of higher rated debt securities and could make it difficult at times for the Trust to sell such securities at their value. See "Principal Risks of the Trust--Non-Investment Grade Securities Risk."

#### Strategic Transactions Risk

Strategic transactions in which the Trust may engage from time to time to enhance total return, including engaging in transactions involving futures, swaps, foreign currency transactions including forward contracts, currency swaps or options on currency and other derivatives transactions ("Strategic Transactions"), and other transactions, and special considerations. Strategic Transactions have the potential for imperfect correlation between the value of such instruments and the value of the assets, the

12

possible default of the other party to the transaction or the value of derivative instruments. Furthermore, the ability to successfully execute Strategic Transactions depends on the Highland's ability to predict market price movements, which cannot be assured. Thus, the use of Strategic Transactions may result in losses greater than if they had not been used. The Trust may sell or purchase portfolio securities at inopportune times, which may result in higher than current market values, may limit the amount of appreciation that can be realized on an investment or may cause the Trust to hold securities that it otherwise would sell. The use of foreign currency transactions may result in incurring losses as a result of the imposition of exchange rate fluctuations or of settlements or the inability of the Trust to deliver securities in the currency. Additionally, amounts paid by the Trust as premiums for Strategic Transactions assets held in margin accounts with respect to Strategic Transactions may be otherwise available to the Trust for investment purposes. See "Principal Risks of the Trust--Strategic Transactions Risk."

To the extent that the Trust purchases options pursuant to Strategic Transactions, the Trust will be subject to the following additional risks. If an option purchased by the Trust is not sold when it has reached its market price of the underlying security remains equal to or above its exercise price (in the case of a put), or remains less than its exercise price (in the case of a call), the Trust will not realize any profit in the option.

Also, where a put or call option on a particular security is purchased to protect against price movements in a related security, the price of the option may move more or less than the price of the related security. If the restrictions on exercise were imposed, the Trust might not be able to exercise the option it had purchased. If the Trust were unable to exercise the option it had purchased on a security, it would have to exercise the option to realize any profit or the option may expire worthless.

In general, there can be no assurance as to the percentage of distributions on the common shares that will qualify for treatment as common shareholdings as "qualified dividend income." Qualified dividend income received by individual common shareholders is taxed at the individual's applicable rates (currently at a maximum rate of 15%) provided certain other requirements are satisfied by the Trust and the

shareholders. The special tax treatment afforded to qu set to end as of December 31, 2008. Higher tax rates w unless further legislative action is taken by Congress

#### Market Risk Generally

The profitability of a significant portion of the Trus depends to a great extent upon correctly assessing the movements of securities and other investments and the rates. There can be no assurance that the Investment M predict accurately these price and interest rate movem investment strategies the Trust may utilize, there wil market risk.

#### Reinvestment Risk

The Trust reinvests the cash flows received from a sec income from such reinvestment, sometimes called intere on the prevailing interest rate levels at the time of risk that the interest rate at which interim cash flow fall. Reinvestment risk is greater for longer holding with large, early cash flows such as high-coupon bonds applies generally to the reinvestment of the proceeds maturity or sale of a portfolio security.

#### Timing Risk

13

Many agency, corporate and municipal bonds, and most m contain a provision that allows the issuer to "call" a before the bond's maturity date often after 5 or 10 ye retains the right to refinance the bond in the future decline below the coupon rate. There are three disadva provision. First, the cash flow pattern of a callable certainty. Second, because an issuer is more likely to interest rates have dropped, the Trust is exposed to r i.e., the Trust may have to reinvest at lower interest received when the bond is called. Finally, the capital a bond will be reduced because the price of a callable above the price at which the issuer may call the bond.

#### Inflation Risk

Inflation risk results from the variation in the value security due to inflation, as measured in terms of pur if the Trust purchases a five (5) year bond in which i of five percent (5%), but the rate of inflation increa to six percent (6%), then the purchasing power of the all but adjustable bonds or floating rate bonds, the T inflation risk because the interest rate the issuer pr the life of the security. To the extent that interest inflation rate, floating rate bonds have a lower level

#### Arbitrage Risks

The Trust will engage in capital structure arbitrage a strategies. Arbitrage strategies entail various risks external events, regulatory approvals and other factor consummation of announced corporate events and/or the positions. In addition, hedging is an important featur

arbitrage. There is no guarantee that the Investment Manager will be able to hedge the Trust's portfolio in the manner necessary to implement the Trust's strategy.

#### Short Sales

Short sales by the Trust that are not made "against the box" may involve unlimited loss potential since the market price of the securities may continuously increase. Short selling involves selling securities that may not be owned and borrowing the same securities for sale. Short selling may not be owned and borrowing the same securities for sale with an obligation to replace the borrowed securities. Short selling allows the Trust to profit from declines in market prices. If such a decline exceeds the transaction costs and the cost of borrowing the securities. However, since the borrowed securities must be purchased at market prices in order to close out the short position, a decline in the price of the borrowed securities would result in a loss. If the price of the securities to close out the short position can itself decline, the price of the securities to rise further, thereby exacerbating the losses. Such losses by replacing the securities sold short before they are replaced increased significantly. Under adverse market conditions, the Trust may have difficulty purchasing securities to meet its short sale obligations. The Trust might have to sell portfolio securities to raise the cash to meet its short sale obligations at a time when fundamental market conditions would not favor such sales.

#### Structured Finance Securities

A portion of the Trust's investments may consist of equity securities, collateralized mortgage obligations, collateralized bond obligations, collateralized loan obligations or similar instruments. Structured finance securities may present risks similar to those of the obligations in which the Trust may invest and, in fact, may present a greater significance in the case of structured finance securities. Investing in structured finance securities

14

may entail a variety of unique risks. Among other risks, structured finance securities may be subject to prepayment risk. In addition, a structured finance security will be affected by a variety of factors, including its priority in the capital structure of the issuer, the presence or absence of any credit enhancement, the level and timing of payments, the characteristics of the underlying receivables, loans or other assets being securitized, remoteness of those assets from the issuer, the adequacy of and ability to realize upon any related assets, and the capability of the servicer of the securitized assets.

#### Preferred Securities

There are special risks associated with investing in preferred securities, including:

- o Deferral. Preferred securities may include provisions that allow the issuer, at its discretion, to defer distributions to holders of the preferred security without any adverse consequences to the issuer. The issuer of the preferred security that is deferring its distributions may be required to report income for tax purposes although the issuer has not received such income.
- o Subordination. Preferred securities are subordinated to other securities of the issuer.

debt instruments in a company's capital structure to corporate income and liquidation payments, subject to greater credit risk than more senior

- o Liquidity. Preferred securities may be subordinate to many other securities, such as common stocks and other securities.
- o Limited Voting Rights. Generally, preferred securities have limited voting rights with respect to the issuing company. Dividends have been in arrears for a specified period of time which time the preferred security holders may have the right to elect members to the issuer's board. Generally, once all the dividends are paid, the preferred security holders no longer have the right to elect members to the issuer's board.

#### Synthetic Securities

In addition to credit risks associated with holding non-investment grade and high-yield debt securities, with respect to synthetic securities, the Trust will usually have a contractual relationship only with the issuer of the synthetic securities, and not the Reference Obligor (as defined below). The Trust generally does not have the right to directly enforce compliance by the Reference Obligor with the Reference Obligation nor any rights of set-off against the Reference Obligor. The Trust does not have any voting rights with respect to the Reference Obligor and does not benefit directly from any collateral supporting the Reference Obligation. The Trust will have the benefit of the remedies on default that would be available to the holder of such Reference Obligation. In addition, in the event of default by its counterparty, the Trust will be treated as a general creditor of the counterparty and will not have any claim with respect to the counterparty as well as that of the Reference Obligor. The Trust's concentrations of synthetic securities with any one counterparty increases the notes to an additional degree of risk with respect to the counterparty as well as by the Reference Obligor. The Trust will perform independent credit analyses of the counterparty and, where appropriate, or an entity guaranteeing such counterparty, individually. The "Reference Obligation" is the debt security or other obligation of the synthetic security is based. A "Reference Obligor" is the obligor of the Reference Obligation.

15

#### Valuation Risk

Fair value is defined as the amount for which assets could be sold in a disposition over a reasonable period of time, taking into account the nature of the asset. Fair value pricing, however, involves judgment and is inherently subjective and inexact, since fair valuation procedures are not possible to be sure what value should be attributed to an asset when an event will affect the market price of an asset. As a result, there can be no assurance that fair value pricing will be materially different from the market value and it is possible that the fair value determined will be materially different from the value that actually would be realized upon the sale of that asset.

#### Exemptive Relief Consideration

The Investment Manager expects to apply to the Commission for an exemptive relief to enable the registered investment companies advised by the Trust, including the Trust, to co-invest with other accounts

Edgar Filing: Highland Credit Strategies Fund - Form N-2

Investment Manager and its affiliates in certain private and other situations. There are no assurances that the Investor will receive the requested relief. If such relief is not obtained, the Investment Manager may be required to allocate assets solely to the Trust and/or other registered funds and other investment accounts that are not registered investment companies. The Trust's investment in certain securities it would acquire in and could adversely affect the speed at which the Trust's assets and, consequently, the performance of the Trust's investments.

Market Disruption And Geopolitical Risk

The aftermath of the war in Iraq and the continuing economic instability in the Middle East and terrorist attacks in other parts of the world may have resulted in market volatility and effects on the U.S. and worldwide financial markets and economic uncertainties in the United States and worldwide. We do not know how long the securities markets will continue to operate and cannot predict the effects of the occupation or situation in Iraq on the U.S. economy and securities markets. Given the nature of the investment in the common shares may not be appropriate under the circumstances, you should carefully consider your ability to assume these risks in connection with your investment in the Trust.

Anti-Takeover Provisions

The Trust's Agreement and Declaration of Trust include provisions that may limit the ability of other entities or persons to acquire the Trust or convert the Trust to open-end status. These provisions may limit the ability of common shareholders to sell their common shares at the then current market price of the common shares or to exercise their rights as common shareholders.

SUMMARY OF TRUST EXPENSES

The following table shows Trust expenses as a percentage of net assets attributable to common shares and assumes that the Trust has issued Preferred Shares or employed some other form of leverage in an amount equal to \_\_\_\_\_ % of the Trust's Managed Assets:

Shareholder Transaction Expenses

Sales load paid by you (as a percentage of offering price).....  
 Offering expenses borne by the Trust (as a percentage of offering price).....  
 Dividend reinvestment plan fees.....

Per  
 Attr  
 (assumes  
 or o

-----  
 Annual Expenses

Management fee.....

Edgar Filing: Highland Credit Strategies Fund - Form N-2

Other expenses.....

Total annual expenses.....

- (1) The Trust will pay offering costs of the Trust (other than the sales load) up to an aggregate of \$ per share of the Trust's common shares sold in this offering which may include a reimbursement of Highland's expenses incurred in connection with this offering. Highland has agreed to pay such offering costs of the Trust to the extent they exceed \$ per share of the Trust's common shares.
- (2) You will be charged a \$ service charge and a brokerage commission of \$ per share sold if you direct the Plan Agent (as defined below) to sell your common shares held in a dividend reinvestment account.
- (3) Does not include the portion of the Management Fee that is payable to Highland for the provision of administrative services to the Trust, which is included in "Other expenses."
- (4) Certain of these expenses represent the administrative fee of % payable to Highland for the provision of administrative services to the Trust and the reimbursement at cost to Highland for non-advisory services provided to the Trust by employees of Highland. See "Management of the Trust--Investment Management Agreement." If the Trust offers Preferred Shares, costs of that offering, estimated to be approximately % of the total dollar amount of the Preferred Share offering, will be borne immediately by the Trust's common shareholders and result in a reduction of the net asset value of the common shares. Assuming the issuance of Preferred Shares in an amount equal to % of the Trust's capital (after their issuance), these offering costs are estimated to be approximately \$ or \$. per common share (0. % of the offering price). These offering costs are not included among the expenses shown in this table.
- (5) The table presented below in this footnote estimates what the Trust's annual expenses would be stated as percentages of the Trust's net assets attributable to common shares. This table assumes the Trust is the same size as in the table above, but unlike the table above, assumes that no Preferred Shares are issued and no other leverage is used. This will be the case, for instance, prior to the Trust's expected issuance of Preferred Shares and prior to it employing any other form of leverage. Footnotes used in the table below correspond to the footnotes appearing above this footnote (5). In accordance with these assumptions, the Trust's expenses would be estimated to be as follows:

	Perce Attribu (assume issued or
-----	
Annual Expenses	
Management fee.....	
Other expenses.....	



Edgar Filing: Highland Credit Strategies Fund - Form N-2

Total annual expenses.....

Highland may pay certain qualifying underwriters a sales incentive fee, structuring fee or, alternatively, additional compensation in connection with the offering provided that certain specified sales targets are met. Highland may also pay commissions to employees of its affiliates that participate in the marketing of the Trust's common shares. See "Underwriting."

The purpose of the table above and the example below is to help you understand all fees and expenses that you, as a holder of common shares, would bear directly or indirectly. The expenses shown in the table under "Other Expenses" and "Total Annual Expenses" are based on estimated amounts for the Trust's first full year of operations and assume that the Trust issues common shares. If the Trust issues fewer common shares, all other things being equal, these expenses, as a percentage of the Trust's net assets attributable to common shares, would increase. See "Management of the Trust" and "Dividend Reinvestment Plan."

The following example illustrates the expenses (including the offering expenses borne by the Trust, the sales load of \$ and the estimated offering costs of issuing Preferred Shares assuming the Trust issues Preferred Shares representing % of the Trust's Managed Assets (after their issuance) of \$ ) that you would pay on a \$1,000 investment in common shares, assuming (1) total net annual expenses of % of net assets attributable to common shares and (2) a 5% annual return:(1)

	1 Year	3 Years	5 Years	10 Years
Total expenses incurred..... \$	\$	\$	\$	\$

(1) The example should not be considered a representation of future expenses. Actual expenses may be greater or less than those assumed. The example assumes that the estimated "Other Expenses" set forth in the Annual Expenses table are accurate and that all dividends and distributions are reinvested at net asset value. Actual expenses may be greater or less than those assumed. Moreover, the Trust's actual rate of return may be greater or less than the hypothetical 5% return shown in the example.

THE TRUST

The Trust is a newly organized, non-diversified, closed-end management investment company registered under the Investment Company Act of 1940 (the "Investment Company Act"). The Trust was organized as a Delaware statutory trust on March 10, 2006, pursuant to an Agreement and Declaration of Trust governed by the laws of the State of Delaware. The Trust has no operating

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

history. The Trust's principal office is located at Two Galleria Tower, 13455 Noel Road, Suite 800, Dallas, Texas 75240, and its telephone number is (877) 655-1287.

### USE OF PROCEEDS

The net proceeds of this offering of common shares will be approximately \$ ( \$ if the Underwriters exercise the over-allotment option in full) after payment of the estimated offering costs incurred and paid by the Trust. The Trust will invest the net proceeds of this offering in accordance with the Trust's investment objectives and policies as stated below. We currently anticipate that the Trust will be able to invest primarily in securities and other investments that meet the Trust's investment objectives and policies within approximately three months after the completion of this offering. Pending such investment, it is anticipated that the proceeds of this offering will be invested in short-term debt securities.

### THE TRUST'S INVESTMENTS

#### Investment Objectives And Policies

The Trust's primary investment objective is to deliver attractive risk-adjusted returns to its investors by employing a multi-strategy investment approach to exploit relative value and arbitrage opportunities within the credit markets. Under normal market conditions, Highland will execute, on behalf of the Trust, directional, relative value, capital structure arbitrage and event-driven investment strategies across various credit markets where the Investment Manager holds significant investment experience: primarily the leveraged loan, high yield, structured products, and distressed markets. The Trust will seek to create a portfolio of investments that will maintain low correlation to the broader equity and corporate bond markets, as well as to other alternative investment strategies. There can be no assurance that the Trust's investment objectives will be achieved, and the Investment Manager has full discretion regarding the capital markets from which it can access investment opportunities.

Under normal market conditions, the Investment Manager will employ, on behalf of the Trust, directional, capital structure arbitrage, relative value, and event-driven investment strategies across various credit markets where the Investment Manager holds significant investment experience; primarily the leveraged loan, high yield, structured products, and distressed markets. The Trust will utilize a multi-strategy investment approach to exploit relative value and arbitrage opportunities within these markets. An objective of the Trust is to maintain low correlation to the broader equity and corporate bond markets, as well as other alternative investment strategies, and to provide high risk-adjusted returns on capital. No assurance can be given that the Trust will achieve its objectives, and the Investment Manager has full discretion regarding the capital markets from which it can access investment opportunities.

The Investment Manager will select investments from a wide range of trading strategies and credit markets in order to create the desired amount of diversification and to optimize the risk-reward parameters of the Trust. Highland does not intend to invest the Trust's assets according to pre-determined allocations. The investment team and other Highland personnel will use a wide range of resources to identify attractive individual investments and promising investment strategies for consideration in connection with investments by the Trust. The following is a description of the general types of securities in which the Trust may invest. This description is merely a summary and the Investment Manager has discretion to cause the Trust to invest in other types of securities and to follow other investment criteria and guidelines as described herein. See "- Portfolio Composition" below for a more

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

complete description of the types of securities and investments the Trust intends to make.

The Trust will invest and trade in listed and unlisted, public and private, rated and unrated, debt and equity instruments and other obligations, including structured debt and equity instruments as well as financial derivatives. Investments may include investments in distressed positions, which may include publicly-traded debt and equity securities, obligations which were privately placed with banks, insurance companies and other lending institutions, trade claims, accounts receivable and any other form of obligation recognized as a claim in a bankruptcy or workout process. The Trust may invest in securities traded in foreign countries and denominated in foreign currencies.

As part of its investment program, the Trust may invest, from time to time, in debt or synthetic instruments that are sold in direct placement transactions between their issuers and their purchasers and that are neither listed on an exchange, nor traded

19

over the counter. The Trust may also receive equity or equity-related securities from time to time in connection with a workout transaction.

The Trust may employ currency hedges (either in the forward or options markets) in certain circumstances to reduce currency risk, and may engage in other strategic transactions for hedging purposes or to enhance total return. The Trust may also lend securities and engage in short sales of securities. The Trust plans to employ leverage in the form of Preferred Shares, and the Trust may invest in the securities of companies whose capital structures are highly leveraged.

From time to time, the Investment Manager may also invest a portion of the Trust's assets in short-term U.S. Government obligations, certificates of deposit, commercial paper and other money market instruments, including repurchase agreements with respect to such obligations to enable the Trust to make investments quickly and to serve as collateral with respect to certain of its investments. A greater percentage of Trust assets may be invested in such obligations if the Investment Manager believes that a defensive position is appropriate because of expected economic or business conditions or the outlook for security prices. From time to time cash balances in the Trust's brokerage account may be placed in a money-market fund.

For a more complete discussion of the Trust's portfolio composition, see "The Trust's Investments--Portfolio Composition."

### Investment Philosophy

The Investment Manager looks to implement selected trading strategies to exploit pricing inefficiencies across the credit markets and within an individual issuer's capital structure. The Trust seeks to achieve diversification by strategy, industry, security type and credit market, but reserves the right to re-position its portfolio toward more concentrated levels depending on market dynamics. Highland manages interest rate, default, currency and systemic risks through a variety of trading methods and market tools, including derivative hedging instruments, as it deems appropriate.

The Investment Manager believes that the Trust will benefit from Highland's industry focused investment platform and specialist trading skills. In finding relative value and directional opportunities, the Investment Manager looks to leverage its investment platform of approximately sixty (60) credit investment

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

professionals, which actively monitor approximately 1,200 companies and currently have investments in approximately 1,000 credits. Their continuous monitoring of the market and existing positions often leads to a meaningful advantage in the timeliness and quality of information that the Investment Manager can obtain on prospective investments. Additionally, the Investment Manager has senior professionals that focus on individual credit markets, such as the distressed or structured products segments. This broad platform of industry, product and market specialists differentiates the Investment Manager from numerous funds which rely on a limited number of investment professionals working in a more generalist capacity. The Investment Manager believes that credit investing is a due-diligence intensive process that requires long-term committed resources to industry and product specialization so that investment decisions are proactive as opposed to reactive in nature.

The multi-strategy investment program to be implemented by the Trust will allow the Investment Manager to assess what it considers to be the best risk-adjusted opportunities across multiple markets and to quickly adjust the Trust's trading strategies and market focus to changing conditions. The Investment Manager intends to focus primarily on the U.S. marketplace, but may pursue opportunities in the global credit markets.

### Portfolio Composition

The Trust will pursue its objectives by investing primarily in the following categories of securities and instruments of corporations and other business entities: (i) senior, secured floating and fixed rate loans; (ii) bonds and other debt obligations; and (iii) securities and other obligations of distressed and bankrupt issuers.

Under normal market conditions, at least 80% of the Fund's total assets will be invested in its principal investment categories collectively, including through the use of derivatives. Subject only to this general guideline, the Investment Manager has broad discretion to allocate the Trust's assets among investment categories and to change allocations over time as conditions warrant. The Trust is not obligated to hold investments in each of its three investment categories and may at times concentrate its investments in a single category. In order to most effectively pursue its opportunistic investment strategy, the Trust will not maintain fixed duration, maturity or credit quality policies. The Trust may invest in debt obligations of any credit quality. The Trust may invest without limitation in securities and obligations of both domestic and foreign issuers and obligors.

The Trust's portfolio will be composed principally of the following investments. Additional information relating to the Trust's investment policies and restrictions and the Trust's portfolio investments is contained in the Statement of Additional Information.

20

### Senior Loans

Senior loans hold the most senior position in the capital structure of a business entity, are typically secured with specific collateral and have a claim on the general assets of the borrower that is senior to that held by subordinated debtholders and stockholders of the borrower. The proceeds of senior loans primarily are used to finance leveraged buyouts, recapitalizations, mergers, acquisitions, stock repurchases, and, to a lesser extent, to finance internal growth and for other corporate purposes. Senior loans typically have rates of interest which are redetermined either daily, monthly, quarterly or semi-annually by reference to a base lending rate, plus a

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

premium. These base lending rates generally are LIBOR, the prime rate offered by one or more major United States banks (Prime Rate) or the certificate of deposit (CD) rate or other base lending rates used by commercial lenders.

The Trust also may purchase unsecured loans, other floating rate debt securities such as notes, bonds and asset-backed securities (such as securities issued by special purpose funds investing in bank loans), investment grade and below investment grade fixed income debt obligations and money market instruments, such as commercial paper. The Trust also may purchase obligations issued in connection with a restructuring pursuant to Chapter 11 of the U.S. Bankruptcy Code. While these investments are not a primary focus of the Trust, the Trust does not have a policy limiting such investments to a specific percentage of the Trust's assets.

Loans and other corporate debt obligations are subject to the risk of non-payment of scheduled interest or principal. Such non-payment would result in a reduction of income to the Trust, a reduction in the value of the investment and a potential decrease in the net asset value of the Trust. There can be no assurance that the liquidation of any collateral securing a senior loan would satisfy a borrower's obligation in the event of non-payment of scheduled interest or principal payments, or that such collateral could be readily liquidated. In the event of bankruptcy of a borrower, the Trust could experience delays or limitations with respect to its ability to realize the benefits of the collateral securing a senior loan. To the extent that a senior loan is collateralized by stock in the borrower or its subsidiaries, such stock may lose all or substantially all of its value in the event of the bankruptcy of a borrower. Some senior loans are subject to the risk that a court, pursuant to fraudulent conveyance or other similar laws, could subordinate senior loans to presently existing or future indebtedness of the borrower or take other action detrimental to the holders of senior loans including, in certain circumstances, invalidating such senior loans or causing interest previously paid to be refunded to the borrower. If interest were required to be refunded, it could negatively affect the Trust's performance.

Many loans in which the Investment Manager anticipates the Trust will invest may not be rated by a rating agency, will not be registered with the Securities and Exchange Commission or any state securities commission and will not be listed on any national securities exchange. The amount of public information available with respect to issuers of senior loans will generally be less extensive than that available for issuers of registered or exchange listed securities. In evaluating the creditworthiness of borrowers, Investment Manager will consider, and may rely in part, on analyses performed by others. The Investment Manager does not view ratings as the determinative factor in its investment decisions and relies more upon its credit analysis abilities than upon ratings. Borrowers may have outstanding debt obligations that are rated below investment grade by a rating agency. A high percentage of senior loans in the Trust may be rated below investment grade by independent rating agencies. In the event senior loans are not rated, they are likely to be the equivalent of below investment grade quality. Debt securities which are unsecured and rated below investment grade (i.e., Ba and below by Moody's or BB and below by S&P) and comparable unrated bonds, are viewed by the rating agencies as having speculative characteristics and are commonly known as "junk bonds." A description of the ratings of corporate bonds by Moody's and S&P is included as Appendix A to the Statement of Additional Information. Because senior loans are senior in a borrower's capital structure and are often secured by specific collateral, the Investment Manager believes that senior loans have more favorable loss recovery rates as compared to most other types of below investment grade debt obligations. However, there can be no assurance that the Trust's actual loss recovery experience will be consistent with the Investment Manager's prior experience or that the Trust's senior loans will achieve any specific loss recovery rates.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

The Trust may hold securities that are unrated or in the lowest ratings categories (rated C by Moody's or D by S&P). Debt securities rated C by Moody's are regarded as having extremely poor prospects of ever attaining any real investment standing. Debt securities rated D by S&P are in payment default or a bankruptcy petition has been filed and debt service payments are jeopardized. In order to enforce its rights with defaulted securities, the Trust may be required to retain legal counsel and/or a financial adviser. The Trust may have to pursue legal remedies, the results of which are uncertain and expensive. This may increase operating expenses and adversely affect net asset value. The credit quality of most securities held by the Trust reflects a greater possibility that adverse changes in the financial condition of an issuer, or in general economic conditions, or both, may impair the ability of the issuer to make payments of interest or principal. The inability (or perceived inability) of issuers to make timely payment of interest and principal would likely make the values of such securities more volatile and could limit the ability to sell securities at favorable prices. In the absence of a liquid trading market for securities held by it,

21

the Trust may have difficulties determining the fair market value of such securities. Because of the greater number of investment considerations involved in investing in high yield, high risk bonds, the achievement of the Trust's objectives depends more on the Investment Manager's judgment and analytical abilities than would be the case if invested primarily in securities in the higher ratings categories.

No active trading market may exist for many senior loans, and some senior loans may be subject to restrictions on resale. The Trust is not limited in the percentage of its assets that may be invested in senior loans and other securities deemed to be illiquid. A secondary market may be subject to irregular trading activity, wide bid/ask spreads and extended trade settlement periods, which may impair the ability to realize full value on the disposition of an illiquid senior loan, and cause a material decline in the Trust's net asset value.

The Trust may invest up to 20% of total assets in obligations of non-U.S. issuers, predominantly in developed countries, but the Trust may also invest in securities of emerging market issuers. The value of obligations of non-U.S. issuers is affected by changes in foreign tax laws (including withholding tax), government policies (in this country or abroad) and relations between nations, and trading, settlement, custodial and other operational risks. In addition, the costs of investing abroad are generally higher than in the United States.

Use of Agents. Senior loans generally are arranged through private negotiations between a borrower and a group of financial institutions initially represented by an agent who is usually one of the originating lenders. In larger transactions, it is common to have several agents. Generally, however, only one such agent has primary responsibility for on-going administration of a senior loan. Agents are typically paid fees by the borrower for their services. The agent is primarily responsible for negotiating the credit agreement which establishes the terms and conditions of the senior loan and the rights of the borrower and the lenders. The agent is also responsible for monitoring collateral and for exercising remedies available to the lenders such as foreclosure upon collateral.

Credit agreements may provide for the termination of the agent's status in the event that it fails to act as required under the relevant credit agreement, becomes insolvent, enters FDIC receivership or, if not FDIC insured, enters into bankruptcy. Should such an agent, lender or assignor with respect to an

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

assignment inter-positioned between the Trust and the borrower become insolvent or enter FDIC receivership or bankruptcy, any interest in the senior loan of such person and any loan payment held by such person for the benefit of the Trust should not be included in such person's or entity's bankruptcy estate. If, however, any such amount were included in such person's or entity's bankruptcy estate, the Trust would incur certain costs and delays in realizing payment or could suffer a loss of principal or interest. In this event, the Trust could experience a decrease in net asset value.

Form of Investment. The Trust's investments in senior loans may take one of several forms, including acting as one of the group of lenders originating a senior loan, purchasing an assignment of a portion of a senior loan from a third party or acquiring a participation in a senior loan. When the Trust is a member of the originating syndicate for a senior loan, it may share in a fee paid to the syndicate. When the Trust acquires a participation in, or an assignment of, a senior loan, it may pay a fee to, or forego a portion of interest payments from, the lender selling the participation or assignment. The Trust will act as lender, or purchase an assignment or participation, with respect to a senior loan only if the agent is determined by the Investment Manager to be creditworthy.

Original Lender. When the Trust is one of the original lenders, it will have a direct contractual relationship with the borrower and can enforce compliance by the borrower with terms of the credit agreement. It also may have negotiated rights with respect to any funds acquired by other lenders through set-off. Original lenders also negotiate voting and consent rights under the credit agreement. Actions subject to lender vote or consent generally require the vote or consent of the majority of the holders of some specified percentage of the outstanding principal amount of the senior loan. Certain decisions, such as reducing the interest rate, or extending the maturity of a senior loan, or releasing collateral securing a senior loan, among others, frequently require the unanimous vote or consent of all lenders affected.

Assignments. When the Trust is a purchaser of an assignment, it typically succeeds to all the rights and obligations under the credit agreement of the assigning lender and becomes a lender under the credit agreement with the same rights and obligations as the assigning lender. Assignments are, however, arranged through private negotiations between potential assignees and potential assignors, and the rights and obligations acquired by the purchaser of an assignment may be more limited than those held by the assigning lender.

Participations. The Trust may also invest in participations in senior loans. The rights of the Trust when it acquires a participation are likely to be more limited than the rights of an original lender or an investor who acquired an assignment. Participation by the Trust in a lender's portion of a senior loan typically means that the Trust has only a contractual relationship with the lender, not with the borrower. This means that the Trust has the right to receive payments of principal,

interest and any fees to which it is entitled only from the lender selling the participation and only upon receipt by the lender of payments from the borrower.

With a participation, the Trust will have no rights to enforce compliance by the borrower with the terms of the credit agreement or any rights with respect to any funds acquired by other lenders through set-off against the borrower. In addition, the Trust may not directly benefit from the collateral supporting the senior loan because it may be treated as a general creditor of the lender

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

instead of a senior secured creditor of the borrower. As a result, the Trust may be subject to delays, expenses and risks that are greater than those that exist when the Trust is the original lender or holds an assignment. This means the Trust must assume the credit risk of both the borrower and the lender selling the participation. The Trust will consider a purchase of participations only in those situations where the Investment Manager considers the participating lender to be creditworthy.

In the event of a bankruptcy or insolvency of a borrower, the obligation of the borrower to repay the senior loan may be subject to certain defenses that can be asserted by such borrower against the Trust as a result of improper conduct of the lender selling the participation. A participation in a senior loan will be deemed to be a senior loan for the purposes of the Trust's investment objectives and policies.

Investing in senior loans involves investment risk. Some borrowers default on their senior loan payments. The Trust attempts to manage this credit risk through portfolio diversification and ongoing analysis and monitoring of borrowers. The Trust also is subject to market, liquidity, interest rate and other risks. See "Risk Factors."

### Investment Grade Bonds

The Trust may invest in a wide variety of bonds that are rated or determined by the Investment Manager to be of investment grade quality of varying maturities issued by U.S. corporations and other business entities. Bonds are fixed or variable rate debt obligations, including bills, notes, debentures, money market instruments and similar instruments and securities. Bonds generally are used by corporations and other issuers to borrow money from investors for a variety of business purposes. The issuer pays the investor a fixed or variable rate of interest and normally must repay the amount borrowed on or before maturity. Certain bonds are "perpetual" in that they have no maturity date. Some investment grade bonds, such as zero coupon bonds, do not pay current interest, but are sold at a discount from their face values. Although more creditworthy and generally less risky than non-investment grade bonds, investment grade bonds are subject to market and credit risk. Market risk relates to changes in a security's value as a result of interest rate changes generally. Investment grade bonds have varying levels of sensitivity to changes in interest rates and varying degrees of credit quality. In general, bond prices rise when interest rates fall, and fall when interest rates rise. Longer-term bonds and zero coupon bonds are generally more sensitive to interest rate changes. Credit risk relates to the ability of the issuer to make payments of principal and interest. The values of investment grade bonds like those of other debt securities may be affected by changes in the credit rating or financial condition of an issuer. Investment grade bonds are generally considered medium- and high-quality securities. Some, however, may possess speculative characteristics, and may be more sensitive to economic changes and to changes in the financial condition of issuers. The market prices of investment grade bonds in the lowest investment grade categories may fluctuate more than higher-quality securities and may decline significantly in periods of general or regional economic difficulty. Like non-investment grade bonds, such investment grade bonds in the lowest investment grade categories may be thinly traded, making them difficult to sell promptly at an acceptable price.

### Other Fixed Income Securities

The Trust also may purchase unsecured loans, other floating rate or fixed rate debt securities such as notes, bonds and asset-backed securities (such as securities issued by special purpose funds investing in bank loans), investment grade and below investment grade fixed income debt obligations and money market instruments, such as commercial paper. The high yield securities in which the Trust invests are rated Ba or lower by Moody's or BB or lower by S&P or are



## Edgar Filing: Highland Credit Strategies Fund - Form N-2

unrated but determined by the Investment Manager to be of comparable quality. Debt securities rated below investment grade are commonly referred to as "junk bonds" and are considered speculative with respect to the issuer's capacity to pay interest and repay principal. Below investment grade debt securities involve greater risk of loss, are subject to greater price volatility and are less liquid, especially during periods of economic uncertainty or change, than higher rated debt securities. The Trust's fixed-income securities may have fixed or variable principal payments and all types of interest rate and dividend payment and reset terms, including fixed rate, adjustable rate, zero coupon, contingent, deferred, payment in kind and auction rate features. The Trust may invest in fixed-income securities with a broad range of maturities.

The Trust may invest in zero coupon bonds, deferred interest bonds and bonds or preferred stocks on which the interest is payable in-kind (PIK bonds). To the extent the Trust invests in such instruments, they will not contribute to the Trust's

23

primary goal of current income. Zero coupon and deferred interest bonds are debt obligations which are issued at a significant discount from face value. While zero coupon bonds do not require the periodic payment of interest, deferred interest bonds provide for a period of delay before the regular payment of interest begins. PIK bonds are debt obligations that provide that the issuer thereof may, at its option, pay interest on such bonds in cash or in the form of additional debt obligations. Such investments may experience greater volatility in market value due to changes in interest rates. The Trust may be required to accrue income on these investments for federal income tax purposes and is required to distribute its net income each year in order to qualify for the favorable federal income tax treatment potentially available to regulated investment companies. The Trust may be required to sell securities to obtain cash needed for income distributions.

### Asset-Backed Securities

The Trust may invest a portion of its assets in asset-backed securities. Asset-backed securities are generally issued as pass-through certificates, which represent undivided fractional ownership interests in an underlying pool of assets, or as debt instruments, which are also known as collateralized obligations, and are generally issued as the debt of a special purpose entity organized solely for the purpose of owning such assets and issuing such debt. Asset-backed securities are often backed by a pool of assets representing the obligations of a number of different parties. Credit card receivables are generally unsecured, and the debtors are entitled to the protection of a number of state and federal consumer credit laws which give debtors the right to set off certain amounts owed on the credit cards, thereby reducing the balance due. Most issuers of automobile receivables permit the servicers to retain possession of the underlying obligations. If the servicer were to sell these obligations to another party, there is a risk that the purchaser would acquire an interest superior to that of the holders of the related automobile receivables. In addition, because of the large number of vehicles involved in a typical issuance and technical requirements under state laws, the trustee for the holders of the automobile receivables may not have an effective security interest in all of the obligations backing such receivables. Therefore, there is a possibility that recoveries on repossessed collateral may not, in some cases, be able to support payments on these securities.

### Second Lien Loans and Debt Obligations

The Trust may invest in loans and other debt securities that have the same

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

characteristics as senior loans except that such loans are second in lien property rather than first. Such "second lien" loans and securities, like senior loans, typically have adjustable floating rate interest payments. Accordingly, the risks associated with "second lien" loans are higher than the risk of loans with first priority over the collateral. In the event of default on a "second lien" loan, the first priority lien holder has first claim to the underlying collateral of the loan. It is possible, that no collateral value would remain for the second priority lien holder and therefore result in a loss of investment to the Trust.

### Collateralized Loan Obligations and Bond Obligations

The Trust may invest in certain asset-backed securities that are securitizing certain financial assets by issuing securities in the form of negotiable paper that are issued by a financing company (generally called a Special Purpose Vehicle or "SPV"). These securitized assets are, as a rule, corporate financial assets brought into a pool according to specific diversification rules. The SPV is a company founded solely for the purpose of securitizing these claims and its only asset is the diversified asset pool. On this basis, marketable securities are issued which, due to the diversification of the underlying risk, generally represent a lower level of risk than the original assets. The redemption of the securities issued by the SPV takes place at maturity out of the cash flow generated by the collected claims.

A collateralized loan obligation ("CLO") is a structured debt security issued by an SPV that was created to reapportion the risk and return characteristics of a pool of assets. The assets, typically senior loans, are used as collateral supporting the various debt tranches issued by the SPV. The key feature of the CLO structure is the prioritization of the cash flows from a pool of debt securities among the several classes of securities issued by a CLO.

The Trust may also invest in collateralized bond obligations ("CBOs"), which are structured debt securities backed by a diversified pool of high yield, public or private fixed income securities. These may be fixed pools or may be "market value" (or managed) pools of collateral. The CBO issues debt securities that are typically separated into tranches representing different degrees of credit quality. The top tranche of securities has the greatest collateralization and pays the lowest interest rate. Lower CBO tranches have a lesser degree of collateralization quality and pay higher interest rates intended to compensate for the attendant risks. The bottom tranche specifically receives the residual interest payments (i.e., money that is left over after the higher tranches have been paid) rather than a fixed interest rate. The return on the lower tranches of CBOs is especially sensitive to the rate of defaults in the collateral pool. Under normal market conditions, the Trust expects to invest in the lower tranches of CBOs.

### Credit Default Swaps

The Trust may enter into credit default swap agreements. The "buyer" in a credit default contract is obligated to pay the "seller" a periodic stream of payments over the term of the contract provided that no event of default on an underlying reference obligation has occurred. If an event of default occurs, the seller must pay the buyer the "par value" (full notional value) of the reference obligation in exchange for the reference obligation. The Trust may be either the buyer or seller in the transaction. If the Trust is a buyer and no event of default occurs, the Trust loses its investment and recovers nothing. However, if an event of default occurs, the buyer receives full notional value for a reference obligation that may have little or no value. As a seller, the

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Trust receives income throughout the term of the contract, which typically is between six months and three years, provided that there is no default event.

Credit default swaps involve greater risks than if the Trust had invested in the reference obligation directly. In addition to general market risks, credit default swaps are subject to illiquidity risk, counterparty risk and credit risks. The Trust will enter into swap agreements only with counterparties that are rated investment grade quality by at least one nationally recognized statistical rating organization at the time of entering into such transaction or whose creditworthiness is believed by the Investment Manager to be equivalent to such rating. A buyer also will lose its investment and recover nothing should no event of default occur. If an event of default were to occur, the value of the reference obligation received by the seller, coupled with the periodic payments previously received, may be less than the full notional value it pays to the buyer, resulting in a loss of value to the seller. When the Trust acts as a seller of a credit default swap agreement it is exposed to many of the same risks of leverage described under "Risk Factors - Leverage Risk" and "Leverage" in this prospectus since if an event of default occurs the seller must pay the buyer the full notional value of the reference obligation.

### Senior Loan Based Derivatives

The Trust may obtain exposure to senior loans and baskets of senior loans through the use of derivative instruments. Such derivative instruments have recently become increasingly available. The Investment Manager reserves the right to utilize these instruments and similar instruments that may be available in the future. For example, the Trust may invest in a derivative instrument known as the Select Aggregate Market Index ("SAMI"), which provides investors with exposure to a reference basket of senior loans. SAMIs are structured as floating rate instruments. SAMIs consist of a basket of credit default swaps whose underlying reference securities are senior loans. While investing in SAMIs will increase the universe of floating rate debt securities to which the Trust is exposed, such investments entail risks that are not typically associated with investments in other floating rate debt securities. The liquidity of the market for SAMIs will be subject to liquidity in the secured loan and credit derivatives markets. Investment in SAMIs involves many of the risks associated with investments in derivative instruments discussed generally below. The Trust may also be subject to the risk that the counterparty in a derivative transaction will default on its obligations. Derivative transactions generally involve the risk of loss due to unanticipated adverse changes in securities prices, interest rates, the inability to close out a position, imperfect correlation between a position and the desired hedge, tax constraints on closing out positions and portfolio management constraints on securities subject to such transactions. The potential loss on derivative instruments may be substantially greater than the initial investment therein.

### Credit-Linked Notes

The Trust may invest in credit-linked notes ("CLNs") for risk management purposes, including diversification. A CLN is a derivative instrument. It is a synthetic obligation between two or more parties where the payment of principal and/or interest is based on the performance of some obligation (a reference obligation). In addition to credit risk of the reference obligations and interest rate risk, the buyer/seller of the CLN is subject to counterparty risk.

### Common Stocks

The Trust may acquire an interest in common stocks upon the default of a senior loan secured by such common stock. The Trust may also acquire warrants or other rights to purchase a borrower's common stock in connection with the making of a senior loan. Common stocks are shares of a corporation or other entity that

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

entitle the holder to a pro rata share of the profits, if any, of the corporation without preference over any other shareholder or class of shareholders, including holders of such entity's preferred stock and other senior equity securities. Common stock usually carries with it the right to vote and frequently an exclusive right to do so. In selecting common stocks for investment, the Trust generally expects to focus primarily on the security's dividend paying capacity rather than on its potential for capital appreciation.

25

### Preferred Securities

The Trust may invest in preferred securities. Preferred securities are equity securities, but they have many characteristics of fixed income securities, such as a fixed dividend payment rate and/or a liquidity preference over the issuer's common shares. However, because preferred shares are equity securities, they may be more susceptible to risks traditionally associated with equity investments than the Trust's fixed income securities.

Fixed rate preferred stocks have fixed dividend rates. They can be perpetual, with no mandatory redemption date, or issued with a fixed mandatory redemption date. Certain issues of preferred stock are convertible into other equity securities. Perpetual preferred stocks provide a fixed dividend throughout the life of the issue, with no mandatory retirement provisions, but may be callable. Sinking fund preferred stocks provide for the redemption of a portion of the issue on a regularly scheduled basis with, in most cases, the entire issue being retired at a future date. The value of fixed rate preferred stocks can be expected to vary inversely with interest rates.

Adjustable rate preferred stocks have a variable dividend rate which is determined periodically, typically quarterly, according to a formula based on a specified premium or discount to the yield on particular U.S. Treasury securities, typically the highest base-rate yield of one of three U.S. Treasury securities: the 90-day Treasury bill; the 10-year Treasury note; and either the 20-year or 30-year Treasury bond or other index. The premium or discount to be added to or subtracted from this base-rate yield is fixed at the time of issuance and cannot be changed without the approval of the holders of the adjustable rate preferred stock. Some adjustable rate preferred stocks have a maximum and a minimum rate and in some cases are convertible into common stock.

Auction rate preferred stocks pay dividends that adjust based on periodic auctions. Such preferred stocks are similar to short-term corporate money market instruments in that an auction rate preferred stockholder has the opportunity to sell the preferred stock at par in an auction, normally conducted at least every 49 days, through which buyers set the dividend rate in a bidding process for the next period. The dividend rate set in the auction depends on market conditions and the credit quality of the particular issuer. Typically, the auction rate preferred stock's dividend rate is limited to a specified maximum percentage of an external commercial paper index as of the auction date. Further, the terms of the auction rate preferred stocks generally provide that they are redeemable by the issuer at certain times or under certain conditions.

### Convertible Securities

The Trust's investment in fixed income securities may include bonds and preferred stocks that are convertible into the equity securities of the issuer or a related company. Depending on the relationship of the conversion price to the market value of the underlying securities, convertible securities may trade more like equity securities than debt instruments.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

### Money Market Instruments

Money market instruments include short-term U.S. government securities, U.S. dollar-denominated, high quality commercial paper (unsecured promissory notes issued by corporations to finance their short-term credit needs), certificates of deposit, bankers' acceptances and repurchase agreements relating to any of the foregoing. U.S. government securities include Treasury notes, bonds and bills, which are direct obligations of the U.S. government backed by the full faith and credit of the

United States and securities issued by agencies and instrumentalities of the U.S. government, which may be guaranteed by the U.S. Treasury, may be supported by the issuer's right to borrow from the U.S. Treasury or may be backed only by the credit of the federal agency or instrumentality itself.

### U.S. Government Securities

U.S. government securities in which the Trust invests include debt obligations of varying maturities issued by the U.S. Treasury or issued or guaranteed by an agency or instrumentality of the U.S. government, including the Federal Housing Administration, Federal Financing Bank, Farmers Home Administration, Export-Import Bank of the United States, Small Business Administration, Government National Mortgage Association (GNMA), General Services Administration, Central Bank for Cooperatives, Federal Farm Credit Banks, Federal Home Loan Banks, Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), Maritime Administration, Tennessee Valley Authority, District of Columbia Armory Board, Student Loan Marketing Association, Resolution Trust Corporation and various institutions that previously were or currently are part of the Farm Credit System (which has been undergoing reorganization since 1987). Some U.S. government securities, such as U.S. Treasury bills, Treasury notes and Treasury bonds, which differ only in their interest rates, maturities and times of issuance, are supported by the full faith and credit of the United States government. Others are supported by (i) the right of the issuer to borrow from the U.S. Treasury, such as securities of the Federal Home

26

Loan Banks; (ii) the discretionary authority of the U.S. government to purchase the agency's obligations, such as securities of the FNMA; or (iii) only the credit of the issuer. No assurance can be given that the U.S. government will provide financial support in the future to U.S. government agencies, authorities or instrumentalities that are not supported by the full faith and credit of the United States. Securities guaranteed as to principal and interest by the U.S. government, its agencies, authorities or instrumentalities include (i) securities for which the payment of principal and interest is backed by an irrevocable letter of credit issued by the U.S. government or any of its agencies, authorities or instrumentalities; and (ii) participations in loans made to non-U.S. governments or other entities that are so guaranteed. The secondary market for certain of these participations is limited and therefore may be regarded as illiquid.

### Other Investment Companies

The Trust may invest in the securities of other investment companies to the extent that such investments are consistent with the Trust's investment objectives and principal investment strategies and permissible under the Investment Company Act. Under one provision of the Investment Company Act, the Trust may not acquire the securities of other investment companies if, as a

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

result, (i) more than 10% of the Trust's total assets would be invested in securities of other investment companies, (ii) such purchase would result in more than 3% of the total outstanding voting securities of any one investment company being held by the Trust or (iii) more than 5% of the Trust's total assets would be invested in any one investment company. Other provisions of the Investment Company Act are less restrictive provided that the Trust is able to meet certain conditions. These limitations do not apply to the acquisition of shares of any investment company in connection with a merger, consolidation, reorganization or acquisition of substantially all of the assets of another investment company. However, the Adviser has obtained an exemptive order from the Securities and Exchange Commission that permits the Trust to invest cash balances in money market funds managed by the Adviser.

The Trust, as a holder of the securities of other investment companies, will bear its pro rata portion of the other investment companies' expenses, including advisory fees. These expenses will be in addition to the direct expenses incurred by the Trust.

### Exchange Traded Funds

Subject to the limitations on investment in other investment companies, the Trust may invest in exchange traded funds ("ETFs"). ETFs, such as SPDRs, NASDAQ 100 Index Trading Stock (QQQs), iShares and various country index funds, are funds whose shares are traded on a national exchange or the National Association of Securities Dealers' Automatic Quotation System (NASDAQ). ETFs may be based on underlying equity or fixed income securities. SPDRs, for example, seek to provide investment results that generally correspond to the performance of the component common stocks of the S&P 500. ETFs do not sell individual shares directly to investors and only issue their shares in large blocks known as "creation units." The investor purchasing a creation unit may sell the individual shares on a secondary market. Therefore, the liquidity of ETFs depends on the adequacy of the secondary market. There can be no assurance that an ETF's investment objective will be achieved. ETFs based on an index may not replicate and maintain exactly the composition and relative weightings of securities in the index. ETFs are subject to the risks of investing in the underlying securities. The Trust, as a holder of the securities of the ETF, will bear its pro rata portion of the ETF's expenses, including advisory fees. These expenses are in addition to the direct expenses of the Trust's own operations.

### Zero Coupon Securities

The securities in which the Trust invests may include zero coupon securities, which are debt obligations that are issued or purchased at a significant discount from face value. The discount approximates the total amount of interest the security will accrue and compound over the period until maturity or the particular interest payment date at a rate of interest reflecting the market rate of the security at the time of issuance. Zero coupon securities do not require the periodic payment of interest. These investments benefit the issuer by mitigating its need for cash to meet debt service but generally require a higher rate of return to attract investors who are willing to defer receipt of cash. These investments may experience greater volatility in market value than securities that make regular payments of interest. The Trust accrues income on these investments for tax and accounting purposes, which is distributable to shareholders and which, because no cash is received at the time of accrual, may require the liquidation of other portfolio securities to satisfy the Trust's distribution obligations, in which case the Trust will forgo the purchase of additional income producing assets with these funds.

### Strategic Transactions

In addition to the credit default swaps and senior loan bond derivatives

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

discussed above the Trust may, but is not required to, use various strategic transactions described below to earn income, facilitate portfolio management and mitigate risks. Such

27

strategic transactions are generally accepted under modern portfolio management and are regularly used by many mutual funds and other institutional investors. Although the Investment Manager seeks to use the practices to further the Trust's investment objectives, no assurance can be given that these practices will achieve this result. While the Trust reserves the ability to use these strategic transactions, the Investment Manager does not anticipate that strategic transactions other than credit default swaps and senior loan bond derivatives will initially be a significant part of the Trust's investment approach. With changes in the market or the Investment Manager's strategy, it is possible that these instruments may be a more significant part of the Trust's investment approach in the future.

The Trust may purchase and sell derivative instruments such as exchange-listed and over-the-counter put and call options on securities, financial futures, equity, fixed-income and interest rate indices, and other financial instruments, purchase and sell financial futures contracts and options thereon, enter into various interest rate transactions such as swaps, caps, floors or collars and enter into various currency transactions such as currency forward contracts, currency futures contracts, currency swaps or options on currency or currency futures or credit transactions and credit default swaps. The Trust also may purchase derivative instruments that combine features of these instruments. Collectively, all of the above are referred to as "Strategic Transactions." The Trust generally seeks to use Strategic Transactions as a portfolio management or hedging technique to seek to protect against possible adverse changes in the market value of senior loans or other securities held in or to be purchased for the Trust's portfolio, protect the value of the Trust's portfolio, facilitate the sale of certain securities for investment purposes, manage the effective interest rate exposure of the Trust, protect against changes in currency exchange rates, manage the effective maturity or duration of the Trust's portfolio, or establish positions in the derivatives markets as a temporary substitute for purchasing or selling particular securities.

Strategic Transactions have risks, including the imperfect correlation between the value of such instruments and the underlying assets, the possible default of the other party to the transaction or illiquidity of the derivative instruments. Furthermore, the ability to use successfully Strategic Transactions depends on the Investment Manager's ability to predict pertinent market movements, which cannot be assured. Thus, the use of Strategic Transactions may result in losses greater than if they had not been used, may require the Trust to sell or purchase portfolio securities at inopportune times or for prices other than current market values, may limit the amount of appreciation the Trust can realize on an investment, or may cause the Trust to hold a security that it might otherwise sell. The use of currency transactions can result in the Trust incurring losses as a result of the imposition of exchange controls, suspension of settlements or the inability of the Trust to deliver or receive a specified currency. Additionally, amounts paid by the Trust as premiums and cash or other assets held in margin accounts with respect to Strategic Transactions are not otherwise available to the Trust for investment purposes.

A more complete discussion of Strategic Transactions and their risks is contained in the Statement of Additional Information.

Swaps

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Swap contracts may be purchased or sold to obtain investment exposure and/or to hedge against fluctuations in securities prices, currencies, interest rates or market conditions, to change the duration of the overall portfolio or to mitigate default risk. In a standard "swap" transaction, two parties agree to exchange the returns (or differentials in rates of return) on different currencies, securities, baskets of currencies or securities, indices or other instruments, which returns are calculated with respect to a "notional value," i.e., the designated reference amount of exposure to the underlying instruments. The Trust intends to enter into swaps primarily on a net basis, i.e., the two payment streams are netted out, with the Trust receiving or paying, as the case may be, only the net amount of the two payments. If the other party to a swap contract defaults, the Trust's risk of loss will consist of the net amount of payments that the Trust is contractually entitled to receive. The net amount of the excess, if any, of the Trust's obligations over its entitlements will be maintained in a segregated account by the Trust's custodian. The Trust will not enter into a swap agreement unless the claims-paying ability of the other party thereto is considered to be investment grade by the Investment Manager. If there is a default by the other party to such a transaction, the Trust will have contractual remedies pursuant to the agreements related to the transaction. Swap instruments are not exchange-listed securities and may be traded only in the over-the-counter market.

### Interest Rate Swaps

Interest rate swaps involve the exchange by the Trust with another party of their respective commitments to pay or receive interest (e.g., an exchange of fixed rate payments for floating rate payments). The Trust may use interest rate swaps for risk management purposes and as a speculative investment.

28

### Total Return Swaps

Total return swaps are contracts in which one party agrees to make payments of the total return from the designated underlying asset(s), which may include securities, baskets of securities, or securities indices, during the specified period, in return for receiving payments equal to a fixed or floating rate of interest or the total return from the other designated underlying asset(s). The Trust may use total return swaps for risk management purposes and as a speculative investment.

### Currency Swaps

Currency swaps involve the exchange of the two parties' respective commitments to pay or receive fluctuations with respect to a notional amount of two different currencies (e.g., an exchange of payments with respect to fluctuations in the value of the U.S. dollar relative to the Japanese yen). The Trust may enter into currency swap contracts and baskets thereof for risk management purposes and as a speculative investment.

### Repurchase Agreements

The Trust may enter into repurchase agreements with broker-dealers, member banks of the Federal Reserve System and other financial institutions. Repurchase agreements are arrangements under which the Trust purchases securities and the seller agrees to repurchase the securities within a specific time and at a specific price. The repurchase price is generally higher than the Trust's purchase price, with the difference being income to the Trust. Under the direction of the Board of Trustees, the Investment Manager reviews and



## Edgar Filing: Highland Credit Strategies Fund - Form N-2

monitors the creditworthiness of any institution which enters into a repurchase agreement with the Trust. The counterparty's obligations under the repurchase agreement are collateralized with U.S. Treasury and/or agency obligations with a market value of not less than 100% of the obligations, valued daily. Collateral is held by the Trust's custodian in a segregated, safekeeping account for the benefit of the Trust. Repurchase agreements afford the Trust an opportunity to earn income on temporarily available cash at low risk. In the event of commencement of bankruptcy or insolvency proceedings with respect to the seller of the security before repurchase of the security under a repurchase agreement, the Trust may encounter delay and incur costs before being able to sell the security. Such a delay may involve loss of interest or a decline in price of the security. If the court characterizes the transaction as a loan and the Trust has not perfected a security interest in the security, the Trust may be required to return the security to the seller's estate and be treated as an unsecured creditor of the seller. As an unsecured creditor, the Trust would be at risk of losing some or all of the principal and interest involved in the transaction.

### Lending of Portfolio Securities

The Trust may lend portfolio securities to registered broker-dealers or other institutional investors deemed by the Investment Manager to be of good standing under agreements which require that the loans be secured continuously by collateral in cash, cash equivalents or U.S. Treasury bills maintained on a current basis at an amount at least equal to the market value of the securities loaned. The Trust continues to receive the equivalent of the interest or dividends paid by the issuer on the securities loaned as well as the benefit of an increase and the detriment of any decrease in the market value of the securities loaned and would also receive compensation based on investment of the collateral. The Trust would not, however, have the right to vote any securities having voting rights during the existence of the loan, but would call the loan in anticipation of an important vote to be taken among holders of the securities or of the giving or withholding of consent on a material matter affecting the investment.

As with other extensions of credit, there are risks of delay in recovery or even loss of rights in the collateral should the borrower of the securities fail financially. The Trust will lend portfolio securities only to firms that have been approved in advance by the Board of Trustees, which will monitor the creditworthiness of any such firms.

### Non-U.S. Securities

The Trust may invest a substantial portion of its portfolio in non-U.S. securities, which may include securities denominated in U.S. dollars or in non-U.S. currencies or multinational currency units. The Trust may invest in non-U.S. securities of so-called emerging market issuers. For purposes of the Trust, a company is deemed to be a non-U.S. company if it meets the following tests: (i) such company was not organized in the United States; (ii) such company's primary business office is not in the United States; (iii) the principal trading market for such company's securities is not located in the United States; (iv) less than 50% of such company's assets are located in the United States; or (v) 50% or more of such issuer's revenues are derived from outside the United States. Non-U.S. securities markets generally are not as developed or efficient as those in the United States. Securities of some non-U.S. issuers are less liquid and more volatile than securities of comparable U.S. issuers. Similarly, volume and liquidity in most non-U.S.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

securities markets are less than in the United States and, at times, volatility of price can be greater than in the United States.

Because evidences of ownership of such securities usually are held outside the United States, the Trust would be subject to additional risks if it invested in non-U.S. securities, which include possible adverse political and economic developments, seizure or nationalization of foreign deposits and adoption of governmental restrictions which might adversely affect or restrict the payment of principal and interest on the non-U.S. securities to investors located outside the country of the issuer, whether from currency blockage or otherwise.

Since non-U.S. securities may be purchased with and payable in foreign currencies, the value of these assets as measured in U.S. dollars may be affected favorably or unfavorably by changes in currency rates and exchange control regulations.

### Options

An option on a security is a contract that gives the holder of the option, in return for a premium, the right to buy from (in the case of a call) or sell to (in the case of a put) the writer of the option the security underlying the option at a specified exercise or "strike" price. The writer of an option on a security has the obligation upon exercise of the option to deliver the underlying security upon payment of the exercise price or to pay the exercise price upon delivery of the underlying security. Certain options, known as "American style" options may be exercised at any time during the term of the option. Other options, known as "European style" options, may be exercised only on the expiration date of the option.

If an option written by the Trust expires unexercised, the Trust realizes on the expiration date a capital gain equal to the premium received by the Trust at the time the option was written. If an option purchased by the Trust expires unexercised, the Trust realizes a capital loss equal to the premium paid. Prior to the earlier of exercise or expiration, an exchange-traded option may be closed out by an offsetting purchase or sale of an option of the same series (type, underlying security, exercise price and expiration). There can be no assurance, however, that a closing purchase or sale transaction can be effected when the Trust desires. The Trust may sell put or call options it has previously purchased, which could result in a net gain or loss depending on whether the amount realized on the sale is more or less than the premium and other transaction costs paid on the put or call option when purchased. The Trust will realize a capital gain from a closing purchase transaction if the cost of the closing option is less than the premium received from writing the option, or, if it is more, the Trust will realize a capital loss. If the premium received from a closing sale transaction is more than the premium paid to purchase the option, the Trust will realize a capital gain or, if it is less, the Trust will realize a capital loss. Net gains from the Trust's option strategy will be short-term capital gains which, for federal income tax purposes, will constitute net investment company taxable income.

### Non-Investment Grade Securities

The Trust may invest in securities rated below investment grade, such as those rated Ba or lower by Moody's Investors Service, Inc. ("Moody's") and BB or lower by Standard & Poor's Ratings Group, a division of The McGraw-Hill Companies, Inc. ("S&P") or Fitch Ratings ("Fitch") or securities comparably rated by other rating agencies or in unrated securities determined by Highland to be of comparable quality. Securities rated Ba by Moody's are judged to have speculative elements, their future cannot be considered as well assured and often the protection of interest and principal payments may be very moderate. Securities rated BB by S&P or Fitch are regarded as having predominantly speculative characteristics and, while such obligations have less near-term

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

vulnerability to default than other speculative grade debt, they face major ongoing uncertainties or exposure to adverse business, financial or economic conditions which could lead to inadequate capacity to meet timely interest and principal payments. Securities rated C are regarded as having extremely poor prospects of ever attaining any real investment standing. Securities rated D are in default and the payment of interest and/or repayment of principal is in arrears. The Trust may purchase securities rated as low as D or unrated securities deemed by Highland to be of comparable quality. When Highland believes it to be in the best interests of the Trust's shareholders, the Trust will reduce its investment in lower grade securities.

Lower grade securities, though high yielding, are characterized by high risk. They may be subject to certain risks with respect to the issuing entity and to greater market fluctuations than certain lower yielding, higher rated securities. The secondary market for lower grade securities may be less liquid than that of higher rated securities. Adverse conditions could make it difficult at times for the Trust to sell certain securities or could result in lower prices than those used in calculating the Trust's net asset value.

The prices of debt securities generally are inversely related to interest rate changes; however, the price volatility caused by fluctuating interest rates of securities also is inversely related to the coupon of such securities. Accordingly, lower grade securities may be relatively less sensitive to interest rate changes than higher quality securities of comparable maturity, because of their higher coupon. This higher coupon is what the investor receives in return for bearing greater credit risk. The

30

higher credit risk associated with lower grade securities potentially can have a greater effect on the value of such securities than may be the case with higher quality issues of comparable maturity, and will be a substantial factor in the Trust's relative share price volatility.

Lower grade securities may be particularly susceptible to economic downturns. It is likely that an economic recession could disrupt severely the market for such securities and may have an adverse impact on the value of such securities. In addition, it is likely that any such economic downturn could adversely affect the ability of the issuers of such securities to repay principal and pay interest thereon and increase the incidence of default for such securities.

The ratings of Moody's, S&P, Fitch and the other rating agencies represent their opinions as to the quality of the obligations which they undertake to rate. Ratings are relative and subjective and, although ratings may be useful in evaluating the safety of interest and principal payments, they do not evaluate the market value risk of such obligations. Although these ratings may be an initial criterion for selection of portfolio investments, Highland also will independently evaluate these securities and the ability of the issuers of such securities to pay interest and principal. To the extent that the Trust invests in lower grade securities that have not been rated by a rating agency, the Trust's ability to achieve its investment objectives will be more dependent on Highland's credit analysis than would be the case when the Trust invests in rated securities.

Short-Term Debt Securities; Temporary Defensive Position; Invest-Up Period

During the period in which the net proceeds of this offering of common shares are being invested, during periods in which Highland determines that it is temporarily unable to follow the Trust's investment strategy or that it is impractical to do so or pending re-investment of proceeds received in

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

connection with the sale of a security, the Trust may deviate from its investment strategy and invest all or any portion of its assets in cash or cash equivalents. Highland's determination that it is temporarily unable to follow the Trust's investment strategy or that it is impractical to do so will generally occur only in situations in which a market disruption event has occurred and where trading in the securities selected through application of the Trust's investment strategy is extremely limited or absent. In such a case, shares of the Trust may be adversely affected and the Trust may not pursue or achieve its investment objectives.

### PRINCIPAL RISKS OF THE TRUST

The net asset value of, and dividends paid on, the common shares will fluctuate with and be affected by, among other things, the risks more fully described below.

#### No Operating History

The Trust is a non-diversified, closed-end management investment company with no operating history.

#### Investment And Market Discount Risk

An investment in the Trust's common shares is subject to investment risk, including the possible loss of the entire amount that you invest. As with any stock, the price of the Trust's shares will fluctuate with market conditions and other factors. If shares are sold, the price received may be more or less than the original investment. Net asset value will be reduced immediately following the initial offering by the amount of the sales load and offering expenses paid by the Trust. Common shares are designed for long-term investors and should not be treated as trading vehicles. Shares of closed-end management investment companies frequently trade at a discount from their net asset value. The Trust's shares may trade at a price that is less than the initial offering price. This risk may be greater for investors who sell their shares in a relatively short period of time after completion of the initial offering.

#### Concentration of the Trust's Portfolio

While the Investment Manager will invest in a number of fixed-income and equity instruments issued by different institutions and plans to employ multiple investment strategies with respect to the Trust's portfolio, it is possible that a significant amount of the Trust's investment could be invested in the instruments of only a few companies or that at any particular point in time one investment strategy could be more heavily weighted than the others. The concentration of the Trust's portfolio in any one obligor would subject the Trust to a greater degree of risk with respect to defaults by such obligor, and the concentration of the portfolio in any one industry would subject the Trust to a greater degree of risk with respect to economic downturns relating to such industry. The concentration of the Trust's portfolio in any one investment strategy would subject the Trust to a greater degree of risk than if the Trust's portfolio was diversified with respect to several investment strategies.

#### Illiquidity of Investments

The investments made by the Trust may be very illiquid, and consequently the Trust may not be able to sell such investments at prices that reflect the Investment Manager's assessment of their value or the amount paid for such

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

investments by the Trust. Illiquidity may result from the absence of an established market for the investments as well as legal, contractual or other restrictions on their resale by the Trust and other factors. Furthermore, the nature of the Trust's investments, especially those in financially distressed companies, may require a long holding period prior to being able to determine whether the investment will be profitable or not.

### Bank Loans

A portion of the Trust investments may consist of loans and participations therein originated by banks and other financial institutions, typically referred to as "bank loans." The Trust investments may include loans of a type generally incurred by borrowers in connection with highly leveraged transactions, often to finance internal growth, acquisitions, mergers or stock purchases, or for other reasons. As a result of the additional debt incurred by the borrower in the course of the transaction, the borrower's creditworthiness is often judged by the rating agencies to be below investment-grade. Such loans are typically private corporate loans which are negotiated by one or more commercial banks or financial institutions and syndicated among a group of commercial banks and financial institutions. In order to induce the lenders to extend credit and to offer a favorable interest rate, the borrower often provides the lenders with extensive information about its business which is not generally available to the public.

Bank loans are typically at the most senior level of the capital structure, and are often secured by specific collateral, including, but not limited to, trademarks, patents, accounts receivable, inventory, equipment, buildings, real estate, franchises and common and preferred stock of the obligor or its affiliates. Bank loans often contain restrictive covenants designed to limit the activities of the borrower in an effort to protect the right of lenders to receive timely payments of principal and interest. Such covenants may include restrictions on dividend payments, specific mandatory minimum financial ratios, limits on total debt and other financial tests. Bank loans usually have shorter terms than subordinated obligations and may require mandatory prepayments from excess cash flow, asset dispositions and offerings of debt and/or equity securities. The bank loans and other debt obligations to be acquired by the Trust are likely to be below investment-grade. For a discussion of the risks associated with below investment-grade investments, see "-- High-Yield Securities" above.

The Trust may acquire interests in bank loans and other debt obligations either directly (by way of sale or assignment) or indirectly (by way of participation). The purchaser of an assignment typically succeeds to all the rights and obligations of the assigning institution and becomes a lender under the credit agreement with respect to the debt obligation; however, its rights can be more restricted than those of the assigning institution. A participation interest in a portion of a debt obligation typically results in a contractual relationship only with the institution participating out the interest, not with the borrower. In purchasing participations, the Trust generally will have no right to enforce compliance by the borrower with the terms of the loan agreement, nor any rights of set off against the borrower, and the Trust may not directly benefit from the collateral supporting the debt obligation in which it has purchased the participation. As a result, the Trust will be exposed to the credit risk of both the borrower and the institution selling the participation.

Purchasers of bank loans are predominantly commercial banks, investment funds and investment banks. As secondary market trading volumes increase, new bank loans frequently adopt standardized documentation to facilitate loan trading which should improve market liquidity. There can be no assurance, however, that future levels of supply and demand in bank loan trading will provide an adequate degree of liquidity or that the current level of liquidity will

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

continue. Because of the provision to holders of such loans of confidential information relating to the borrower, the unique and customized nature of the loan agreement, and the private syndication of the loan, bank loans are not as easily purchased or sold as a publicly traded security, and historically the trading volume in the bank loan market has been small relative to the high-yield debt market.

### Distressed Debt

The Trust is authorized to invest in the securities and other obligations of distressed and bankrupt issuers, including debt obligations that are in covenant or payment default. Such investments generally trade significantly below par and are considered speculative. The repayment of defaulted obligations is subject to significant uncertainties. Defaulted obligations might be repaid only after lengthy workout or bankruptcy proceedings, during which the issuer might not make any interest or other payments. Typically such workout or bankruptcy proceedings result in only partial recovery of cash payments or an exchange of the defaulted obligation for other debt or equity securities of the issuer or its affiliates, which may in turn be illiquid or speculative.

32

There are a number of significant risks inherent in the bankruptcy process. First, many events in a bankruptcy are the product of contested matters and adversary proceedings and are beyond the control of the creditors. While creditors are generally given an opportunity to object to significant actions, there can be no assurance that a bankruptcy court in the exercise of its broad powers would not approve actions that would be contrary to the interests of the Trust. Second, the effect of a bankruptcy filing on an issuer may adversely and permanently affect the issuer. The issuer may lose its market position and key employees and otherwise become incapable of restoring itself as a viable entity. If for this or any other reason the proceeding is converted to a liquidation, the value of the issuer may not equal the liquidation value that was believed to exist at the time of the investment. Third, the duration of a bankruptcy proceeding is difficult to predict. A creditor's return on investment can be adversely affected by delays while the plan of reorganization is being negotiated, approved by the creditors and confirmed by the bankruptcy court and until it ultimately becomes effective. Fourth, the administrative costs in connection with a bankruptcy proceeding are frequently high and would be paid out of the debtor's estate prior to any return to creditors. For example, if a proceeding involves protracted or difficult litigation, or turns into a liquidation, substantial assets may be devoted to administrative costs. Fifth, bankruptcy law permits the classification of "substantially similar" claims in determining the classification of claims in a reorganization. Because the standard for classification is vague, there exists the risk that the Trust's influence with respect to the class of securities or other obligations it owns can be lost by increases in the number and amount of claims in that class or by different classification and treatment. Sixth, in the early stages of the bankruptcy process it is often difficult to estimate the extent of, or even to identify, any contingent claims that might be made. Seventh, especially in the case of investments made prior to the commencement of bankruptcy proceedings, creditors can lose their ranking and priority if they exercise "domination and control" over a debtor and other creditors can demonstrate that they have been harmed by such actions. Eighth, certain claims that have priority by law (for example, claims for taxes) may be substantial.

In any investment involving distressed debt obligations, there exists the risk that the transaction involving such debt obligations will be unsuccessful, take considerable time or will result in a distribution of cash or a new security or

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

obligation in exchange for the distressed debt obligations, the value of which may be less than the Trust's purchase price of such debt obligations. Furthermore, if an anticipated transaction does not occur, the Trust may be required to sell its investment at a loss. Given the substantial uncertainties concerning transactions involving distressed debt obligations in which the Trust invests, there is a potential risk of loss by the Trust of its entire investment in any particular investment.

Investments in companies operating in workout modes or under Chapter 11 of the Bankruptcy Code are also, in certain circumstances, subject to certain additional liabilities which may exceed the value of the Trust's original investment in a company. For example, under certain circumstances, creditors who have inappropriately exercised control over the management and policies of a debtor may have their claims subordinated or disallowed or may be found liable for damages suffered by parties as a result of such actions. The Investment Manager's active management style may present a greater risk in this area than would a more passive approach. In addition, under certain circumstances, payments to the Trust and distributions by the Trust or payments on the debt may be reclaimed if any such payment is later determined to have been a fraudulent conveyance or a preferential payment. See "--Fraudulent Conveyance Considerations" below.

The Investment Manager on behalf of the Trust may participate on committees formed by creditors to negotiate with the management of financially troubled companies that may or may not be in bankruptcy or may negotiate directly with debtors with respect to restructuring issues. If the Trust does choose to join a committee, the Trust would likely be only one of many participants, all of whom would be interested in obtaining an outcome that is in their individual best interests. There can be no assurance that the Trust would be successful in obtaining results most favorable to it in such proceedings, although the Trust may incur significant legal and other expenses in attempting to do so. As a result of participation by the Trust on such committees, the Trust may be deemed to have duties to other creditors represented by the committees, which might thereby expose the Trust to liability to such other creditors who disagree with the Trust's actions. Participation by the Trust on such committees may cause the Trust to be subject to certain restrictions on its ability to trade in a particular investment and may also make the Trust an "insider" for purposes of the federal securities laws. Either circumstance will restrict the Trust's ability to trade in or acquire additional positions in a particular investment when it might otherwise desire to do so.

### High-Yield Securities

A portion of the Trust's investments will consist of investments that may generally be characterized as "high-yield securities." Such securities are typically rated below investment grade by one or more nationally recognized statistical rating organizations or are unrated but of comparable credit quality to obligations rated below investment grade, and have greater credit and liquidity risk than more highly rated obligations. High-yield securities are generally unsecured and may be subordinate to other obligations of the obligor. The lower rating of high-yield securities reflects a greater possibility that adverse changes in the financial condition of the issuer or in general economic conditions (including, for example, a substantial period of rising interest rates or declining earnings) or both may impair the ability of the issuer to make payment

of principal and interest. Many issuers of high-yield securities are highly

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

leveraged, and their relatively high debt to equity ratios create increased risks that their operations might not generate sufficient cash flow to service their obligations. Overall declines in the below investment grade bond and other markets may adversely affect such issuers by inhibiting their ability to refinance their obligations at maturity.

High-yield securities are often issued in connection with leveraged acquisitions or recapitalizations in which the issuers incur a substantially higher amount of indebtedness than the level at which they had previously operated. High-yield securities that are debt instruments have historically experienced greater default rates than has been the case for investment grade securities. The Trust may also invest in equity securities issued by entities whose obligations are unrated or are rated below investment grade.

The Trust is authorized to invest in obligations of issuers which are generally trading at significantly higher yields than had been historically typical of the applicable issuer's obligations. Such investments may include debt obligations that have a heightened probability of being in covenant or payment default in the future. Such investments generally are considered speculative. The repayment of defaulted obligations is subject to significant uncertainties. Defaulted obligations might be repaid only after lengthy workout or bankruptcy proceedings, during which the issuer might not make any interest or other payments. Typically such workout or bankruptcy proceedings result in only partial recovery of cash payments or an exchange of the defaulted security for other debt or equity securities of the issuer or its affiliates, which may in turn be illiquid or speculative.

High-yield securities purchased by the Trust will be subject to certain additional risks to the extent that such obligations may be unsecured and subordinated to substantial amounts of senior indebtedness, all or a significant portion of which may be secured. Moreover, such obligations purchased by the Trust may not be protected by financial covenants or limitations upon additional indebtedness.

### Insolvency Considerations with Respect to Issuers of Debt Obligations

Various laws enacted for the protection of creditors may apply to the debt obligations held by the Trust. The information in this paragraph is applicable with respect to U.S. issuers subject to United States bankruptcy laws. Insolvency considerations may differ with respect to other issuers. If a court in a lawsuit brought by an unpaid creditor or representative of creditors of an issuer of a debt obligation, such as a trustee in bankruptcy, were to find that the issuer did not receive fair consideration or reasonably equivalent value for incurring the indebtedness constituting the debt obligation and, after giving effect to such indebtedness, the issuer (i) was insolvent, (ii) was engaged in a business for which the remaining assets of such issuer constituted unreasonably small capital or (iii) intended to incur, or believed that it would incur, debts beyond its ability to pay such debts as they mature, such court could determine to invalidate, in whole or in part, such indebtedness as a fraudulent conveyance, to subordinate such indebtedness to existing or future creditors of such issuer, or to recover amounts previously paid by such issuer in satisfaction of such indebtedness. The measure of insolvency for purposes of the foregoing will vary. Generally, an issuer would be considered insolvent at a particular time if the sum of its debts were then greater than all of its property at a fair valuation, or if the present fair saleable value of its assets was then less than the amount that would be required to pay its probable liabilities on its existing debts as they became absolute and matured. There can be no assurance as to what standard a court would apply in order to determine whether the issuer was "insolvent" after giving effect to the incurrence of the indebtedness constituting the debt obligation or that, regardless of the method of valuation, a court would not determine that the issuer was "insolvent" upon giving effect to such incurrence. In addition, in



## Edgar Filing: Highland Credit Strategies Fund - Form N-2

the event of the insolvency of an issuer of a debt obligation, payments made on such debt obligation could be subject to avoidance as a "preference" if made within a certain period of time (which may be as long as one year) before insolvency. Similarly, a court might apply the doctrine of equitable subordination to subordinate the claim of a lending institution against an issuer, to claims of other creditors of the borrower, when the lending institution, another investor, or any of their transferees, is found to have engaged in unfair, inequitable, or fraudulent conduct. In general, if payments on a debt obligation are avoidable, whether as fraudulent conveyances or preferences, such payments can be recaptured either from the initial recipient (such as the Trust) or from subsequent transferees of such payments (such as the investors in the Trust). To the extent that any such payments are recaptured from the Trust the resulting loss will be borne by the investors. However, a court in a bankruptcy or insolvency proceeding would be able to direct the recapture of any such payment from a holder of notes only to the extent that such court has jurisdiction over such holder or its assets. Moreover, it is likely that avoidable payments could not be recaptured directly from a holder that has given value in exchange for its note, in good faith and without knowledge that the payments were avoidable. The Investment Manager does not intend to engage in conduct that would form the basis for a successful cause of action based upon fraudulent conveyance, preference or equitable subordination. There can be no assurance, however, as to whether any lending institution or other investor from which the issuer acquired the debt obligations engaged in any such conduct (or any other conduct that would subject the debt obligations and the issuer to insolvency laws) and, if it did, as to whether such creditor claims could be asserted in a U.S. court (or in the courts of any other country) against the issuer.

34

### Analysis of Troubled, Distressed or Bankrupt Companies

The Trust invests in companies that are troubled, in distress, or bankrupt. As such, they are subject to a multitude of legal, industry, market, economic and governmental forces that make analysis of these companies inherently risky. Further, the Investment Manager relies on company management, outside experts, market participants, and personal experience to analyze potential investments for the Trust. There can be no assurance that any of these sources will prove credible, or that the Investment Manager's analysis will produce conclusions that lead to profitable investments.

### Leverage

The use of leverage, which can be described as exposure to changes in price at a ratio greater than the amount of equity invested, either through borrowing or other forms of market exposure, magnifies both the favorable and unfavorable effects of price movements in the investments made by the Trust. Subject to applicable margins and other limitations, the Trust may borrow money, or utilize other transactions, for the purpose of leveraging its investments. Insofar as the Trust employs leverage in its investment operations, shareholders will be subject to substantial risks of loss. Interest on borrowings will be a portfolio expense of the Trust and will affect the operating results of the Trust. With volatile instruments, downward price swings can result in margin calls that could require liquidation of securities at inopportune times or at prices that are not favorable to the Trust and cause significant losses.

### Common Stock Risk

The Trust will have exposure to common stocks. Although common stocks have

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

historically generated higher average total returns than fixed income securities over the long-term, common stocks also have experienced significantly more volatility in those returns and in recent years have significantly under-performed relative to fixed income securities. An adverse event, such as an unfavorable earnings report, may depress the value of a particular common stock held by the Trust. Also, the price of common stocks is sensitive to general movements in the stock market and a drop in the stock market may depress the price of common stocks to which the Trust has exposure. Common stock prices fluctuate for several reasons, including changes in investors' perceptions of the financial condition of an issuer or the general condition of the relevant stock market, or when political or economic events affecting the issuers occur. In addition, common stock prices may be particularly sensitive to rising interest rates, as the cost of capital rises and borrowing costs increase. Interest rates are at historical lows and, accordingly, it is likely that they will rise.

### Dividend Risk

Dividends on common stocks are not fixed but are declared at the discretion of an issuer's board of directors. There is no guarantee that the issuers of the common stocks in which the Trust invests will declare dividends in the future or that if declared they will remain at current levels or increase over time. As described further in "Tax Matters," "qualified dividend income" received by the Trust will generally be eligible for the reduced tax rate applicable to such dividends in the case of individual shareholders of the Trust. Unless subsequent legislation is enacted, this reduced tax rate will expire for taxable years beginning on or after January 1, 2009. There is no assurance as to what portion of the Trust's distributions will constitute qualified dividend income.

### Small And Mid-Cap Stock Risk

The Trust may invest in companies with small and mid-capitalizations. Smaller and medium company stocks can be more volatile than, and perform differently from, larger company stocks. There may be less trading in a smaller or medium company's stock, which means that buy and sell transactions in that stock could have a larger impact on the stock's price than is the case with larger company stocks. Smaller and medium companies may have fewer business lines; changes in any one line of business, therefore, may have a greater impact on a smaller and medium company's stock price than is the case for a larger company. As a result, the purchase or sale of more than a limited number of shares of a small and medium company may affect its market price. The Trust may need a considerable amount of time to purchase or sell its positions in these securities. In addition, smaller or medium company stocks may not be well known to the investing public.

### Non-U.S. Securities Risk

Investments in securities of non-U.S. issuers involve certain factors not typically associated with investing in securities issued by U.S. issuers, such as risks relating to (i) currency exchange matters, including fluctuations in the rate of exchange between the U.S. dollar (the currency in which the books of the Trust are maintained) and the various foreign currencies in which the Trust's portfolio securities will be denominated and costs associated with conversion of investment principal and income

from one currency into another; (ii) differences between the U.S. and foreign securities markets, including the absence of uniform accounting, auditing and

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

financial reporting standards and practices and disclosure requirements, and less government supervision and regulation; (iii) political, social or economic instability; and (iv) the extension of credit, especially in the case of sovereign debt.

### Emerging Markets Risk

Investing in securities of issuers based in underdeveloped emerging markets entails all of the risks of investing in securities of non-U.S. issuers to a heightened degree. These heightened risks include: (i) greater risks of expropriation, confiscatory taxation, nationalization, and less social, political and economic stability; (ii) the smaller size of the markets for such securities and a lower volume of trading, resulting in lack of liquidity and in price volatility; and (iii) certain national policies which may restrict the Trust's investment opportunities including restrictions on investing in issuers or industries deemed sensitive to relevant national interests.

### Foreign Currency Risk

Because the Trust will invest in securities denominated or quoted in currencies other than the U.S. dollar, changes in foreign currency exchange rates may affect the value of securities owned by the Trust, the unrealized appreciation or depreciation of investments and gains on and income from investments. Currencies of certain countries may be volatile and therefore may affect the value of securities denominated in such currencies, which means that the Trust's net asset value could decline as a result of changes in the exchange rates between foreign currencies and the U.S. dollar. In addition, the Trust may enter into foreign currency transactions in an attempt to enhance total return which may further expose the Trust to the risks of foreign currency movements and other risks. See "Principal Risks of the Trust--Strategic Transactions Risk."

### Securities Lending Risk

The Trust may lend its portfolio securities to banks or dealers which meet the creditworthiness standards established by the board of trustees of the Trust. Securities lending is subject to the risk that loaned securities may not be available to the Trust on a timely basis and the Trust may, therefore, lose the opportunity to sell the securities at a desirable price. Any loss in the market price of securities loaned by the Trust that occurs during the term of the loan would be borne by the Trust and would adversely affect the Trust's performance. Also, there may be delays in recovery, or no recovery, of securities loaned or even a loss of rights in the collateral should the borrower of the securities fail financially while the loan is outstanding. These risks may be greater for non-U.S. securities.

### Risks Associated with Options on Securities

There are several risks associated with transactions in options on securities. For example, there are significant differences between the securities and options markets that could result in an imperfect correlation between these markets, causing a given transaction not to achieve its objectives. A decision as to whether, when and how to use options involves the exercise of skill and judgment, and even a well conceived transaction may be unsuccessful to some degree because of market behavior or unexpected events.

As the writer of a covered call option, the Trust forgoes, during the option's life, the opportunity to profit from increases in the market value of the security covering the call option above the sum of the premium and the strike price of the call, but has retained the risk of loss should the price of the underlying security decline. As the Trust writes covered calls over more of its portfolio, its ability to benefit from capital appreciation becomes more

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

limited. The writer of an option has no control over the time when it may be required to fulfill its obligation as a writer of the option. Once an option writer has received an exercise notice, it cannot effect a closing purchase transaction in order to terminate its obligation under the option and must deliver the underlying security at the exercise price.

When the Trust writes covered put options, it bears the risk of loss if the value of the underlying stock declines below the exercise price minus the put premium. If the option is exercised, the Trust could incur a loss if it is required to purchase the stock underlying the put option at a price greater than the market price of the stock at the time of exercise plus the put premium the Trust received when it wrote the option. While the Trust's potential gain in writing a covered put option is limited to distributions earned on the liquid assets securing the put option plus the premium received from the purchaser of the put option, the Trust risks a loss equal to the entire exercise price of the option minus the put premium.

36

### Interest Rate Risk

The price of most fixed-income securities moves in the opposite direction of the change in interest rates. For example, as interest rates rise, the price of fixed-income securities falls. Consequently, the longer the maturity of a fixed-income security, the greater the risk that interest rates will rise and thus the fall in price of the security will be larger than the fall in price would have been for a security with a shorter maturity. If the Trust holds a fixed-income security to maturity, the change in its price before maturity will have little impact on the Trust's performance; however, if the Trust has to sell the fixed-income security before the maturity date, an increase in interest rates will result in a loss to the Trust.

### Prepayment Risk

If interest rates fall, the principal on bonds held by the Trust may be paid earlier than expected. If this happens, the proceeds from a prepaid security may be reinvested by the Trust in securities bearing lower interest rates, resulting in a possible decline in the Trust's income and distributions to shareholders. The Trust may invest in pools of mortgages issued or guaranteed by private issuers or U.S. government agencies and instrumentalities. These mortgage-related securities are especially sensitive to prepayment risk because borrowers often refinance their mortgages when interest rates drop.

### Non-Investment Grade Securities Risk

The Trust may invest in securities that are below investment grade. Non-investment grade securities are commonly referred to as "junk bonds." Investments in lower grade securities will expose the Trust to greater risks than if the Trust owned only higher grade debt securities. Because of the substantial risks associated with lower grade securities, you could lose money on your investment in common shares of the Trust, both in the short-term and the long-term. Lower grade securities, though high yielding, are characterized by high risk. They may be subject to certain risks with respect to the issuing entity and to greater market fluctuations than certain lower yielding, higher rated securities. The retail secondary market for lower grade debt securities may be less liquid than that of higher rated debt securities. Adverse conditions could make it difficult at times for the Trust to sell certain securities or could result in lower prices than those used in calculating the Trust's net asset value.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

### Strategic Transactions Risk

Strategic Transactions in which the Trust may engage for hedging purposes or to enhance total return also involve certain risks and special considerations. Strategic Transactions have risks, including the imperfect correlation between the value of such instruments and the underlying assets, the possible default of the other party to the transaction or illiquidity of the derivative instruments. Furthermore, the ability to successfully use Strategic Transactions depends on Highland's ability to predict pertinent market movements, which cannot be assured. Thus, the use of Strategic Transactions may result in losses greater than if they had not been used, may require the Trust to sell or purchase portfolio securities at inopportune times or for prices other than current market values, may limit the amount of appreciation the Trust can realize on an investment or may cause the Trust to hold a security that it might otherwise sell. The use of foreign currency transactions can result in the Trust incurring losses as a result of the imposition of exchange controls, suspension of settlements or the inability of the Trust to deliver or receive a specified currency. Additionally, amounts paid by the Trust as premiums and cash or other assets held in margin accounts with respect to Strategic Transactions are not otherwise available to the Trust for investment purposes.

To the extent that the Trust purchases options pursuant to a hedging strategy, the Trust will be subject to the following additional risks. If a put or call option purchased by the Trust is not sold when it has remaining value, and if the market price of the underlying security remains equal to or greater than the exercise price (in the case of a put), or remains less than or equal to the exercise price (in the case of a call), the Trust will lose its entire investment in the option.

Also, where a put or call option on a particular security is purchased to hedge against price movements in a related security, the price of the put or call option may move more or less than the price of the related security. If restrictions on exercise were imposed, the Trust might be unable to exercise an option it had purchased. If the Trust were unable to close out an option that it had purchased on a security, it would have to exercise the option in order to realize any profit or the option may expire worthless.

### Market Risk Generally

The profitability of a significant portion of the Trust's investment program depends to a great extent upon correctly assessing the future course of the price movements of securities and other investments and the movements of interest rates. There can be no assurance that the Investment Manager will be able to predict accurately these price and interest rate movements. With respect to the investment strategies the Trust may utilize, there will be a high degree of market risk.

### Reinvestment Risk

The Trust reinvests the cash flows received from a security. The additional income from such reinvestment, sometimes called interest-on-interest, is reliant on the prevailing interest rate levels at the time of reinvestment. There is a risk that the interest rate at which interim cash flows can be reinvested will fall. Reinvestment risk is greater for longer holding periods and for securities with large, early cash flows such as high-coupon bonds. Reinvestment risk also applies generally to the reinvestment of the proceeds the Trust receives upon the maturity or sale of a portfolio security.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

### Timing Risk

Many agency, corporate and municipal bonds, and most mortgage-backed securities, contain a provision that allows the issuer to "call" all or part of the issue before the bond's maturity date often after 5 or 10 years. The issuer usually retains the right to refinance the bond in the future if market interest rates decline below the coupon rate. There are three disadvantages to the call provision. First, the cash flow pattern of a callable bond is not known with certainty. Second, because an issuer is more likely to call the bonds when interest rates have dropped, the Trust is exposed to reinvestment rate risk, i.e., the Trust may have to reinvest at lower interest rates the proceeds received when the bond is called. Finally, the capital appreciation potential of a bond will be reduced because the price of a callable bond may not rise much above the price at which the issuer may call the bond.

### Inflation Risk

Inflation risk results from the variation in the value of cash flows from a security due to inflation, as measured in terms of purchasing power. For example, if the Trust purchases a five (5) year bond in which it can realize a coupon rate of five percent (5%), but the rate of inflation increases from two percent (2%) to six percent (6%), then the purchasing power of the cash flow has declined. For all but adjustable bonds or floating rate bonds, the Trust is exposed to inflation risk because the interest rate the issuer promises to make is fixed for the life of the security. To the extent that interest rates reflect the expected inflation rate, floating rate bonds have a lower level of inflation risk.

### Arbitrage Risks

The Trust will engage in capital structure arbitrage and other arbitrage strategies. Arbitrage strategies entail various risks including the risk that external events, regulatory approvals and other factors will impact the consummation of announced corporate events and/or the prices of certain positions. In addition, hedging is an important feature of capital structure arbitrage. There is no guarantee that the Investment Manager will be able to hedge the Trust's portfolio in the manner necessary to successfully employ the Trust's strategy.

### Short Sales Risks

Short sales by the Trust that are not made "against the box" theoretically involve unlimited loss potential since the market price of securities sold short may continuously increase. Short selling involves selling securities which may or may not be owned and borrowing the same securities for delivery to the purchaser, with an obligation to replace the borrowed securities at a later date. Short selling allows the Trust to profit from declines in market prices to the extent such decline exceeds the transaction costs and the costs of borrowing the securities. However, since the borrowed securities must be replaced by purchases at market prices in order to close out the short position, any appreciation in the price of the borrowed securities would result in a loss. Purchasing securities to close out the short position can itself cause the price of the securities to rise further, thereby exacerbating the loss. The Trust may mitigate such losses by replacing the securities sold short before the market price has increased significantly. Under adverse market conditions, the Trust might have difficulty purchasing securities to meet its short sale delivery obligations, and might have to sell portfolio securities to raise the capital necessary to meet its short sale obligations at a time when fundamental investment considerations would not favor such sales.

### Structured Finance Securities

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

A portion of the Trust's investments may consist of equipment trust certificates, collateralized mortgage obligations, collateralized bond obligations, collateralized loan obligations or similar instruments. Structured finance securities may present risks similar to those of the other types of debt obligations in which the Trust may invest and, in fact, such risks may be of greater significance in the case of structured finance securities. Moreover, investing in structured finance securities may entail a variety of unique risks. Among other risks, structured finance securities may be subject to prepayment risk. In addition, the performance of a structured finance security will be affected by a variety of factors, including its priority in the capital structure of the issuer thereof, and the availability of any credit enhancement, the level and timing of payments and

38

recoveries on and the characteristics of the underlying receivables, loans or other assets that are being securitized, remoteness of those assets from the originator or transferor, the adequacy of and ability to realize upon any related collateral and the capability of the servicer of the securitized assets.

### Preferred Securities Risks

There are special risks associated with investing in preferred securities, including:

- o Deferral. Preferred securities may include provisions that permit the issuer, at its discretion, to defer distributions for a stated period without any adverse consequences to the issuer. If the Trust owns a preferred security that is deferring its distributions, the Trust may be required to report income for tax purposes although it has not yet received such income.
- o Subordination. Preferred securities are subordinated to bonds and other debt instruments in a company's capital structure in terms of priority to corporate income and liquidation payments, and therefore will be subject to greater credit risk than more senior debt instruments.
- o Liquidity. Preferred securities may be substantially less liquid than many other securities, such as common stocks or U.S. government securities.
- o Limited Voting Rights. Generally, preferred security holders have no voting rights with respect to the issuing company unless preferred dividends have been in arrears for a specified number of periods, at which time the preferred security holders may elect a number of trustees to the issuer's board. Generally, once all the arrearages have been paid, the preferred security holders no longer have voting rights.

### Derivative Instruments Risks

Derivative instruments, or "derivatives," include futures, options, swaps, structured securities and other instruments and contracts that are derived from, or the value of which is related to, one or more underlying securities, financial benchmarks, currencies or indices. Derivatives allow an investor to hedge or speculate upon the price movements of a particular security, financial benchmark currency or index at a fraction of the cost of investing in the

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

underlying asset. The value of a derivative depends largely upon price movements in the underlying asset. Therefore, many of the risks applicable to trading the underlying asset are also applicable to derivatives of such asset. However, there are a number of other risks associated with derivatives trading. For example, because many derivatives are "leveraged," and thus provide significantly more market exposure than the money paid or deposited when the transaction is entered into, a relatively small adverse market movement can not only result in the loss of the entire investment, but may also expose the Trust to the possibility of a loss exceeding the original amount invested. Derivatives may also expose investors to liquidity risk, as there may not be a liquid market within which to close or dispose of outstanding derivatives contracts, and to counterparty risk. The counterparty risk lies with each party with whom the Trust contracts for the purpose of making derivative investments (the "Counterparty"). In the event of the Counterparty's default, the Trust will only rank as an unsecured creditor and risks the loss of all or a portion of the amounts it is contractually entitled to receive.

### Swaps

Investments in swaps involve the exchange with another party of their respective commitments. Use of swaps subjects the Trust to risk of default by the counterparty. If there is a default by the Counterparty to such a transaction, there may be contractual remedies pursuant to the agreements related to the transaction although contractual remedies may not be sufficient in the event the Counterparty is insolvent. However, the swap market has grown substantially in recent years with a large number of banks and investment banking firms acting both as principals and agents utilizing standardized swap documentation. As a result, the swap market has become relatively liquid in comparison with the markets for other similar instruments which are traded in the interbank market. The Trust may enter into credit default swaps, currency swaps or other swaps which may be surrogates for other instruments such as currency forwards or options.

### Synthetic Securities

In addition to credit risks associated with holding non-investment grade loans and high-yield debt securities, with respect to synthetic securities the Trust will usually have a contractual relationship only with the counterparty of such synthetic securities, and not the Reference Obligor (as defined below) on the Reference Obligation (as defined below). The Trust generally will have no right to directly enforce compliance by the Reference Obligor with the terms of the Reference

Obligation nor any rights of set-off against the Reference Obligor, nor have any voting rights with respect to the Reference Obligation. The Trust will not benefit directly from any collateral supporting the Reference Obligation or have the benefit of the remedies on default that would normally be available to a holder of such Reference Obligation. In addition, in the event of insolvency of its counterparty, the Trust will be treated as a general creditor of such counterparty and will not have any claim with respect to the credit risk of the counterparty as well as that of the Reference Obligor. As a result, concentrations of synthetic securities with any one counterparty subject the notes to an additional degree of risk with respect to defaults by such counterparty as well as by the Reference Obligor. The Investment Manager will not perform independent credit analyses of the counterparties, any such counterparty, or an entity guaranteeing such counterparty, individually or in the aggregate. A "Reference Obligation" is the debt security or other obligation upon which the synthetic security is based. A "Reference Obligor" is



## Edgar Filing: Highland Credit Strategies Fund - Form N-2

the obligor on a Reference Obligation.

### Tax Considerations

There are certain tax risks related to an investment in the Trust. No assurance can be given that the income tax laws or the present interpretation thereof will not be changed (including on a retroactive basis) or that the Internal Revenue Service will agree with the positions taken on the federal income tax returns of the Trust. Accordingly, prospective investors should obtain professional guidance from their personal tax advisors in evaluating the tax risks involved in investing in the Trust and should take into account the cost of obtaining such advice in evaluating this investment. See "Tax Matters."

### Forward-Looking Statements

Certain statements contained in this Memorandum, including without limitation, statements containing the words "believes," "anticipates," "intends," "expects," and words of similar import constitute "forward-looking statements." Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Trust to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Certain of these factors are discussed in more detail elsewhere in this Memorandum, including without limitation under "Summary of Terms," "Risk Factors and Potential Conflicts of Interest," and "Investment Program." Given these uncertainties, prospective investors are cautioned not to place undue reliance on such forward-looking statements. The Investment Manager and the Trust disclaim any obligation to update any such factors or to announce the result of any revisions to any of the forward-looking statements contained herein to reflect future events or developments.

### Valuation Risk

Fair value is defined as the amount for which assets could be sold in an orderly disposition over a reasonable period of time, taking into account the nature of the asset. Fair value pricing, however, involves judgments that are inherently subjective and inexact, since fair valuation procedures are used only when it is not possible to be sure what value should be attributed to a particular asset or when an event will affect the market price of an asset and to what extent. As a result, there can be no assurance that fair value pricing will reflect actual market value and it is possible that the fair value determined for a security will be materially different from the value that actually could be or is realized upon the sale of that asset.

### Investments In Unseasoned Companies

The Trust may invest in the securities of smaller, less seasoned companies. These investments may present greater opportunities for growth, but also involve greater risks than customarily are associated with investments in securities of more established companies. Some of the companies in which the Trust may invest will be start-up companies which may have insubstantial operational or earnings history or may have limited products, markets, financial resources or management depth. Some may also be emerging companies at the research and development stage with no products or technologies to market or approved for marketing. Securities of emerging companies may lack an active secondary market and may be subject to more abrupt or erratic price movements than securities of larger, more established companies or stock market averages in general. Competitors of certain companies may have substantially greater financial resources than many of the companies in which the Trust may invest.

### Initial Public Offerings (IPOs) Risk

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

The Trust may invest in shares of companies through IPOs. IPOs and companies that have recently gone public have the potential to produce substantial gains for the Trust, subject to the Trust's option writing strategy. However, there is no assurance that the Trust will have access to profitable IPOs. The investment performance of the Trust during periods when it is unable to invest significantly or at all in IPOs may be lower than during periods when the Trust is able to do so. Securities

40

issued in IPOs are subject to many of the same risks as investing in companies with smaller market capitalizations. Securities issued in IPOs have no trading history, and information about the companies may be available for limited periods of time. In addition, the prices of securities sold in IPOs may be highly volatile or may decline shortly after the IPO.

### Market Disruption And Geopolitical Risk

The aftermath of the war in Iraq and the continuing occupation of Iraq, instability in the Middle East and terrorist attacks in the United States and around the world may have resulted in market volatility and may have long-term effects on the U.S. and worldwide financial markets and may cause further economic uncertainties in the United States and worldwide. The Trust does not know how long the securities markets will continue to be affected by these events and cannot predict the effects of the occupation or similar events in the future on the U.S. economy and securities markets. Given the risks described above, an investment in the common shares may not be appropriate for all investors. You should carefully consider your ability to assume these risks before making an investment in the Trust.

### Anti-Takeover Provisions

The Trust's Agreement and Declaration of Trust includes provisions that could limit the ability of other entities or persons to acquire control of the Trust or convert the Trust to open-end status. These provisions could deprive the holders of common shares of opportunities to sell their common shares at a premium over the then current market price of the common shares or at net asset value.

## MANAGEMENT OF THE TRUST

### Trustees And Officers

The board of trustees is responsible for the overall management of the Trust, including supervision of the duties performed by Highland. There are trustees of the Trust. of the trustees are not "interested persons" (as defined in the Investment Company Act) of the Trust. The name and business address of the trustees and officers of the Trust and their principal occupations and other affiliations during the past five years are set forth under "Management of the Trust" in the Statement of Additional Information.

### Investment Manager

Highland acts as the Trust's investment manager. Highland is located at Two Galleria Tower, 13455 Noel Road, Suite 800, Dallas, Texas 75240. As of , 2006, the Investment Manager managed approximately \$ billion in debt securities on behalf of institutional investors and retail clients around the world. Highland is controlled by James Dondero and Mark Okada, by virtue of their respective share ownership, and its general partner, Strand Advisors, Inc., of which Mr. Dondero is the sole stockholder.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

### Portfolio Managers

The Trust's portfolio will initially be managed by James Dondero, Mark Okada and Kurtis Plumer.

James Dondero, CFA, CPA, CMA. Mr. Dondero is a founder and President of Highland. Formerly, Mr. Dondero served as Chief Investment Officer of Protective Life's GIC subsidiary and helped grow the business from concept to over \$2 billion between 1989 and 1993. His portfolio management experience includes mortgage-backed securities, investment grade corporates, leveraged bank loans, emerging markets, derivatives, preferred stocks and common stocks. From 1985 to 1989, he managed approximately \$1 billion in fixed income funds for American Express. Prior to American Express, he completed the financial training at Morgan Guaranty Trust Company. Mr. Dondero is a Beta Gamma Sigma graduate of the University of Virginia, 1984 with degrees in Accounting and Finance. Mr. Dondero is a Certified Public Accountant, Chartered Financial Analyst and a Certified Management Accountant.

Mark Okada, CFA. Mr. Okada is a founder and Chief Investment Officer of Highland. He is responsible for overseeing Highland's investment activities for its various funds and has over 19 years of experience in the leveraged finance market. Formerly, Mr. Okada served as Manager of Fixed Income for Protective Life's GIC subsidiary from 1990 to 1993. He was primarily responsible for the bank loan portfolio and other risk assets. Protective was one of the first non-bank entrants into the syndicated loan market. From 1986 to 1990, he served as Vice President for Hibernia National Bank, managing over \$1 billion of high yield bank loans. Mr. Okada is an honors graduate of the University of California Los Angeles with degrees in Economics and Psychology. He completed his credit training at Mitsui and is a Chartered Financial Analyst. Mr. Okada is also Chairman of the Board of Directors of Common Grace Ministries Inc.

41

Kurtis Plumer, CFA. Mr. Plumer is a Senior Portfolio Manager and co-head of the Distressed Group at Highland where he is responsible for managing the sourcing, investing and monitoring process. He has over 14 years of experience in distressed, high yield bond and leveraged loan products. Prior to joining Highland in 1999, Mr. Plumer was a distressed high yield bond trader at Lehman Brothers in New York, where he managed a \$250 million portfolio invested in global distressed securities. While at Lehman, he also traded emerging market sovereign bonds. Prior to joining Lehman Brothers, Mr. Plumer was a corporate finance banker at NationsBanc Capital Markets, Inc. (now Bank of America Capital Markets, Inc.) where he focused on M&A and financing transactions for the bank's clients. Mr. Plumer earned a BBA in Economics and Finance from Baylor University and an MBA in Strategy and Finance from the Kellogg School at Northwestern University. Mr. Plumer is a Chartered Financial Analyst.

The Statement of Additional Information provides additional information about the portfolio managers' compensation, other accounts managed by the portfolio managers and the portfolio managers' ownership of securities issued by the Trust.

### Investment Management Agreement

Pursuant to an investment management agreement between Highland and the Trust, the Trust has agreed to pay for the investment advisory services and facilities provided by Highland a fee payable monthly in arrears at an annual rate equal to % of the average weekly value of the Trust's Managed Assets (the "ManagementFee"). The Management Fee is comprised of two components: %

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

of the Management Fee is paid to Highland as compensation for the portfolio management services it provides to the Trust, and % of the Management Fee is paid to Highland as compensation for the administrative services it provides to the Trust.

In addition to the Management Fee of Highland, the Trust pays all other costs and expenses of its operations, including compensation of its trustees (other than those affiliated with Highland), custodian, transfer and dividend disbursing agent expenses, legal fees, listing fees and expenses, expenses of independent auditors, expenses of preparing, printing and distributing shareholder reports, notices, proxy statements and reports to governmental agencies, and taxes, if any.

### NET ASSET VALUE

The net asset value of the common shares of the Trust will be computed based upon the value of the Trust's portfolio securities and other assets. Net asset value per common share will be determined daily on each day that the New York Stock Exchange is open for business as of the close of the regular trading session on the New York Stock Exchange. The Trust calculates net asset value per common share by subtracting liabilities (including accrued expenses or dividends) from the total assets of the Trust (the value of the securities plus cash or other assets, including interest accrued but not yet received) and dividing the result by the total number of outstanding common shares of the Trust.

### Valuations

The Trust's investments will generally be valued by the Investment Manager as follows:

- (i) The market value of each security listed or traded on any recognized securities exchange or automated quotation system will be the last reported sale price at the relevant valuation date on the composite tape or on the principal exchange on which such security is traded. If no sale is reported on that date, the Investment Manager utilizes, when available, pricing quotations from principal market makers. Such quotations may be obtained from third-party pricing services or directly from investment brokers and dealers in the secondary market. Generally, the Trust's loan and bond positions are not traded on exchanges and consequently are valued based on marks received from third-party pricing services or broker-dealer sources.
- (ii) Dividends declared but not yet received, and rights in respect of securities which are quoted ex-dividend or ex-rights, will be recorded at the fair value thereof, as determined by the Investment Manager, which may (but need not) be the value so determined on the day such securities are first quoted ex-dividend or ex-rights.
- (iii) Listed options, or over-the-counter options for which representative brokers' quotations are available, will be valued in the same manner as listed or over-the-counter securities as hereinabove provided. Premiums for the sale of such options written by the Trust will be included in the assets of the Trust, and the market value of such options shall be included as a liability.
- (iv) The Trust's non-marketable investments will generally be valued in such manner as the Investment Manager determines in good faith to reflect their fair values under procedures established by, and under the general supervision and responsibility of, the Trust's board of trustees. The pricing of all assets that are fair valued in this manner will be subsequently reported to and ratified by the Trust's

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

board of trustees.

42

When determining the fair value of an asset, the Investment Manager will seek to determine the price that the Trust might reasonably expect to receive from the current sale of that asset in an arm's-length transaction. Fair value determinations shall be based upon all available factors that the Investment Manager deems relevant.

### DISTRIBUTIONS

Commencing with the Trust's initial dividend, the Trust intends to make regular monthly cash distributions. We expect to declare the initial monthly dividend on the Trust's common shares within approximately 45 days after completion of this offering and to pay that initial monthly dividend approximately 60 to 90 days after completion of this offering. The Trust expects to pay common shareholders annually at least 90% of its investment company taxable income.

Various factors will affect the level of the Trust's current income and current gains, such as its asset mix, and the Trust's use of options. To permit the Trust to maintain more stable monthly distributions, the Trust may from time to time distribute less than the entire amount of income and gains earned in a particular period. The undistributed income and gains would be available to supplement future distributions. As a result, the distributions paid by the Trust for any particular month may be more or less than the amount of income and gains actually earned by the Trust during that month. Undistributed income and gains will add to the Trust's net asset value and, correspondingly, distributions from undistributed income and gains and from capital, if any, will deduct from the Trust's net asset value. Shareholders will automatically have all dividends and distributions reinvested in common shares of the Trust issued by the Trust or purchased in the open market in accordance with the Trust's dividend reinvestment plan unless an election is made to receive cash. See "Dividend reinvestment plan."

### DIVIDEND REINVESTMENT PLAN

Unless the registered owner of common shares elects to receive cash by contacting the Plan Agent, all dividends declared for your common shares of the Trust will be automatically reinvested by ALPS Mutual Trust Services, Inc. (the "Plan Agent"), agent for shareholders in administering the Trust's Dividend Reinvestment Plan (the "Plan"), in additional common shares of the Trust. If a registered owner of common shares elects not to participate in the Plan, you will receive all dividends in cash paid by check mailed directly to you (or, if the shares are held in street or other nominee name, then to such nominee) by ALPS Mutual Trust Services, Inc., as dividend disbursing agent. You may elect not to participate in the Plan and to receive all dividends in cash by sending written instructions or by contacting ALPS Mutual Trust Services, Inc., as dividend disbursing agent, at the address set forth below. Participation in the Plan is completely voluntary and may be terminated or resumed at any time without penalty by contacting the Plan Agent before the dividend record date; otherwise such termination or resumption will be effective with respect to any subsequently declared dividend or other distribution. Some brokers may automatically elect to receive cash on your behalf and may re-invest that cash in additional common shares of the Trust for you. If you wish for all dividends declared on your common shares of the Trust to be automatically reinvested pursuant to the Plan, please contact your broker.

The Plan Agent will open an account for each common shareholder under the Plan in the same name in which such common shareholder's common shares are

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

registered. Whenever the Trust declares a dividend or other distribution (together, a "dividend") payable in cash, non-participants in the Plan will receive cash and participants in the Plan will receive the equivalent in common shares. The common shares will be acquired by the Plan Agent for the participants' accounts, depending upon the circumstances described below, either (i) through receipt of additional unissued but authorized common shares from the Trust ("newly issued common shares") or (ii) by purchase of outstanding common shares on the open market ("open-market purchases") on the New York Stock Exchange or elsewhere.

If, on the payment date for any dividend, the market price per common share plus estimated brokerage commissions is greater than the net asset value per common share (such condition being referred to herein as "market premium"), the Plan Agent will invest the dividend amount in newly issued common shares, including fractions, on behalf of the participants. The number of newly issued common shares to be credited to each participant's account will be determined by dividing the dollar amount of the dividend by the net asset value per common share on the payment date; provided that, if the net asset value per common share is less than 95% of the market price per common share on the payment date, the dollar amount of the dividend will be divided by 95% of the market price per common share on the payment date.

If, on the payment date for any dividend, the net asset value per common share is greater than the market value per common share plus estimated brokerage commissions (such condition being referred to herein as "market discount"), the Plan Agent will invest the dividend amount in common shares acquired on behalf of the participants in open-market purchases.

In the event of a market discount on the payment date for any dividend, the Plan Agent will have until the last business day before the next date on which the common shares trade on an "ex-dividend" basis or 120 days after the payment date for such dividend, whichever is sooner (the "last purchase date"), to invest the dividend amount in common shares acquired in open-

43

market purchases. It is contemplated that the Trust will pay monthly dividends. Therefore, the period during which open-market purchases can be made will exist only from the payment date of each dividend through the date before the "ex-dividend" date of the third month of the quarter. If, before the Plan Agent has completed its open-market purchases, the market price of a common share exceeds the net asset value per common share, the average per common share purchase price paid by the Plan Agent may exceed the net asset value of the common shares, resulting in the acquisition of fewer common shares than if the dividend had been paid in newly issued common shares on the dividend payment date. Because of the foregoing difficulty with respect to open market purchases, if the Plan Agent is unable to invest the full dividend amount in open market purchases during the purchase period or if the market discount shifts to a market premium during the purchase period, the Plan Agent may cease making open-market purchases and may invest the uninvested portion of the dividend amount in newly issued common shares at the net asset value per common share at the close of business on the last purchase date; provided that, if the net asset value per common share is less than 95% of the market price per common share on the payment date, the dollar amount of the dividend will be divided by 95% of the market price per common share on the payment date.

The Plan Agent maintains all shareholders' accounts in the Plan and furnishes written confirmation of all transactions in the accounts, including information needed by shareholders for tax records. Common shares in the account of each Plan participant will be held by the Plan Agent on behalf of the Plan

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

participant, and each shareholder proxy will include those shares purchased or received pursuant to the Plan. The Plan Agent will forward all proxy solicitation materials to participants and vote proxies for shares held under the Plan in accordance with the instructions of the participants.

In the case of shareholders such as banks, brokers or nominees which hold shares for others who are the beneficial owners, the Plan Agent will administer the Plan on the basis of the number of common shares certified from time to time by the record shareholder's name and held for the account of beneficial owners who participate in the Plan.

There will be no brokerage charges with respect to common shares issued directly by the Trust. However, each participant will pay a pro rata share of brokerage commissions incurred in connection with open-market purchases. The automatic reinvestment of dividends will not relieve participants of any federal, state or local income tax that may be payable (or required to be withheld) on such dividends. See "Tax Matters." Participants that request a sale of shares through the Plan Agent are subject to \$ sales fee and a brokerage commission of \$ per share sold.

The Trust reserves the right to amend or terminate the Plan. There is no direct service charge to participants in the Plan; however, the Trust reserves the right to amend the Plan to include a service charge payable by the participants.

All correspondence concerning the Plan should be directed to the Plan Agent at ALPS Mutual Trust Services, Inc, 1625 Broadway, Suite 2200, Denver, Colorado 80202; telephone ( ) .

### DESCRIPTION OF SHARES

#### Common Shares

The Trust is an unincorporated statutory trust organized under the laws of Delaware pursuant to an Agreement and Declaration of Trust dated as of March 10, 2006. The Trust is authorized to issue an unlimited number of common shares of beneficial interest, par value \$0.001 per share. Each common share has one vote and, when issued and paid for in accordance with the terms of this offering, will be fully paid and non-assessable, except that the trustees shall have the power to cause shareholders to pay expenses of the Trust by setting off charges due from shareholders from declared but unpaid dividends or distributions owed the shareholders and/or by reducing the number of common shares owned by each respective shareholder. The Trust currently is not aware of any expenses that will be paid pursuant to this provision, except to the extent fees payable under its Dividend Reinvestment Plan are deemed to be paid pursuant to this provision.

The Trust has no present intention of offering any additional shares other than the Preferred Shares and common shares issued under the Trust's Dividend Reinvestment Plan. Any additional offerings of shares will require approval by the Trust's board of trustees. Any additional offering of common shares will be subject to the requirements of the Investment Company Act, which provides that shares may not be issued at a price below the then current net asset value, exclusive of sales load, except in connection with an offering to existing holders of common shares or with the consent of a majority of the Trust's outstanding voting securities.

The Trust anticipates that its common shares will be listed on the New York Stock Exchange under the symbol " ." Net asset value will be reduced immediately following the offering of common shares by the amount of the sales load and offering costs paid by the Trust. See "Summary of Trust Expenses."

Unlike open-end funds, closed-end funds like the Trust do not continuously offer shares and do not provide daily redemptions. Rather, if a shareholder determines to buy additional common shares or sell shares already held, the shareholder may do so by trading through a broker on the New York Stock Exchange or otherwise. Shares of closed-end investment companies frequently trade on an exchange at prices lower than net asset value. Shares of closed-end investment companies like the Trust that invest predominantly in equity securities have during some periods traded at prices higher than net asset value and during other periods have traded at prices lower than net asset value. Because the market value of the common shares may be influenced by such factors as dividend levels (which are in turn affected by expenses), dividend stability, net asset value, relative demand for and supply of such shares in the market, general market and economic conditions and other factors beyond the control of the Trust, the Trust cannot assure you that common shares will trade at a price equal to or higher than net asset value in the future. The common shares are designed primarily for long-term investors and you should not purchase the common shares if you intend to sell them soon after purchase. See the Statement of Additional Information under "Repurchase of Common Shares."

#### Preferred Shares

The Agreement and Declaration of Trust provides that the Trust's Board of Trustees may authorize and issue Preferred Shares with rights as determined by the Board of Trustees, by action of the Board of Trustees without the approval of the holders of the common shares. Holders of Common shares have no preemptive right to purchase any Preferred Shares that might be issued.

The Trust may elect to issue Preferred Shares as part of its leverage strategy. If Preferred Shares are issued, the Trust currently intends to issue Preferred Shares representing no more than % of the Trust's Managed Assets immediately after the Preferred Shares are issued. The Board of Trustees also reserves the right to change the foregoing percentage limitation and may issue Preferred Shares to the extent permitted by the Investment Company Act, which currently limits the aggregate liquidation preference of all outstanding Preferred Shares to 50% of the value of the Trust's Managed Assets less liabilities and indebtedness of the Trust. We cannot assure you, however, that any Preferred Shares will be issued. Although the terms of any Preferred Shares, including dividend rate, liquidation preference and redemption provisions, will be determined by the Board of Trustees, subject to applicable law and the Agreement and Declaration of Trust, it is likely that the Preferred Shares will be structured to carry a relatively short-term dividend rate reflecting interest rates on short-term bonds, by providing for the periodic redetermination of the dividend rate at relatively short intervals through an auction, remarketing or other procedure. The Trust also believes that it is likely that the liquidation preference, voting rights and redemption provisions of the Preferred Shares will be similar to those stated below.

**Liquidation Preference.** In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Trust, the holders of Preferred Shares will be entitled to receive a preferential liquidating distribution, which is expected to equal the original purchase price per Preferred Share plus accrued and unpaid dividends, whether or not declared, before any distribution of assets is made to holders of common shares. After payment of the full amount of the liquidating distribution to which they are entitled, the holders of Preferred Shares will not be entitled to any further participation in any distribution of assets by the Trust.

**Voting Rights.** The Investment Company Act requires that the holders of any



## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Preferred Shares, voting separately as a single class, have the right to elect at least two trustees at all times. The remaining trustees will be elected by holders of common shares and Preferred Shares, voting together as a single class. In addition, subject to the prior rights, if any, of the holders of any other class of senior securities outstanding, the holders of any Preferred Shares have the right to elect a majority of the trustees of the Trust at any time two years' dividends on any Preferred Shares are unpaid. The Investment Company Act also requires that, in addition to any approval by shareholders that might otherwise be required, the approval of the holders of a majority of any outstanding Preferred Shares, voting separately as a class, would be required to (1) adopt any plan of reorganization that would adversely affect the Preferred Shares, and (2) take any action requiring a vote of security holders under Section 13(a) of the Investment Company Act, including, among other things, changes in the Trust's subclassification as a closed-end investment company or changes in its fundamental investment restrictions. See "Certain Provisions in the Agreement and Declaration of Trust." As a result of these voting rights, the Trust's ability to take any such actions may be impeded to the extent that there are any Preferred Shares outstanding. The Board of Trustees presently intends that, except as otherwise indicated in this prospectus and except as otherwise required by applicable law, holders of Preferred Shares will have equal voting rights with holders of common shares (one vote per share, unless otherwise required by the Investment Company Act) and will vote together with holders of common shares as a single class.

The affirmative vote of the holders of a majority of the outstanding Preferred Shares, voting as a separate class, will be required to amend, alter or repeal any of the preferences, rights or powers of holders of Preferred Shares so as to affect materially and adversely such preferences, rights or powers, or to increase or decrease the authorized number of Preferred

45

Shares. The class vote of holders of Preferred Shares described above will in each case be in addition to any other vote required to authorize the action in question.

Redemption, Purchase and Sale of Preferred Shares by the Trust. The terms of the Preferred Shares are expected to provide that (1) they are redeemable by the Trust in whole or in part at the original purchase price per share plus accrued dividends per share, (2) the Trust may tender for or purchase Preferred Shares and (3) the Trust may subsequently resell any shares so tendered for or purchased. Any redemption or purchase of Preferred Shares by the Trust will reduce the leverage applicable to the common shares, while any resale of shares by the Trust will increase that leverage.

The discussion above describes the possible offering of Preferred Shares by the Trust. If the Board of Trustees determines to proceed with such an offering, the terms of the Preferred Shares may be the same as, or different from, the terms described above, subject to applicable law and the Trust's Agreement and Declaration of Trust. The Board of Trustees, without the approval of the holders of common shares, may authorize an offering of Preferred Shares or may determine not to authorize such an offering, and may fix the terms of the Preferred Shares to be offered.

### ANTI-TAKEOVER PROVISIONS IN THE AGREEMENT AND DECLARATION OF TRUST

The Agreement and Declaration of Trust includes provisions that could have the effect of limiting the ability of other entities or persons to acquire control

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

of the Trust or to change the composition of its board of trustees. This could have the effect of depriving shareholders of an opportunity to sell their shares at a premium over prevailing market prices by discouraging a third party from seeking to obtain control over the Trust. Such attempts could have the effect of increasing the expenses of the Trust and disrupting the normal operation of the Trust. The board of trustees is divided into three classes, with the terms of one class expiring at each annual meeting of shareholders. At each annual meeting, one class of trustees is elected to a three-year term. This provision could delay for up to two years the replacement of a majority of the board of trustees. A trustee may be removed from office by the action of a majority of the remaining trustees followed by a vote of the holders of at least 75% of the shares then entitled to vote for the election of the respective trustee.

In addition, the Trust's Agreement and Declaration of Trust requires the favorable vote of a majority of the Trust's board of trustees followed by the favorable vote of the holders of at least 75% of the outstanding shares of each affected class or series of the Trust, voting separately as a class or series, to approve, adopt or authorize certain transactions with 5% or greater holders of a class or series of shares and their associates, unless the transaction has been approved by at least 80% of the trustees, in which case "a majority of the outstanding voting securities" (as defined in the Investment Company Act) of the Trust shall be required. For purposes of these provisions, a 5% or greater holder of a class or series of shares (a "Principal Shareholder") refers to any person who, whether directly or indirectly and whether alone or together with its affiliates and associates, beneficially owns 5% or more of the outstanding shares of all outstanding classes or series of shares of beneficial interest of the Trust.

The 5% holder transactions subject to these special approval requirements are: the merger or consolidation of the Trust or any subsidiary of the Trust with or into any Principal Shareholder; the issuance of any securities of the Trust to any Principal Shareholder for cash, except pursuant to any automatic dividend reinvestment plan; the sale, lease or exchange of all or any substantial part of the assets of the Trust to any Principal Shareholder, except assets having an aggregate fair market value of less than 2% of the total assets of the Trust, aggregating for the purpose of such computation all assets sold, leased or exchanged in any series of similar transactions within a twelve-month period; or the sale, lease or exchange to the Trust or any subsidiary of the Trust, in exchange for securities of the Trust, of any assets of any Principal Shareholder, except assets having an aggregate fair market value of less than 2% of the total assets of the Trust, aggregating for purposes of such computation all assets sold, leased or exchanged in any series of similar transactions within a twelve-month period.

To convert the Trust to an open-end investment company, the Trust's Agreement and Declaration of Trust requires the favorable vote of a majority of the board of the trustees followed by the favorable vote of the holders of at least 75% of the outstanding shares of each affected class or series of shares of the Trust, voting separately as a class or series, unless such amendment has been approved by at least 80% of the trustees, in which case "a majority of the outstanding voting securities" (as defined in the Investment Company Act) of the Trust shall be required. The foregoing vote would satisfy a separate requirement in the Investment Company Act that any conversion of the Trust to an open-end investment company be approved by the shareholders. If approved in the foregoing manner, conversion of the Trust to an open-end investment company could not occur until 90 days after the shareholders' meeting at which such conversion was approved and would also require at least 30 days' prior notice to all shareholders. Following any such conversion, it is possible that certain of the Trust's investment policies and strategies would have to be modified to assure sufficient portfolio liquidity. In the event of conversion, the common shares would cease to be listed on the New York Stock Exchange or other

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

national securities

46

exchanges or market systems. Shareholders of an open-end investment company may require the company to redeem their shares at any time, except in certain circumstances as authorized by or under the Investment Company Act, at their net asset value, less such redemption charge, if any, as might be in effect at the time of a redemption. The Trust expects to pay all such redemption requests in cash, but reserves the right to pay redemption requests in a combination of cash or securities. If such partial payment in securities were made, investors may incur brokerage costs in converting such securities to cash. If the Trust were converted to an open-end fund, it is likely that new shares would be sold at net asset value plus a sales load. The board of trustees believes, however, that the closed-end structure is desirable in light of the Trust's investment objectives and policies. Therefore, you should assume that it is not likely that the board of trustees would vote to convert the Trust to an open-end fund.

For the purposes of calculating "a majority of the outstanding voting securities" under the Trust's Agreement and Declaration of Trust, each class and series of the Trust shall vote together as a single class, except to the extent required by the Investment Company Act or the Trust's Agreement and Declaration of Trust, with respect to any class or series of shares. If a separate class vote is required, the applicable proportion of shares of the class or series, voting as a separate class or series, also will be required.

The Declaration of Trust also provides that the Trust may be liquidated upon the approval of 80% of the trustees.

The board of trustees has determined that provisions with respect to the board of trustees and the shareholder voting requirements described above, which voting requirements are greater than the minimum requirements under Delaware law or the Investment Company Act, are in the best interest of shareholders generally. Reference should be made to the Trust's Agreement and Declaration of Trust, on file with the Commission for the full text of these provisions.

### CLOSED-END FUND STRUCTURE

The Trust is a diversified, closed-end management investment company with no operating history (commonly referred to as a closed-end fund). Closed-end funds differ from open-end funds (which are generally referred to as mutual funds) in that closed-end funds generally list their shares for trading on a stock exchange and do not redeem their shares at the request of the shareholder. This means that if you wish to sell your shares of a closed-end fund you must trade them on the market like any other stock at the prevailing market price at that time. In a mutual fund, if the shareholder wishes to sell shares of the fund, the mutual fund will redeem or buy back the shares at "net asset value." Also, mutual funds generally offer new shares on a continuous basis to new investors, and closed-end funds generally do not. The continuous inflows and outflows of assets in a mutual fund can make it difficult to manage a mutual fund's investments. By comparison, closed-end funds are generally able to stay more fully invested in securities that are consistent with their investment objective, and also have greater flexibility to make certain types of investments, and to use certain investment strategies, such as financial leverage and investments in illiquid securities.

Shares of closed-end funds frequently trade at a discount to their net asset value. Because of this possibility and the recognition that any such discount may not be in the interest of shareholders, the Trust's board of trustees might consider from time to time engaging in open-market repurchases, tender offers

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

for shares or other programs intended to reduce the discount. We cannot guarantee or assure, however, that the Trust's board of trustees will decide to engage in any of these actions. Nor is there any guarantee or assurance that such actions, if undertaken, would result in the shares trading at a price equal or close to net asset value per share. The board of trustees might also consider converting the Trust to an open-end mutual fund, which would also require a vote of the shareholders of the Trust.

### REPURCHASE OF COMMON SHARES

Shares of closed-end investment companies often trade at a discount to their net asset value, and the Trust's common shares may also trade at a discount to their net asset value, although it is possible that they may trade at a premium above net asset value. The market price of the Trust's common shares will be determined by such factors as relative demand for and supply of such common shares in the market, the Trust's net asset value, general market and economic conditions and other factors beyond the control of the Trust. See "Net Asset Value." Although the Trust's common shareholders will not have the right to redeem their common shares, the Trust may take action to repurchase common shares in the open market or make tender offers for its common shares. This may have the effect of reducing any market discount from net asset value.

There is no assurance that, if action is undertaken to repurchase or tender for common shares, such action will result in the common shares trading at a price which approximates their net asset value. Although share repurchases and tenders could have a favorable effect on the market price of the Trust's common shares, you should be aware that the acquisition of common shares by the Trust will decrease the capital of the Trust and, therefore, may have the effect of increasing the Trust's expense ratio and decreasing the asset coverage with respect to any preferred shares outstanding. Any share repurchases or

47

tender offers will be made in accordance with requirements of the Securities Exchange Act of 1934, as amended, the Investment Company Act and the principal stock exchange on which the common shares are traded.

### TAX MATTERS

The following discussion summarizes certain U.S. federal income tax considerations affecting the Trust and its U.S. shareholders. For more information, please see the Statement of Additional Information, under "Tax Matters." Because each shareholder's tax situation is unique, ask your tax professional about the tax consequences to you of an investment in the Trust.

The Trust intends to qualify annually as a regulated investment company under the Internal Revenue Code. Accordingly, the Trust generally will not be subject to U.S. federal income tax on income and gains that the Trust distributes to its shareholders.

Distributions paid to you by the Trust from its net realized long-term capital gains, if any, that the Trust designates as capital gains dividends ("capital gain dividends") are taxable as long-term capital gains, regardless of how long you have held your common shares. All other dividends paid to you by the Trust (including dividends from short-term capital gains) from its current or accumulated earnings and profits ("ordinary income dividends") are generally subject to tax as ordinary income.

Special rules apply, however, to ordinary income dividends paid to individuals with respect to taxable years beginning on or before December 31, 2008. If you

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

are an individual, any such ordinary income dividend that you receive from the Trust generally will be eligible for taxation at the rates applicable to long-term capital gains (currently at a maximum rate of 15%) to the extent that: (i) the ordinary income dividend is attributable to "qualified dividend income" (i.e., generally dividends paid by U.S. corporations and certain foreign corporations) received by the Trust, (ii) the Trust satisfies certain holding period and other requirements with respect to the stock on which such qualified dividend income was paid and (iii) you satisfy certain holding period and other requirements with respect to your common shares. Ordinary income dividends subject to these special rules are not actually treated as capital gains, however, and thus will not be included in the computation of your net capital gain and generally cannot be used to offset any capital losses. Congress has recently considered certain proposals to extend the preferential tax rates for qualified dividend income beyond 2008, but no assurances can be given in this regard.

Dividends and other taxable distributions are taxable to you even if they are reinvested in additional common shares of the Trust. Dividends and other distributions paid by the Trust are generally treated as received by you at the time the dividend or distribution is made. If, however, the Trust pays you a dividend in January that was declared in the previous October, November or December and you were the shareholder of record on a specified date in one of such months, then such dividend will be treated for tax purposes as being paid by the Trust and received by you on December 31 of the year in which the dividend was declared.

The price of common shares purchased at any time may reflect the amount of a forthcoming distribution. If you purchase common shares just prior to a distribution, you will receive a distribution that will be taxable to you even though it represents in part a return of your invested capital.

The Trust will send you information after the end of each year setting forth the amount and tax status of any distributions paid to you by the Trust. Ordinary income dividends and capital gain dividends may also be subject to state and local taxes.

If you sell or otherwise dispose of common shares of the Trust (including exchange them for common shares of another fund), you will generally recognize a gain or loss in an amount equal to the difference between your tax basis in such common shares of the Trust and the amount you receive in exchange for such common shares. If you hold your common shares as capital assets, any such gain or loss will be long-term capital gain or loss if you have held such common shares for more than one year at the time of sale.

The Trust may be required to withhold, for U.S. federal backup withholding tax purposes, a portion of the dividends, distributions and redemption proceeds payable to a shareholder who fails to provide the Trust (or its agent) with the shareholder's correct taxpayer identification number (in the case of an individual, generally, such individual's social security number) or to make the required certification, or who has been notified by the Internal Revenue Service that such shareholder is subject to backup withholding. Certain shareholders are exempt from backup withholding. Backup withholding is not an additional tax and any amount withheld may be refunded or credited against your U.S. federal income tax liability, if any, provided that you furnish the required information to the IRS.

The discussions set forth herein and in the Statement of Additional Information do not constitute tax advice, and you are urged to consult your own tax advisor

**Edgar Filing: Highland Credit Strategies Fund - Form N-2**

to determine the specific U.S. federal, state, local and foreign tax consequences to you of investing in the Trust.

UNDERWRITING

The Underwriters named below, acting through \_\_\_\_\_ as their representatives (the "Representatives"), have severally agreed, subject to the terms and conditions of a purchase agreement with the Trust and Highland (the "Underwriting Agreement") to purchase from the Trust the number of common shares set forth opposite their respective names. The Underwriters are committed to purchase and pay for all such common shares (other than those covered by the over-allotment option described below) if any are purchased.

	Number of
Underwriters	common shares
-----	

Total	-----
	=====

The Trust granted to the Underwriters an option, exercisable for 45 days from the date of this prospectus, \_\_\_\_\_ to purchase up to an additional common shares to cover over-allotments, if any, at the initial offering price per common share minus the commission described in the following paragraph. The Underwriters may exercise such option solely for the purpose of covering over-allotments incurred in the sale of the common shares offered hereby. To the extent that the Underwriters exercise this option, each of the Underwriters will have a firm commitment, subject to certain conditions, to purchase an additional number of common shares proportionate to such Underwriter's initial commitment.

The Trust has agreed to pay a commission to the Underwriters in the amount of up to \$ \_\_\_\_\_ per common share ( \_\_\_\_\_ % of the public offering price per common share). The Representatives have advised the Trust that the Underwriters may pay up to \$ \_\_\_\_\_ per common share from such commission to selected dealers who sell the common shares and that such dealers may reallocate a concession of up to \$ \_\_\_\_\_ per common share to certain other dealers who sell common shares. Investors must pay for any common shares purchased on or before \_\_\_\_\_, 2006.

Prior to this offering, there has been no public or private market for the common shares or any other securities of the Trust. Consequently, the offering price for the common shares was determined by negotiation among the Trust, Highland and the Representatives. There can be no assurance, however, that the price at which the common shares sell after this offering will not be lower than the price at which they are sold by the Underwriters or that an active trading market in the common shares will develop and continue after this offering. The minimum investment requirement is 100 common shares (\$2,000).

The Trust and Highland have agreed not to offer, sell or register with the Commission any equity securities of the Trust, other than issuances of common shares as contemplated in this prospectus, for a period of 180 days after the date of the Underwriting Agreement without the prior written consent of the

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Representatives. The Representatives have informed the Trust that the Underwriters do not intend to confirm any sales to any accounts over which they exercise discretionary authority.

In connection with this offering, the Underwriters may purchase and sell common shares in the open market. These transactions may include over-allotment and stabilizing transactions and purchases to cover syndicate short positions created in connection with this offering. Stabilizing transactions consist of certain bids or purchases for the purpose of preventing or retarding a decline in the market price of the common shares and syndicate short positions involve the sale of the Underwriters of a greater number of common shares than they are required to purchase from the Trust in this offering. The Underwriters also may impose a penalty bid, whereby selling concessions allowed to syndicate members or other broker-dealers in respect of the common shares sold in this offering for their account may be reclaimed by the syndicate if such

49

common shares are repurchased by the syndicate in stabilizing or covering transactions. These activities may stabilize, maintain or otherwise affect the market price of the common shares, which may be higher than the price that might otherwise prevail in the open market; and these activities, if commenced, may be discontinued at any time without notice. These transactions may be effected on the New York Stock Exchange or otherwise.

The Trust anticipates that the Representatives and certain other Underwriters may from time to time act as brokers and dealers in connection with the execution of its portfolio transactions after they have ceased to be Underwriters and, subject to certain restrictions, may act as such brokers while they are Underwriters.

In connection with this offering, certain of the Underwriters or selected dealers may distribute prospectuses electronically.

Highland (and not the Trust) may pay certain qualifying Underwriters a sales incentive fee, structuring fee or, alternatively, additional compensation in connection with this offering. The total amount of these payments will not exceed % of the total price to the public of the common shares sold in this offering.

Highland (and not the Trust) has agreed to pay a commission to certain wholesalers of its broker dealer affiliate, , that participate in the marketing of the Trust's common shares, which commissions will not exceed % of the total price to the public of the common shares sold in this offering. The Trust may reimburse Highland for all or a portion of its expenses incurred in connection with this offering (other than those described in the preceding sentence), to the extent that the offering expenses of the Trust do not equal or exceed the \$ per common share the Trust has agreed to pay for the offering expenses of the Trust.

The sum of the fees described above, plus the amount paid by the Trust as the \$ per common share partial reimbursement of expenses to the Underwriters, will not exceed % of the aggregate initial offering price of the common shares offered hereby. The sum total of all compensation to Underwriters in connection with this public offering of common shares, including sales load and additional compensation to and reimbursement of Underwriters, will be limited to 9% of the total price to the public of the common shares sold in this offering.

CUSTODIAN AND TRANSFER AGENT

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

The Custodian of the assets of the Trust will be ALPS Mutual Trust Services, Inc. The Custodian will perform custodial, fund accounting and portfolio accounting services. ALPS Mutual Trust Services, Inc. will also serve as the Trust's Transfer Agent with respect to its common shares.

### LEGAL OPINIONS

Certain legal matters in connection with the common shares will be passed upon for the Trust by Skadden, Arps, Slate, Meagher & Flom LLP, New York, New York and for the Underwriters by , , .

### PRIVACY PRINCIPLES OF THE TRUST

The Trust is committed to maintaining the privacy of its shareholders and to safeguarding their non-public personal information. The following information is provided to help you understand what personal information the Trust collects, how the Trust protects that information and why, in certain cases, the Trust may share information with select other parties.

Generally, the Trust does not receive any non-public personal information relating to its shareholders, although certain non-public personal information of its shareholders may become available to the Trust. The Trust does not disclose any non-public personal information about its shareholders or former shareholders to anyone, except as permitted by law or as is necessary in order to service shareholder accounts (for example, to a transfer agent or third party administrator).

The Trust restricts access to non-public personal information about its shareholders to employees of the Trust's investment manager and its affiliates with a legitimate business need for the information. The Trust maintains physical, electronic and procedural safeguards designed to protect the non-public personal information of its shareholders.

50

### TABLE OF CONTENTS FOR THE STATEMENT OF ADDITIONAL INFORMATION

USE OF PROCEEDS.....	B-2
INVESTMENT OBJECTIVES AND POLICIES.....	B-2
INVESTMENT POLICIES AND TECHNIQUES.....	B-3
OTHER INVESTMENT POLICIES AND TECHNIQUES.....	B-8
MANAGEMENT OF THE TRUST.....	B-10
PORTFOLIO TRANSACTIONS AND BROKERAGE.....	B-16
DESCRIPTION OF SHARES.....	B-16
REPURCHASE OF COMMON SHARES.....	B-18
TAX MATTERS.....	B-19
EXPERTS.....	B-22
ADDITIONAL INFORMATION.....	B-22
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM.....	F-1
STATEMENT OF ASSETS AND LIABILITIES.....	F-2
STATEMENT OF OPERATIONS.....	F-3
STATEMENT OF CHANGES IN NET ASSETS.....	F-4
NOTES TO FINANCIAL STATEMENTS.....	F-5
APPENDIX A GENERAL CHARACTERISTICS AND RISKS OF STRATEGIC TRANSACTIONS.....	A-1
APPENDIX B PROXY VOTING PROCEDURES.....	B-1



# Edgar Filing: Highland Credit Strategies Fund - Form N-2

Highland Credit Strategies Fund

[flag]

The information in this Statement of Additional Information is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This Statement of Additional Information is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

Subject to Completion  
Preliminary Statement of Additional Information  
Dated , 2006

## STATEMENT OF ADDITIONAL INFORMATION

Highland Credit Strategies Fund (the "Trust") is a newly organized, non-diversified, closed-end management investment company with no operating history. This Statement of Additional Information relating to common shares does not constitute a prospectus, but should be read in conjunction with the prospectus relating thereto dated , 2006. This Statement of Additional Information, which is not a prospectus, does not include all information that a prospective investor should consider before purchasing common shares, and investors should obtain and read the prospectus prior to purchasing such shares. A copy of the prospectus may be obtained without charge by calling (877) 665-1287. You may also obtain a copy of the prospectus on the Securities and Exchange Commission's web site (<http://www.sec.gov>). Capitalized terms used but not defined in this Statement of Additional Information have the meanings ascribed to them in the prospectus.

## TABLE OF CONTENTS

USE OF PROCEEDS.....	B-2
INVESTMENT OBJECTIVES AND POLICIES.....	B-2
INVESTMENT POLICIES AND TECHNIQUES.....	B-3
OTHER INVESTMENT POLICIES AND TECHNIQUES.....	B-8
MANAGEMENT OF THE TRUST.....	B-10
PORTFOLIO TRANSACTIONS AND BROKERAGE.....	B-16
DESCRIPTION OF SHARES.....	B-16
REPURCHASE OF COMMON SHARES.....	B-18
TAX MATTERS.....	B-19
EXPERTS.....	B-22
ADDITIONAL INFORMATION.....	B-22
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM.....	F-1
STATEMENT OF ASSETS AND LIABILITIES.....	F-2
STATEMENT OF OPERATIONS.....	F-3
STATEMENT OF CHANGES IN NET ASSETS.....	F-4
NOTES TO FINANCIAL STATEMENTS.....	F-5
APPENDIX A GENERAL CHARACTERISTICS AND RISKS OF STRATEGIC TRANSACTIONS.....	A-1
APPENDIX B PROXY VOTING PROCEDURES.....	B-1

This Statement of Additional Information is dated , 2006.

B-1

USE OF PROCEEDS

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Pending investment in securities that meet the Trust's investment objectives and policies, the net proceeds of this offering will be invested in short-term debt securities of the type described under "Investment Policies and Techniques--Short-Term Debt Securities." We currently anticipate that the Trust will be able to invest primarily in securities that meet the Trust's investment objectives and policies within approximately three months after the completion of this offering.

### INVESTMENT OBJECTIVES AND POLICIES

The Trust's primary investment objective is to deliver attractive risk-adjusted returns to its investors by employing a multi-strategy investment approach to exploit relative value and arbitrage opportunities within the credit markets. Highland will execute, on behalf of the Trust, directional, relative value, capital structure arbitrage and event-driven investment strategies across various credit markets where the Investment Manager holds significant investment experience: primarily the leveraged loan, high yield, structured products, and distressed markets. The Trust will seek to create a portfolio of investments that will maintain low correlation to the broader equity and corporate bond markets, as well as to other alternative investment strategies.

#### Investment Restrictions

Except as described below, the Trust, as a fundamental policy, may not, without the approval of the holders of a majority of the outstanding common shares and any preferred shares, if any, voting together as a single class, and of the holders of a majority of the outstanding preferred shares, if any, voting as a separate class:

- (1) invest 25% or more of the value of its total assets in any single industry;
- (2) issue senior securities or borrow money other than as permitted by the Investment Company Act or pledge its assets other than to secure such issuances or in connection with hedging transactions, short sales, securities lending, when issued and forward commitment transactions and similar investment strategies;
- (3) make loans of money or property to any person, except through loans of portfolio securities, the purchase of debt securities, including bank loans and participations therein, or the entry into repurchase agreements;
- (4) underwrite the securities of other issuers, except to the extent that, in connection with the disposition of portfolio securities or the sale of its own securities, the Trust may be deemed to be an underwriter;
- (5) purchase or sell real estate, except that the Trust may invest in securities of companies that deal in real estate or are engaged in the real estate business, including real estate investment trusts and real estate operating companies, and instruments secured by real estate or interests therein and the Trust may acquire, hold and sell real estate acquired through default, liquidation, or other distributions of an interest in real estate as a result of the Trust's ownership of such other assets; or
- (6) purchase or sell commodities or commodity contracts for any purposes except as, and to the extent, permitted by applicable law without the Trust becoming subject to registration with the Commodity Futures Trading Commission (the "CFTC") as a commodity pool.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

When used with respect to particular shares of the Trust, "majority of the outstanding" shares means (i) 67% or more of the shares present at a meeting, if the holders of more than 50% of the shares are present or represented by proxy, or (ii) more than 50% of the shares, whichever is less.

The Trust is also subject to the following non-fundamental restrictions and policies, which may be changed by the board of trustees. The Trust may not:

(1) make any short sale of securities except in conformity with applicable laws, rules and regulations and unless after giving effect to such sale, the market value of all securities sold short does not exceed 25% of the value of the Trust's total assets and the Trust's aggregate short sales of a particular class of securities of an issuer does not exceed 25% of the then outstanding securities of that class. The Trust may also make short sales "against the box" without respect to such limitations. In this type of short sale, at the time of the sale, the Trust owns or has the immediate and unconditional right to acquire at no additional cost the identical security; and

B-2

(2) purchase securities of open-end or closed-end investment companies except in compliance with the Investment Company Act or any exemptive relief obtained thereunder. Under the Investment Company Act, the Trust may invest up to 10% of its total assets in the aggregate in shares of other investment companies and up to 5% of its total assets in any one investment company, provided the investment does not represent more than 3% of the voting stock of the acquired investment company at the time such shares are purchased. As a shareholder in any investment company, the Trust will bear its ratable share of that investment company's expenses, and will remain subject to payment of the Trust's advisory fees and other expenses with respect to assets so invested. Holders of common shares will therefore be subject to duplicative expenses to the extent the Trust invests in other investment companies. In addition, the securities of other investment companies may be leveraged and will therefore be subject to the risks of leverage. The net asset value and market value of leveraged shares will be more volatile and the yield to shareholders will tend to fluctuate more than the yield generated by unleveraged shares.

In addition, to comply with federal income tax requirements for qualification as a regulated investment company, the Trust's investments will be limited in a manner such that at the close of each quarter of each taxable year, (a) no more than 25% of the value of the Trust's total assets are invested (i) in the securities (other than U.S. Government securities or securities of other regulated investment companies) of a single issuer or two or more issuers controlled by the Trust and engaged in the same, similar or related trades or businesses or (ii) in the securities of one or more "qualified publicly traded partnerships" (as defined under Section 851(h) of the Code) and (b) with regard to at least 50% of the Trust's total assets, no more than 5% of its total assets are invested in the securities (other than U.S. Government securities or securities of other regulated investment companies) of a single issuer and no investment represents more than 10% of the outstanding voting securities of such issuer. These tax-related limitations may be changed by the trustees to the extent appropriate in light of changes to applicable tax requirements.

The percentage limitations applicable to the Trust's portfolio described in the prospectus and this Statement of Additional Information apply only at the time of investment and the Trust will not be required to sell securities

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

due to subsequent changes in the value of securities it owns.

### INVESTMENT POLICIES AND TECHNIQUES

The following information supplements the discussion of the Trust's investment objectives, policies and techniques that are described in the prospectus.

#### Short-Term Debt Securities

For temporary defensive purposes or to keep cash on hand, the Trust may invest up to 100% of its total assets in cash equivalents and short-term debt securities. Short-term debt investments are defined to include, without limitation, the following:

(1) U.S. Government securities, including bills, notes and bonds differing as to maturity and rates of interest that are either issued or guaranteed by the U.S. Treasury or by U.S. Government agencies or instrumentalities. U.S. Government securities include securities issued by (a) the Federal Housing Administration, Farmers Home Administration, Export-Import Bank of the United States, Small Business Administration, and Government National Mortgage Association, whose securities are supported by the full faith and credit of the United States; (b) the Federal Home Loan Banks, Federal Intermediate Credit Banks, and Tennessee Valley Authority, whose securities are supported by the right of the agency to borrow from the U.S. Treasury; (c) the Federal National Mortgage Association, whose securities are supported by the discretionary authority of the U.S. Government to purchase certain obligations of the agency or instrumentality; and (d) the Student Loan Marketing Association, whose securities are supported only by its credit. While the U.S. Government provides financial support to such U.S. Government-sponsored agencies or instrumentalities, no assurance can be given that it always will do so since it is not so obligated by law. The U.S. Government, its agencies and instrumentalities do not guarantee the market value of their securities. Consequently, the value of such securities may fluctuate.

(2) Certificates of deposit issued against funds deposited in a bank or a savings and loan association. Such certificates are for a definite period of time, earn a specified rate of return, and are normally negotiable. The issuer of a certificate of deposit agrees to pay the amount deposited plus interest to the bearer of the certificate on the date specified thereon. Certificates of deposit purchased by the Trust may not be fully insured by the Federal Deposit Insurance Corporation.

(3) Repurchase agreements, which involve purchases of debt securities. At the time the Trust purchases securities pursuant to a repurchase agreement, it simultaneously agrees to resell and redeliver such securities to the

B-3

seller, who also simultaneously agrees to buy back the securities at a fixed price and time. This assures a predetermined yield for the Trust during its holding period, since the resale price is always greater than the purchase price and reflects an agreed-upon market rate. Such actions afford an opportunity for the Trust to invest temporarily available cash. The Trust may enter into repurchase agreements only with respect to obligations of the U.S. Government, its agencies or instrumentalities; certificates of deposit; or bankers' acceptances in which the Trust may invest. Repurchase agreements may be considered loans to the seller,

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

collateralized by the underlying securities. The risk to the Trust is limited to the ability of the seller to pay the agreed-upon sum on the repurchase date; in the event of default, the repurchase agreement provides that the Trust is entitled to sell the underlying collateral. If the value of the collateral declines after the agreement is entered into, and if the seller defaults under a repurchase agreement when the value of the underlying collateral is less than the repurchase price, the Trust could incur a loss of both principal and interest. Highland monitors the value of the collateral at the time the action is entered into and at all times during the term of the repurchase agreement. Highland does so in an effort to determine that the value of the collateral always equals or exceeds the agreed-upon repurchase price to be paid to the Trust. If the seller were to be subject to a federal bankruptcy proceeding, the ability of the Trust to liquidate the collateral could be delayed or impaired because of certain provisions of the bankruptcy laws.

(4) Commercial paper, which consists of short-term unsecured promissory notes, including variable rate master demand notes issued by corporations to finance their current operations. Master demand notes are direct lending arrangements between the Trust and a corporation. There is no secondary market for such notes. However, they are redeemable by the Trust at any time. Highland will consider the financial condition of the corporation (e.g., earning power, cash flow and other liquidity ratios) and will continually monitor the corporation's ability to meet all of its financial obligations, because the Trust's liquidity might be impaired if the corporation were unable to pay principal and interest on demand. Investments in commercial paper will be limited to commercial paper rated in the highest categories by a major rating agency and which mature within one year of the date of purchase or carry a variable or floating rate of interest.

### Equity Securities

The Trust may invest in equity securities including preferred stocks, convertible securities, warrants and depository receipts.

**Preferred Stock.** Preferred stock has a preference over common stock in liquidation (and generally dividends as well) but is subordinated to the liabilities of the issuer in all respects. As a general rule, the market value of preferred stock with a fixed dividend rate and no conversion element varies inversely with interest rates and perceived credit risk, while the market price of convertible preferred stock generally also reflects some element of conversion value. Because preferred stock is junior to debt securities and other obligations of the issuer, deterioration in the credit quality of the issuer will cause greater changes in the value of a preferred stock than in a more senior debt security with similar stated yield characteristics. Unlike interest payments on debt securities, preferred stock dividends are payable only if declared by the issuer's board of directors. Preferred stock also may be subject to optional or mandatory redemption provisions.

**Convertible Securities.** A convertible security is a bond, debenture, note, preferred stock or other security that may be converted into or exchanged for a prescribed amount of common stock or other equity security of the same or a different issuer within a particular period of time at a specified price or formula. A convertible security entitles the holder to receive interest paid or accrued on debt or the dividend paid on preferred stock until the convertible security matures or is redeemed, converted or exchanged. Before conversion, convertible securities have characteristics similar to nonconvertible income securities in that they ordinarily provide a stable stream of income with generally higher yields than those of common stocks of the same or similar issuers, but lower yields than comparable nonconvertible securities. The value of a convertible security is influenced by changes in interest rates, with

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

investment value declining as interest rates increase and increasing as interest rates decline. The credit standing of the issuer and other factors also may have an effect on the convertible security's investment value. Convertible securities rank senior to common stock in a corporation's capital structure but are usually subordinated to comparable nonconvertible securities. Convertible securities may be subject to redemption at the option of the issuer at a price established in the convertible security's governing instrument.

Warrants. Warrants, which are privileges issued by corporations enabling the owners to subscribe to and purchase a specified number of shares of the corporation at a specified price during a specified period of time. Subscription rights normally have a short life span to expiration. The purchase of warrants involves the risk that the Trust could lose the purchase value of a right or warrant if the right to subscribe to additional shares is not exercised prior to the warrants' expiration. Also, the purchase of warrants involves the risk that the effective price paid for the warrant added to the

B-4

subscription price of the related security may exceed the value of the subscribed security's market price such as when there is no movement in the level of the underlying security.

Depository Receipts. The Trust may invest in both sponsored and unsponsored American Depository Receipts ("ADRs"), European Depository Receipts ("EDRs"), Global Depository Receipts ("GDRs") and other similar global instruments. ADRs typically are issued by an American bank or trust company and evidence ownership of underlying securities issued by a non-U.S. corporation. EDRs, which are sometimes referred to as Continental Depository Receipts, are receipts issued in Europe, typically by non-U.S. banks and trust companies, that evidence ownership of either non-U.S. or domestic underlying securities. GDRs are depository receipts structured like global debt issues to facilitate trading on an international basis. Un-sponsored ADR, EDR and GDR programs are organized independently and without the cooperation of the issuer of the underlying securities. As a result, available information concerning the issuer may not be as current as for sponsored ADRs, EDRs and GDRs, and the prices of unsponsored ADRs, EDRs and GDRs may be more volatile than if such instruments were sponsored by the issuer. Investments in ADRs, EDRs and GDRs present additional investment considerations of non-U.S. securities.

### Variable and Floating Rate Instruments

The Trust may purchase rated and unrated variable and floating rate instruments. These instruments may include variable amount master demand notes that permit the indebtedness thereunder to vary in addition to providing for periodic adjustments in the interest rate. The Trust may invest in leveraged inverse floating rate debt instruments ("Inverse floaters"). The interest rate of an inverse floater resets in the opposite direction from the market rate of interest to which it is indexed. An inverse floater may be considered to be leveraged to the extent that its interest rate varies by a magnitude that exceeds the magnitude of the change in the index rate of interest. The higher degree of leverage inherent in inverse floaters is associated with greater volatility in their market values. Issuers of unrated variable and floating rate instruments must satisfy the same criteria as set forth above for the Trust. The absence of an active secondary market with respect to particular variable and floating rate instruments, however, could make it difficult for the Trust to dispose of a variable or floating rate instrument if the issuer defaulted on its payment obligation or during periods when the Trust is not entitled to exercise its demand rights.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

With respect to purchasable variable and floating rate instruments, Highland will consider the earning power, cash flows and liquidity ratios of the issuers and guarantors of such instruments and, if the instruments are subject to a demand feature, will monitor their financial status to meet payment on demand. Such instruments may include variable amount master demand notes that permit the indebtedness thereunder to vary in addition to providing for periodic adjustments in the interest rate. The absence of an active secondary market with respect to particular variable and floating rate instruments could make it difficult for the Trust to dispose of a variable or floating rate note if the issuer defaulted on its payment obligation or during periods that the Trust is not entitled to exercise its demand rights, and the Trust could, for these or other reasons, suffer a loss, with respect to such instruments. In determining average-weighted portfolio maturity, an instrument will be deemed to have a maturity equal to either the period remaining until the next interest rate adjustment or the time the Trust involved can recover payment of principal as specified in the instrument, depending on the type of instrument involved.

### Strategic Transactions and Risk Management

Consistent with its investment objectives and policies set forth in the prospectus and in addition to its option strategy, the Trust may also enter into certain risk management transactions. In particular, the Trust may purchase and sell futures contracts, exchange listed and over-the-counter put and call options on securities, equity and other indices and futures contracts, forward foreign currency contracts, and may enter into various interest rate transactions (collectively, "Strategic Transactions"). Strategic Transactions may be used to attempt to protect against possible changes in the market value of the Trust's portfolio resulting from fluctuations in the securities markets and changes in interest rates, to protect the Trust's unrealized gains in the value of its portfolio securities, to facilitate the sale of such securities for investment purposes and to establish a position in the securities markets as a temporary substitute for purchasing particular securities. Any or all of these Strategic Transactions may be used at any time. There is no particular strategy that requires use of one technique rather than another. Use of any Strategic Transaction is a function of market conditions. The ability of the Trust to manage them successfully will depend on Highland's ability to predict pertinent market movements as well as sufficient correlation among the instruments, which cannot be assured. The Strategic Transactions that the Trust may use are described below. Although the Trust recognizes it is not likely that it will use certain of these strategies in light of its investment policies, it nevertheless describes them here because the Trust may seek to use these strategies in certain circumstances.

### B-5

**Futures Contracts and Options on Futures Contracts.** In connection with its Strategic Transactions and other risk management strategies, the Trust may also enter into contracts for the purchase or sale for future delivery ("futures contracts") of securities, aggregates of securities or indices or prices thereof, other financial indices and U.S. government debt securities or options on the above. The Trust will engage in such transactions only for bona fide risk management and other portfolio management purposes.

**Forward Foreign Currency Contracts.** The Trust may enter into forward currency contracts to purchase or sell foreign currencies for a fixed amount of U.S. dollars or another foreign currency. A forward currency contract involves an obligation to purchase or sell a specific currency at a future date, which may be any fixed number of days (term) from the date of the forward currency contract agreed upon by the parties, at a price set at the time the forward

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

currency contract is entered into. Forward currency contracts are traded directly between currency traders (usually large commercial banks) and their customers. The Trust may purchase a forward currency contract to lock in the U.S. dollar price of a security denominated in a foreign currency that the Trust intends to acquire. The Trust may sell a forward currency contract to lock in the U.S. dollar equivalent of the proceeds from the anticipated sale of a security or a dividend or interest payment denominated in a foreign currency. The Trust may also use forward currency contracts to shift the Trust's exposure to foreign currency exchange rate changes from one currency to another. For example, if the Trust owns securities denominated in a foreign currency and Highland believes that currency will decline relative to another currency, the Trust might enter into a forward currency contract to sell the appropriate amount of the first foreign currency with payment to be made in the second currency. The Trust may also purchase forward currency contracts to enhance income when Highland anticipates that the foreign currency will appreciate in value but securities denominated in that currency do not present attractive investment opportunities. The Trust may also use forward currency contracts to offset against a decline in the value of existing investments denominated in a foreign currency. Such a transaction would tend to offset both positive and negative currency fluctuations, but would not offset changes in security values caused by other factors. The Trust could also enter into a forward currency contract to sell another currency expected to perform similarly to the currency in which the Trust's existing investments are denominated. This type of transaction could offer advantages in terms of cost, yield or efficiency, but may not offset currency exposure as effectively as a simple forward currency transaction to sell U.S. dollars. This type of transaction may result in losses if the currency sold does not perform similarly to the currency in which the Trust's existing investments are denominated. The Trust may also use forward currency contracts in one currency or a basket of currencies to attempt to offset against fluctuations in the value of securities denominated in a different currency if Highland anticipates that there will be a correlation between the two currencies. The cost to the Trust of engaging in forward currency contracts varies with factors such as the currency involved, the length of the contract period and the market conditions then prevailing. Because forward currency contracts are usually entered into on a principal basis, no fees or commissions are involved. When the Trust enters into a forward currency contract, it relies on the counterparty to make or take delivery of the underlying currency at the maturity of the contract. Failure by the counterparty to do so would result in the loss of some or all of any expected benefit of the transaction. Secondary markets generally do not exist for forward currency contracts, with the result that closing transactions generally can be made for forward currency contracts only by negotiating directly with the counterparty. Thus, there can be no assurance that the Trust will in fact be able to close out a forward currency contract at a favorable price prior to maturity. In addition, in the event of insolvency of the counterparty, the Trust might be unable to close out a forward currency contract. In either event, the Trust would continue to be subject to market risk with respect to the position, and would continue to be required to maintain a position in securities denominated in the foreign currency or to maintain cash or liquid assets in a segregated account. The precise matching of forward currency contract amounts and the value of the securities involved generally will not be possible because the value of such securities, measured in the foreign currency, will change after the forward currency contract has been established. Thus, the Trust might need to purchase or sell foreign currencies in the spot (cash) market to the extent such foreign currencies are not covered by forward currency contracts. The projection of short-term currency market movements is extremely difficult, and the successful execution of a short-term strategy is highly uncertain.

**Calls on Securities, Indices and Futures Contracts.** In addition to its option strategy, in order to enhance income or reduce fluctuations on net asset value, the Trust may sell or purchase call options ("calls") on securities and



## Edgar Filing: Highland Credit Strategies Fund - Form N-2

indices based upon the prices of futures contracts and debt or equity securities that are traded on U.S. and non-U.S. securities exchanges and in the over-the-counter markets. A call option gives the purchaser of the option the right to buy, and obligates the seller to sell, the underlying security, futures contract or index at the exercise price at any time or at a specified time during the option period. All such calls sold by the Trust must be "covered" as long as the call is outstanding (i.e., the Trust must own the instrument subject to the call or other securities or assets acceptable for applicable segregation and coverage requirements). A call sold by the Trust exposes the Trust during the term of the option to possible loss of opportunity to realize appreciation in the market price of the underlying security, index or futures contract and may require the Trust to hold an instrument which it might otherwise have sold. The purchase of a

B-6

call gives the Trust the right to buy a security, futures contract or index at a fixed price. Calls on futures on securities must also be covered by assets or instruments acceptable under applicable segregation and coverage requirements.

**Puts on Securities, Indices and Futures Contracts.** In addition to its option strategy, the Trust may purchase put options ("puts") that relate to securities (whether or not it holds such securities in its portfolio), indices or futures contracts. For the same purposes, the Trust may also sell puts on securities, indices or futures contracts on such securities if the Trust's contingent obligations on such puts are secured by segregated assets consisting of cash or liquid debt securities having a value not less than the exercise price. In selling puts, there is a risk that the Trust may be required to buy the underlying security at a price higher than the current market price.

**Interest Rate Transactions.** Among the Strategic Transactions in which the Trust may enter into are interest rate swaps and the purchase or sale of interest rate caps and floors. The Trust expects to enter into these transactions primarily to preserve a return or spread on a particular investment or portion of its portfolio as a duration management technique or to protect against any increase in the price of securities the Trust anticipates purchasing at a later date. The Trust intends to use these transactions for risk management purposes and not as a speculative investment. The Trust will not sell interest rate caps or floors that it does not own. Interest rate swaps involve the exchange by the Trust with another party of their respective commitments to pay or receive interest, e.g., an exchange of floating rate payments for fixed rate payments with respect to a notional amount of principal. The purchase of an interest rate cap entitles the purchaser, to the extent that a specified index exceeds a predetermined interest rate, to receive payments of interest on a notional principal amount from the party selling such interest rate cap. The purchase of an interest rate floor entitles the purchaser, to the extent that a specified index falls below a predetermined interest rate, to receive payments of interest on a notional principal amount from the party selling such interest rate floor.

The Trust may enter into interest rate swaps, caps and floors on either an asset based or liability-based basis, depending on whether it is offsetting volatility with respect to its assets or liabilities, and will usually enter into interest rate swaps on a net basis, i.e., the two payment streams are netted out, with the Trust receiving or paying, as the case may be, only the net amount of the two payments on the payment dates. Inasmuch as these Strategic Transactions are incurred into for good faith risk management purposes, Highland and the Trust believe such obligations do not constitute senior securities, and, accordingly will not treat them as being subject to its borrowing restrictions. The Trust will accrue the net amount of the excess, if

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

any, of the Trust's obligations over its entitlements with respect to each interest rate swap on a daily basis and will designate on its books and records with a custodian an amount of cash or liquid high grade securities having an aggregate net asset value at all times at least equal to the accrued excess. The Trust will not enter into any interest rate swap, cap or floor transaction unless the unsecured senior debt or the claims paying ability of the other party thereto is rated in the highest rating category of at least one nationally recognized statistical rating organization at the time of entering into such transaction. If there is a default by the other party to such a transaction, the Trust will have contractual remedies pursuant to the agreements related to the transaction. The swap market has grown substantially in recent years with a large number of banks and investment banking firms acting both as principals and as agents utilizing standardized swap documentation. Caps and floors are more recent innovations for which standardized documentation has not yet been developed and, accordingly, they are less liquid than swaps.

Credit Derivatives. The Trust may engage in credit derivative transactions. There are two broad categories of credit derivatives: default price risk derivatives and market spread derivatives. Default price risk derivatives are linked to the price of reference securities or loans after a default by the issuer or borrower, respectively. Market spread derivatives are based on the risk that changes in market factors, such as credit spreads, can cause a decline in the value of a security, loan or index.

There are three basic transactional forms for credit derivatives: swaps, options and structured instruments. The use of credit derivatives is a highly specialized activity which involves strategies and risks different from those associated with ordinary portfolio security transactions. If Highland is incorrect in its forecasts of default risks, market spreads or other applicable factors, the investment performance of the Trust would diminish compared with what it would have been if these techniques were not used. Moreover, even if Highland is correct in its forecasts, there is a risk that a credit derivative position may correlate imperfectly with the price of the asset or liability being purchased. There is no limit on the amount of credit derivative transactions that may be entered into by the Trust. The Trust's risk of loss in a credit derivative transaction varies with the form of the transaction. For example, if the Trust purchases a default option on a security, and if no default occurs with respect to the security, the Trust's loss is limited to the premium it paid for the default option. In contrast, if there is a default by the grantor of a default option, the Trust's loss will include both the premium that it paid for the option and the decline in value of the underlying security that the default option protects.

Appendix A contains further information about the characteristics, risks and possible benefits of Strategic Transactions and the Trust's other policies and limitations (which are not fundamental policies) relating to investment in

B-7

futures contracts and options. The principal risks relating to the use of futures contracts and other Strategic Transactions are: (a) less than perfect correlation between the prices of the instrument and the market value of the securities in the Trust's portfolio; (b) possible lack of a liquid secondary market for closing out a position in such instruments; (c) losses resulting from interest rate or other market movements not anticipated by Highland; and (d) the obligation to meet additional variation margin or other payment requirements, all of which could result in the Trust being in a worse position than if such techniques had not been used.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Certain provisions of the Code may restrict or affect the ability of the Trust to engage in Strategic Transactions. See "Tax Matters."

### OTHER INVESTMENT POLICIES AND TECHNIQUES

#### Restricted and Illiquid Securities

Certain of the Trust's investments may be illiquid. Illiquid securities are subject to legal or contractual restrictions on disposition or lack an established secondary trading market. The sale of restricted and illiquid securities often requires more time and results in higher brokerage charges or dealer discounts and other selling expenses than does the sale of securities eligible for trading on national securities exchanges or in the over-the-counter markets. Restricted securities may sell at a price lower than similar securities that are not subject to restrictions on resale.

#### When-Issued and Forward Commitment Securities

The Trust may purchase securities on a "when-issued" basis and may purchase or sell securities on a "forward commitment" basis in order to acquire the security or to offset against anticipated changes in interest rates and prices. When such transactions are negotiated, the price, which is generally expressed in yield terms, is fixed at the time the commitment is made, but delivery and payment for the securities take place at a later date. When-issued securities and forward commitments may be sold prior to the settlement date, but the Trust will enter into when-issued and forward commitments only with the intention of actually receiving or delivering the securities, as the case may be. If the Trust disposes of the right to acquire a when-issued security prior to its acquisition or disposes of its right to deliver or receive against a forward commitment, it might incur a gain or loss. At the time the Trust enters into a transaction on a when-issued or forward commitment basis, it will designate on its books and records cash or liquid debt securities equal to at least the value of the when-issued or forward commitment securities. The value of these assets will be monitored daily to ensure that their marked to market value will at all times equal or exceed the corresponding obligations of the Trust. There is always a risk that the securities may not be delivered and that the Trust may incur a loss. Settlements in the ordinary course, which may take substantially more than five business days, are not treated by the Trust as when-issued or forward commitment transactions and accordingly are not subject to the foregoing restrictions.

#### Pay-in-kind Bonds

The Trust may invest in Pay-in-kind, or "PIK" bonds. PIK bonds are bonds which pay interest through the issuance of additional debt or equity securities. Similar to zero coupon obligations, PIK bonds also carry additional risk as holders of these types of securities realize no cash until the cash payment date unless a portion of such securities is sold and, if the issuer defaults, the Trust may obtain no return at all on its investment. The market price of PIK bonds is affected by interest rate changes to a greater extent, and therefore tends to be more volatile, than that of securities which pay interest in cash. Additionally, current federal tax law requires the holder of certain PIK bonds to accrue income with respect to these securities prior to the receipt of cash payments. To maintain its qualification as a regulated investment company and avoid liability for federal income and excise taxes, the Trust may be required to distribute income accrued with respect to these securities and may have to dispose of portfolio securities under disadvantageous circumstances in order to generate cash to satisfy these distribution requirements.

#### Brady Bonds

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

The Trust's emerging market debt securities may include emerging market governmental debt obligations commonly referred to as Brady Bonds. Brady Bonds are debt securities, generally denominated in U.S. dollars, issued under the framework of the Brady Plan, an initiative announced by U.S. Treasury Secretary Nicholas F. Brady in 1989 as a mechanism for debtor nations (primarily emerging market countries) to restructure their outstanding external indebtedness (generally, commercial bank debt). Brady Bonds are created through the exchange of existing commercial bank loans to foreign entities for new obligations in connection with debt restructuring. A significant amount of the Brady Bonds that the Trust may purchase have no or limited collateralization, and the Trust will be relying for payment

B-8

of interest and (except in the case of principal collateralized Brady Bonds) principal primarily on the willingness and ability of the foreign government to make payment in accordance with the terms of the Brady Bonds. A substantial portion of the Brady Bonds and other sovereign debt securities in which the Trust may invest are likely to be acquired at a discount.

### Mezzanine Investments

The Trust may invest in certain high yield securities known as mezzanine investments, which are subordinated debt securities which are generally issued in private placements in connection with an equity security (e.g., with attached warrants). Such mezzanine investments may be issued with or without registration rights. Similar to other high yield securities, maturities of mezzanine investments are typically seven to ten years, but the expected average life is significantly shorter at three to five years. Mezzanine investments are usually unsecured and subordinate to other obligations of the issuer. Loan Participations and Assignments

The Trust may invest in fixed and floating rate loans ("Loans") arranged through private negotiations between a corporation or foreign government and one or more financial institutions ("Lenders"). The Trust's investments in Loans are expected in most instances to be in the form of participations in Loans ("Participations") and assignments of all or a portion of Loans ("Assignments") from third parties. Participations typically will result in the Trust having a contractual relationship only with the Lender not the borrower. The Trust will have the right to receive payments of principal, interest and any fees to which it is entitled only from the Lender selling the Participation and the Trust and only upon receipt by the Lender of the payments by the borrower. In connection with purchasing Participations, the Trust generally has no direct right to enforce compliance by the borrower with the terms of the loan agreement relating to the Loan, nor any rights of set-off against the borrower, and the Trust may not directly benefit from any collateral supporting the Loan in which it has purchased the Participation. As a result the Trust will assume the credit risk of both the borrower and the Lender that is selling the Participation. In the event of the insolvency of the Lender selling a Participation, the Trust may be treated as a general creditor of the Lender and may not benefit from any set-off between the Lender and the borrower. The Trust will acquire Participations only if the Lender interpositioned between the Trust and the borrower is determined by Highland to be creditworthy. When the Trust purchases Assignments from Lenders, the Trust will acquire direct rights against the borrower on the Loan. However, since Assignments are arranged through private negotiations between potential assignees and assignors, the rights and obligations acquired by the Trust as the purchaser of an Assignment may differ from, and be more limited than, those held by the assigning Lender.

The Trust may have difficulty disposing of Assignments and Participations.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Because there is no liquid market for such securities, the Trust anticipates that such securities could be sold only to a limited number of institutional investors. The lack of a liquid secondary market will have an adverse impact on the value of such securities and on the Trust's ability to dispose of particular Assignments or Participations when necessary to meet the Trust's liquidity needs or in response to a specific economic event, such as a deterioration in the creditworthiness of the borrower. The lack of a liquid secondary market for Assignments and Participations also may make it more difficult for the Trust to assign a value to those securities for purposes of valuing the Trust's portfolio and calculating its net asset value.

### Structured Investments

The Trust may invest a portion of its assets in interests in entities organized and operated solely for the purpose of restructuring the investment characteristics of securities. This type of restructuring involves the deposit with or purchase by an entity, such as a corporation or a trust, of specified instruments and the issuance by that entity of one or more classes of securities ("Structured Investments") backed by, or representing interests in the underlying instruments. The cash flow on the underlying instruments may be apportioned among the newly issued Structured Investments to create securities with different investment characteristics such as varying maturities, payment priorities and interest rate provisions, and the extent of the payments made with respect to Structured Investments is dependent on the extent of the cash flow on the underlying instruments. Because Structured Investments of the type in which the Trust anticipates it will invest typically involve no credit enhancement, their credit risk generally will be equivalent to that of the underlying instruments.

The Trust is permitted to invest in a class of Structured Investments that is either subordinated or not subordinated to the right of payment of another class. Subordinated Structured Investments typically have higher yields and present greater risks than unsubordinated Structured Investments,

B-9

Certain issuers of Structured Investments may be deemed to be "investment companies" as defined in the Investment Company Act. As a result, the Trust's investment in these Structured Investments may be limited by the restrictions contained in the Investment Company Act. Structured Investments are typically sold in private placement transaction, and there currently is no active trading market for Structured Investments.

### Project Loans

The Trust may invest in project loans, which are fixed income securities of issuers whose revenues are primarily derived from mortgage loans to multi-family, nursing home and other real estate development projects. The principal payments on these mortgage loans will be insured by agencies and authorities of the U.S. Government.

### Zero Coupons and Deferred Payment Obligations

The Trust may invest in zero-coupon bonds, which are normally issued at a significant discount from face value and do not provide for periodic interest payments. Zero-coupon bonds may experience greater volatility in market value than similar maturity debt obligations which provide for regular interest payments. Additionally, current federal tax law requires the holder of certain zero-coupon bonds to accrue income with respect to these securities prior to the receipt of cash payments. To maintain its qualification as a regulated

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

investment company and to potentially avoid liability for federal income and excise taxes, the Trust may be required to distribute income accrued with respect to these securities and may have to dispose of Trust securities under disadvantageous circumstances in order to generate cash to satisfy these distribution requirements.

The Trust may invest in Deferred Payment Securities. Deferred Payment Securities are securities that remain Zero-Coupon Securities until a predetermined date, at which time the stated coupon rate becomes effective and interest becomes payable at regular intervals. Deferred Payment Securities are subject to greater fluctuations in value and may have lesser liquidity in the event of adverse market conditions than comparably rated securities paying cash interest at regular interest payment periods.

### MANAGEMENT OF THE TRUST

#### Information Received by the Board

In considering the Trust's investment management agreement, the board of trustees received information specifically related to the approval of the investment management agreement including information regarding: (i) the team of investment advisory personnel assigned to the Trust; (ii) the structure, expertise and finances of Highland; (iii) the Trust's management fee and total operating expenses as compared to a peer group of closed-end funds with similar investment policies and strategies selected by Lipper, Inc.; (iv) Highland's profitability with respect to other funds in the Highland family of closed-end funds; (v) Highland's overall profitability as compared with available industry data; (vi) certain direct and indirect "fallout" benefits to Highland from its relationship with the Trust; and (vii) Highland's policies and procedures in respect of execution of portfolio transactions. Periodically, the trustees, in connection with their duties as trustees or directors of other funds in the Highland family of closed-end funds, have received other information including general information regarding Highland's management of relationships with service providers and resources devoted to compliance with the such funds' investment objectives and polices and other matters.

#### Matters Considered by the Board

In considering the investment management agreement, the board of trustees, including the non-interested trustees, did not identify any factor as all-important or all-controlling and instead considered these factors collectively in light of all of the Trust's surrounding circumstances. Matters considered by the board of trustees, including the non-interested trustees in approving the investment management agreement included the following:

Nature and Quality of Investment Advisory Services. The board of trustees, including the non-interested trustees, considered the nature and quality of the services to be provided by Highland to the Trust. In this connection the board reviewed:

- o Highland's compliance record, including whether other funds advised or sub-advised by Highland have operated within their investment objectives, policies and restrictions; and

B-10

- o the resources of Highland and the size, education and experience of the Trust's portfolio management team and Highland's use of technology and their approach to recruiting, training and retaining portfolio managers and other research, advisory and management personnel.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Nature and Quality of Other Services. The board of trustees, including the non-interested trustees, considered the nature, quality, cost and extent of administrative and shareholder services to be performed by Highland under the investment management agreement. The board of trustees, including the non-interested trustees, also considered the nature and extent of Highland's supervision of third party service providers.

Fees and Expenses. The board of trustees, including the non-interested trustees, considered the Trust's management fee and expense ratio in comparison to the management fee and expense ratios of two peer groups of funds.

The first peer group selected for the Trust was the \_\_\_\_\_ group. The peer group contained \_\_\_\_\_ closed-end funds (including the Trust). Some but not all of the funds in the peer group used leverage.

The peer group comparison was done within four sub-categories of fees and expenses: (i) management fee before fee waivers; (ii) management fee after fee waivers; (iii) total expenses before fee waivers; and (iv) total expenses after fee waivers. Each comparison was done both with and without giving effect to leverage for those funds in the peer group that use leverage, because leverage increases the effective management fee and other expenses paid by the holders of the common shares of a fund if the management fee or other expenses are payable on total managed assets.

When compared to funds in the peer group and after giving effect to leverage, when ranked from lowest fee to highest fee, the Trust ranked as follows within each of the four sub-categories of fees and expenses:

(i) \_\_\_\_\_ ; (ii) \_\_\_\_\_ ; (iii) \_\_\_\_\_ ; and (iv) \_\_\_\_\_ .

When compared to funds in the peer group assuming no leverage was used by any of the funds, when ranked from lowest fee to highest fee, the Trust ranked as follows within each of the four sub-categories: (i) \_\_\_\_\_ ;

(ii) \_\_\_\_\_ ; (iii) \_\_\_\_\_ ; and (iv) \_\_\_\_\_ .

Profitability. The board of trustees, including the independent trustees, considered the level of Highland's profits in respect of the management of Highland's closed-end funds. The board considered the potential for economies of scale in connection with Highland's management of the Highland closed-end funds. It also considered the profits realized from non-fund businesses which may benefit from or be related to the Trust's business. The board of trustees, including the independent trustees, also considered Highland's profit margins in comparison with available industry data.

Other Benefits. The board of trustees, including the non-interested trustees, also considered the benefits to Highland associated with Highland and its affiliates providing non-advisory services to the Trust, including administrative services. The board of trustees, including the independent trustees, considered the intangible benefits that accrue to Highland and its affiliates by virtue of their relationship with the Trust, including potential benefits accruing to Highland and its affiliates as a result of potentially stronger relationships with members of the broker dealer community, increased name recognition of Highland and its affiliates, enhanced sales of other investment funds and products sponsored by Highland and its affiliates and increased assets under management which may increase the benefits realized by Highland from soft dollar arrangements with broker dealers. The board also considered the unquantifiable nature of these potential benefits.

Miscellaneous. During the board of trustees' deliberations in connection with its approval of the management fee, the board of trustees was aware that Highland intended to pay compensation, out of its own assets, to the lead underwriter and to certain qualifying underwriters of the Trust's common shares

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

and to employees of Highland and its affiliates that participate in the offering of the Trust's common shares, the anticipated amounts of such compensation and the general nature of the services to be rendered to Highland in consideration of such compensation. The board of trustees also considered whether the management fee met applicable standards in light of the services provided by Highland, without regard to whether Highland ultimately pays any portion of the anticipated compensation to the underwriters. The board of trustees considered the scale of Highland's management operations and the potential for economies of scale in the context of the Trust.

### Conclusion

Based on the information reviewed and discussions held with respect to each of the foregoing items, the board of trustees, including a majority of the non-interested trustees,

B-11

The investment management agreement was by the sole common shareholder of the Trust as of , 2006. The investment management agreement will continue in effect for a period of two years from its effective date, and if not sooner terminated, will continue in effect for successive periods of 12 months thereafter, provided that each continuance is specifically approved at least annually by both (1) the vote of a majority of the Trust's board of trustees or the vote of a majority of the outstanding voting securities of the Trust (as such term is defined in the Investment Company Act) and (2) by the vote of a majority of the trustees who are not parties to the investment management agreement or interested persons (as such term is defined in the Investment Company Act) of any such party, cast in person at a meeting called for the purpose of voting on such approval. The investment management agreement may be terminated as a whole at any time by the Trust, without the payment of any penalty, upon the vote of a majority of the Trust's board of trustees or a majority of the outstanding voting securities of the Trust or by Highland, on 60 days' written notice by either party to the other which can be waived by the non-terminating party. The investment management agreement will terminate automatically in the event of its assignment (as such term is defined in the Investment Company Act and the rules thereunder).

### Trustees and Officers

The officers of the Trust manage its day-to-day operations. The officers are directly responsible to the Trust's board of trustees which sets broad policies for the Trust and chooses its officers. Below is a list of the trustees and officers of the Trust and their present positions and principal occupations during the past five years. Trustees who are interested persons of the Trust (as defined in the Investment Company Act) are denoted by an asterisk (\*). Trustees who are independent trustees (as defined in the Investment Company Act) (the "Independent Trustees") are denoted without an asterisk. The business address of the Trust, Highland and their board members and officers is Two Galleria Tower, 13455 Noel Road, Suite 800, Dallas, Texas 75240, unless specified otherwise below.

The trustees listed below are either trustees or directors of other closed-end funds in which Highland acts as investment manager.

Principal Occupation During



Edgar Filing: Highland Credit Strategies Fund - Form N-2

Name and Age	Title	Past Five Years and Other Affil
R. Joseph Dougherty Age: 35	Sole Initial Trustee, President, Chief Executive Officer, Chief Financial Officer, Treasurer and Secretary	Trustee and Chairman of the Board since i Portfolio Manager of Highland sin

Name of Director	Dollar Range of Equity Securities in the Trust (*)	Aggregate Dollar Rang Securities Overseen by Directo all Registered Investment

The Trustees do not own shares in the Trust as the Trust has no operating history.

The fees and expenses of the Independent Trustees of the Trust are paid by the Trust. The trustees who are members of the Highland organization receive no compensation from the Trust. It is estimated that the Independent Trustees will receive from the Trust the amounts set forth below for the Trust's calendar year ending December 31, 2006, assuming the Trust will have been in existence for the full calendar year.

B-12

Name of Board Member	Estimated Compensation from the Trust	Total Compensat Trust and Tru Paid to Board M

(1) Estimates the total compensation to be earned by that person during the calendar year end December 31, 2006 from the closed-end funds advised by Highland (the "Trust Complex").

Each Independent Trustee will receive an annual fee calculated as follows:

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

The board of trustees of the Trust currently has four committees: an Audit Committee, a Nominating Committee, a Litigation Committee and a Qualified Legal Compliance Committee.

The Audit Committee consists of Messrs. , , and . The Audit Committee acts according to the Audit Committee charter. has been appointed as Chairman of the Audit Committee. The Audit Committee is responsible for (1) oversight of the Trust's accounting and financial reporting processes and the audits of the Trust's financial statements and (2) providing assistance to the board of trustees of the Trust in connection with its oversight of the integrity of the Trust's financial statements, the Trust's compliance with legal and regulatory requirements and the independent registered public accounting firm's qualifications, independence and performance. The board of trustees of the Trust has determined that the Trust has audit committee financial experts serving on its Audit Committee, , and , all of whom are independent for the purpose of the definition of audit committee financial expert as applicable to the Trust.

The Nominating Committee's function is to canvass, recruit, interview, solicit and nominate Trustees. The Nominating Committee will consider recommendations for nominees from shareholders sent to the Secretary of the Trust, 13455 Noel Road, Suite 800, Dallas, Texas 75240. A nomination submission must include all information relating to the recommended nominee that is required to be disclosed in solicitations or proxy statements for the election of Trustees, as well as information sufficient to evaluate the factors listed above. Nomination submissions must be accompanied by a written consent of the individual to stand for election if nominated by the Board of Trustees and to serve if elected by the shareholders, and such additional information must be provided regarding the recommended nominee as reasonably requested by the Nominating Committee. The Nominating Committee is comprised of Messrs. , , and .

The Litigation Committee's function is to seek to address any potential conflicts of interest between or among the Trust and the Investment Manager in connection with any potential or existing litigation or other legal proceeding relating to securities held by the Trust and the Investment Manager or another client of the Investment Manager. The Litigation Committee is comprised of Messrs. , , and .

The Qualified Legal Compliance Committee (the "QLCC") is charged with compliance with Rules 205.2(k) and 205.3(c) of the Code of Federal Regulations regarding alternative reporting procedures for attorneys representing the Trust who appear and practice before the Commission on behalf of the Trust. The QLCC is comprised of Messrs. , , and .

As the Trust is a closed-end investment company with no prior investment operations, no meetings of the above committees have been held in the current fiscal year.

Prior to this offering, all of the outstanding shares of the Trust were owned by an affiliate of Highland Advisors.

### Proxy Voting Policies

The board of trustees of the Trust has delegated the voting of proxies for Trust securities to Highland pursuant to Highland's proxy voting guidelines. Under these guidelines, Highland will vote proxies related to Trust securities in the

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

best interests of the Trust and its shareholders. A copy of Highland's proxy voting procedures is attached as Appendix B to this Statement of Additional Information.

### Codes of Ethics

The Trust and the Advisor have adopted codes of ethics under Rule 17j-1 of the Investment Company Act. These codes permit personnel subject to the codes to invest in securities, including securities that may be purchased or held by the Trust. These codes can be reviewed and copied at the Securities and Exchange Commission's Public Reference Room in Washington, D.C. Information on the operation of the Public Reference Room may be obtained by calling the Securities and Exchange Commission at 1-202-942-8090. The code of ethics are available on the EDGAR Database on the Securities and Exchange Commission's web site (<http://www.sec.gov>), and copies of these codes may be obtained, after paying a duplicating fee, by electronic request at the following e-mail address: [publicinfo@sec.gov](mailto:publicinfo@sec.gov), or by writing the Securities and Exchange Commission's Public Reference Section, Washington, D.C. 20549-0102.

### Investment Manager

Highland acts as the Trust's investment manager. Highland is located at Highland Capital Management, L.P., Two Galleria Tower, 13455 Noel Road, Suite 800, Dallas, Texas 75240. As of \_\_\_\_\_, 2006, the Investment Manager managed approximately \$ \_\_\_\_\_ billion in debt securities on behalf of institutional investors and retail clients around the world. Highland is controlled by James Dondero and Mark Okada, by virtue of their respective share ownership, and its general partner, Strand Advisors, Inc., of which Mr. Dondero is the sole stockholder.

### Portfolio Managers

The portfolio managers of the Trust are James Dondero, Mark Okada and Kurtis Plumer.

As of \_\_\_\_\_, 2006, James Dondero managed the following client accounts:

Type of Account	Number of Accounts	Assets of Accounts	Num Acc Subje Perf
Registered Investment Companies.....		\$ _____ billion	
Pooled Investment Vehicles.....		\$ _____ billion	
Other Accounts.....		\$ _____ billion	

-----  
As of \_\_\_\_\_, 2006, Mark Okada managed the following client accounts:

Type of Account	Number of Accounts	Assets of Accounts	Num Acc Subje Perf
Registered Investment Companies.....		\$ _____ billion	
Pooled Investment Vehicles.....		\$ _____ billion	
Other Accounts.....		\$ _____ billion	

Edgar Filing: Highland Credit Strategies Fund - Form N-2

As of \_\_\_\_\_, 2006, Kurtis Plumer managed the following client accounts:

Type of Account	Number of Accounts	Assets of Accounts	Num Acc Subje Perf
Registered Investment Companies.....		\$ billion	
Pooled Investment Vehicles.....		\$ billion	
Other Accounts.....		\$ billion	

B-14

The Investment Manager has built a professional working environment, firm-wide compliance culture and compliance procedures and systems designed to protect against potential incentives that may favor one account over another. The Investment Manager has adopted policies and procedures that address the allocation of investment opportunities, execution of portfolio transactions, personal trading by employees and other potential conflicts of interest that are designed to ensure that all client accounts are treated equitably over time. Nevertheless, the Investment Manager furnishes investment management and advisory services to numerous clients in addition to the Trust, and the Investment Manager may, consistent with applicable law, make investment recommendations to other clients or accounts (including accounts which are hedge funds or have performance or higher fees paid to the Investment Manager, or in which portfolio managers have a personal interest in the receipt of such fees), which may be the same as or different from those made to the Trust. In addition, the Investment Manager, its affiliates and any officer, director, stockholder or employee may or may not have an interest in the securities whose purchase and sale the Investment Manager recommends to the Trust. Actions with respect to securities of the same kind may be the same as or different from the action which the Investment Manager, or any of its affiliates, or any officer, director, stockholder, employee or any member of their families may take with respect to the same securities. Moreover, the Investment Manager may refrain from rendering any advice or services concerning securities of companies of which any of the Investment Managers' (or its affiliates') officers, directors or employees are directors or officers, or companies as to which the Investment Manager or any of its affiliates or the officers, directors and employees of any of them has any substantial economic interest or possesses material non-public information. In addition to its various policies and procedures designed to address these issues, the Investment Manager includes disclosure regarding these matters to its clients in both its Form ADV and investment management agreements.

The Investment Manager, its affiliates or their officers and employees serve or may serve as officers, directors or principals of entities that operate in the same or related lines of business or of investment funds managed by affiliates of the Investment Manager. Accordingly, these individuals may have obligations to investors in those entities or funds or to other clients, the fulfillment of which might not be in the best interests of the Trust. As a result, the Investment Manager will face conflicts in the allocation of investment opportunities to the Trust and other funds and clients. In order to enable such affiliates to fulfill their fiduciary duties to each of the clients for which they have responsibility, the Investment Manager will endeavor to allocate investment opportunities in a fair and equitable manner which may, subject to applicable regulatory constraints, involve pro rata co-investment by

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

the Trust and such other clients or may involve a rotation of opportunities among the Trust and such other clients.

The Investment Manager and its affiliates have procedures and policies in place designed to manage the potential conflicts of interest that may arise from time to time between the Investment Manager's fiduciary obligations to the Trust and their similar fiduciary obligations to other clients so that, for example, investment opportunities are allocated in a fair and equitable manner among the Trust and such other clients. An investment opportunity that is suitable for multiple clients of the Investment Manager and its affiliates may not be capable of being shared among some or all of such clients due to the limited scale of the opportunity or other factors, including regulatory restrictions imposed by the Investment Company Act. There can be no assurance that the Investment Manager's or its affiliates' efforts to allocate any particular investment opportunity fairly among all clients for whom such opportunity is appropriate will result in an allocation of all or part of such opportunity to the Trust. Not all conflicts of interest can be expected to be resolved in favor of the Trust.

Under current Commission regulations, the Trust may be prohibited from co-investing with any unregistered fund managed now or in the future by the Investment Manager (the "Unregistered Trusts") in certain private placements in which the Investment Manager negotiates non-pricing terms. The Trust intends to file for exemptive relief from the Commission to enable it to co-invest with other unregistered funds managed by the Investment Manager.

### Compensation

The Investment Manager's financial arrangements with its portfolio managers, its competitive compensation and its career path emphasis at all levels reflect the value senior management places on key resources. Compensation may include a variety of components and may vary from year to year based on a number of factors including the relative performance of a portfolio managers underlying account, the combined performance of the portfolio managers underlying accounts, and the relative performance of the portfolio managers underlying accounts measured against other employees. The principal components of compensation include a base salary, a discretionary bonus, various retirement benefits and one or more of the incentive compensation programs established by the Investment Manager such as Option It Plan and the Long-Term Incentive Plan.

B-15

### Base compensation

Generally, portfolio managers receive base compensation based on their seniority and/or their position with the firm, which may include the amount of assets supervised and other management roles within the firm.

### Discretionary compensation

In addition to base compensation, portfolio managers may receive discretionary compensation, which can be a substantial portion of total compensation. Discretionary compensation can include a discretionary cash bonus as well as one or more of the following:

Option It Plan. The purpose of the Plan is to attract and retain the highest quality employees for positions of substantial responsibility, and to provide additional incentives to a select group of management or highly compensated employees of Highland so as to promote the success

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

of the Highland.

Long Term Incentive Plan. The purpose of the Plan is to create positive morale and teamwork, to attract and retain key talent, and to encourage the achievement of common goals. The Plan seeks to reward participating Employees based on the increased value of Highland through the use of Long-term Incentive Units.

Senior portfolio managers who perform additional management functions may receive additional compensation in these other capacities. Compensation is structured such that key professionals benefit from remaining with the firm.

### Securities Ownership of Portfolio Managers

The Trust is a newly organized investment company. Accordingly, as of the date of this Statement of Additional Information, none of the portfolio managers beneficially owns any securities issued by the Trust.

### PORTFOLIO TRANSACTIONS AND BROKERAGE

In placing orders for the Company's portfolio, the Investment Manager is required to give primary consideration to obtaining the most favorable price and efficient execution. This means that the Investment Manager will seek to execute each transaction at a price and commission, if any, which provides the most favorable total cost or proceeds reasonably attainable in the circumstances. In seeking the most favorable price and execution, the Investment Manager, having in mind the Company's best interests, will consider all factors it deems relevant, including, by way of illustration: price; the size, type and difficulty of the transaction; the nature of the market for the security; the amount of the commission; the timing of the transaction taking into account market prices and trends; operational capabilities; the reputation, experience and financial stability of the broker-dealer involved; and the quality of service rendered by the broker-dealer in other transactions. Though the Investment Manager generally seeks reasonably competitive commissions or spreads, the Company will not necessarily be paying the lowest commission or spread available. Within the framework of the policy of obtaining the most favorable price and efficient execution, the Investment Manager does not consider "brokerage and research services" (as defined in the Securities Exchange Act of 1934, as amended) provided by brokers who effect portfolio transactions with the Investment Manager or the Company. "Brokerage and research services" are those which brokerage houses customarily provide to institutional investors and include statistical and economic data and research reports on particular issuers and industries.

### DESCRIPTION OF SHARES

#### Common Shares

The Trust intends to hold annual meetings of shareholders so long as the common shares are listed on a national securities exchange and such meetings are required as a condition to such listing. All common shares are equal as to dividends, assets and voting privileges and have no conversion, preemptive or other subscription rights. The Trust will send annual and semi-annual reports, including financial statements, to all holders of its shares.

#### Preferred Shares

The Trust currently intends to issue Preferred Shares. The Agreement and Declaration of Trust provides that the Trust's board of trustees may authorize and issue Preferred Shares with rights as determined by the board of trustees, by

action of the board of trustees without the approval of the holders of the common shares. Holders of common shares have no preemptive right to purchase any Preferred Shares that might be issued. Whenever Preferred Shares are outstanding, the holders of common shares will not be entitled to receive any distributions from the Trust unless all accrued dividends on Preferred Shares have been paid, unless asset coverage (as defined in the Investment Company Act) with respect to Preferred Shares would be at least 200% after giving effect to the distributions and unless certain other requirements imposed by any rating agencies rating the Preferred Shares have been met.

**Liquidation Preference.** In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Trust, the holders of Preferred Shares will be entitled to receive a preferential liquidating distribution, which is expected to equal the original purchase price per Preferred Share plus accrued and unpaid dividends, whether or not declared, before any distribution of assets is made to holders of common shares. After payment of the full amount of the liquidating distribution to which they are entitled, the holders of Preferred Shares will not be entitled to any further participation in any distribution of assets by the Trust.

**Voting Rights** The Investment Company Act requires that the holders of any Preferred Shares, voting separately as a single class, have the right to elect at least two trustees at all times. The remaining trustees will be elected by holders of common shares and Preferred Shares, voting together as a single class. In addition, subject to the prior rights, if any, of the holders of any other class of senior securities outstanding, the holders of any Preferred Shares have the right to elect a majority of the trustees of the Trust at any time two years' dividends on any Preferred Shares are unpaid. The Investment Company Act also requires that, in addition to any approval by shareholders that might otherwise be required, the approval of the holders of a majority of any outstanding Preferred Shares, voting separately as a class, would be required to (1) adopt any plan of reorganization that would adversely affect the Preferred Shares, and (2) take any action requiring a vote of security holders under Section 13(a) of the Investment Company Act, including, among other things, changes in the Trust's subclassification as a closed-end investment company or changes in its fundamental investment restrictions. As a result of these voting rights, the Trust's ability to take any such actions may be impeded to the extent that there are any Preferred Shares outstanding. The board of trustees presently intends that, except as otherwise indicated in this prospectus and except as otherwise required by applicable law, holders of Preferred Shares will have equal voting rights with holders of common shares (one vote per share, unless otherwise required by the Investment Company Act) and will vote together with holders of common shares as a single class.

The affirmative vote of the holders of a majority of the outstanding Preferred Shares, voting as a separate class, will be required to amend, alter or repeal any of the preferences, rights or powers of holders of Preferred Shares so as to affect materially and adversely such preferences, rights or powers, or to increase or decrease the authorized number of Preferred Shares. The class vote of holders of Preferred Shares described above will in each case be in addition to any other vote required to authorize the action in question.

**Redemption, Purchase and Sale of Preferred Shares by the Trust.** The terms of any Preferred Shares would typically provide that (1) they are redeemable by the Trust in whole or in part at the original purchase price per share plus accrued dividends per share, (2) the Trust may tender for or purchase Preferred Shares and (3) the Trust may subsequently resell any shares so tendered for or purchased. Any redemption or purchase of Preferred Shares by the Trust will

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

reduce the leverage applicable to the common shares, while any resale of shares by the Trust will increase that leverage.

The discussion above describes the possible offering of Preferred Shares by the Trust. If the board of trustees determines to proceed with such an offering, the terms of the Preferred Shares may be the same as, or different from, the terms described above, subject to applicable law and the Trust's Agreement and Declaration of Trust. The board of trustees, without the approval of the holders of common shares, may authorize an offering of Preferred Shares or may determine not to authorize such an offering, and may fix the terms of the Preferred Shares to be offered.

The Trust may apply for ratings for any Preferred Shares from Moody's, S&P or Fitch. In order to obtain and maintain the required ratings, the Trust will be required to comply with investment quality, diversification and other guidelines established by Moody's and/or S&P. Such guidelines will likely be more restrictive than the restrictions otherwise applicable to the Trust as described in the Trust's prospectus or above in this Statement of Additional Information. The Trust does not anticipate that such guidelines would have a material adverse effect on the Trust's holders of common shares or its ability to achieve its investment objectives. The Trust anticipates that any Preferred Shares that it issues would be initially given the highest ratings by Moody's ("Aaa") or by S&P ("AAA"), but no assurance can be given that such ratings will be obtained. No minimum rating is required for the issuance of Preferred Shares by the Trust. Moody's and S&P receive fees in connection with their ratings issuances.

B-17

### Other Shares

The board of trustees (subject to applicable law and the Trust's Agreement and Declaration of Trust) may authorize an offering, without the approval of the holders of either common shares or Preferred Shares, of other classes of shares, or other classes or series of shares, as they determine to be necessary, desirable or appropriate, having such terms, rights, preferences, privileges, limitations and restrictions as the board of trustees see fit. The Trust currently does not expect to issue any other classes of shares, or series of shares, except for the common shares and the Preferred Shares.

### REPURCHASE OF COMMON SHARES

The Trust is a closed-end management investment company and as such its shareholders will not have the right to cause the Trust to redeem their shares. Instead, the Trust's common shares will trade in the open market at a price that will be a function of several factors, including dividend levels (which are in turn affected by expenses), net asset value, call protection, dividend stability, relative demand for and supply of such shares in the market, general market and economic conditions and other factors. Because shares of a closed-end investment company may frequently trade at prices lower than net asset value, the Trust's board of trustees may consider action that might be taken to reduce or eliminate any material discount from net asset value in respect of common shares, which may include the repurchase of such shares in the open market or in private transactions, the making of a tender offer for such shares, or the conversion of the Trust to an open-end investment company. The board of trustees may decide not to take any of these actions. In addition, there can be no assurance that share repurchases or tender offers, if undertaken, will reduce market discount.

Notwithstanding the foregoing, at any time when the Trust's Preferred



## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Shares are outstanding, the Trust may not purchase, redeem or otherwise acquire any of its common shares unless (1) all accrued Preferred Shares dividends have been paid and (2) at the time of such purchase, redemption or acquisition, the net asset value of the Trust's portfolio (determined after deducting the acquisition price of the common shares) is at least 200% of the liquidation value of the outstanding Preferred Shares (expected to equal the original purchase price per share plus any accrued and unpaid dividends thereon). Any service fees incurred in connection with any tender offer made by the Trust will be borne by the Trust and will not reduce the stated consideration to be paid to tendering shareholders.

Subject to its investment restrictions, the Trust may borrow to finance the repurchase of shares or to make a tender offer. Interest on any borrowings to finance share repurchase transactions or the accumulation of cash by the Trust in anticipation of share repurchases or tenders will reduce the Trust's net income. Any share repurchase, tender offer or borrowing that might be approved by the Trust's board of trustees would have to comply with the Securities Exchange Act of 1934, as amended, the Investment Company Act and the rules and regulations thereunder.

Although the decision to take action in response to a discount from net asset value will be made by the board of trustees at the time it considers such issue, it is the board's present policy, which may be changed by the board of trustees, not to authorize repurchases of common shares or a tender offer for such shares if: (1) such transactions, if consummated, would (a) result in the delisting of the common shares from the New York Stock Exchange, or (b) impair the Trust's status as a regulated investment company under the Code (which would make the Trust a taxable entity, causing the Trust's income to be taxed at the corporate level in addition to the taxation of shareholders who receive dividends from the Trust), or as a registered closed-end investment company under the Investment Company Act; (2) the Trust would not be able to liquidate portfolio securities in an orderly manner and consistent with the Trust's investment objectives and policies in order to repurchase shares; or (3) there is, in the board's judgment, any (a) material legal action or proceeding instituted or threatened challenging such transactions or otherwise materially adversely affecting the Trust, (b) general suspension of or limitation on prices for trading securities on the New York Stock Exchange, (c) declaration of a banking moratorium by federal or state authorities or any suspension of payment by United States or New York banks, (d) material limitation affecting the Trust or the issuers of its portfolio securities by federal or state authorities on the extension of credit by lending institutions or on the exchange of foreign currency, (e) commencement of war, armed hostilities or other international or national calamity directly or indirectly involving the United States or (f) other event or condition which would have a material adverse effect (including any adverse tax effect) on the Trust or its shareholders if shares were repurchased. The board of trustees may in the future modify these conditions in light of experience.

The repurchase by the Trust of its shares at prices below net asset value will result in an increase in the net asset value of those shares that remain outstanding. However, there can be no assurance that share repurchases or tender offers at or below net asset value will result in the Trust's shares trading at a price equal to their net asset value. Nevertheless, the fact that the Trust's shares may be the subject of repurchase or tender offers from time to time, or that the Trust may be converted to an open-end investment company, may reduce any spread between market price and net asset value that might otherwise exist.

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

Before deciding whether to take any action if the common shares trade below net asset value, the Trust's board of trustees would likely consider all relevant factors, including the extent and duration of the discount, the liquidity of the Trust's portfolio, the impact of any action that might be taken on the Trust or its shareholders and market considerations. Based on these considerations, even if the Trust's shares should trade at a discount, the board of trustees may determine that, in the interest of the Trust and its shareholders, no action should be taken.

### TAX MATTERS

The following discussion summarizes certain U.S. federal income tax considerations affecting the Trust and the purchase, ownership and disposition of the Trust's common shares by U.S. persons. This discussion is based upon current provisions of the Internal Revenue Code of 1986, as amended (the "Code"), the regulations promulgated thereunder and judicial and administrative authorities, all of which are subject to change or differing interpretations by the courts or the Internal Revenue Service (the "IRS"), possibly with retroactive effect. No attempt is made to present a detailed explanation of all U.S. federal tax concerns affecting the Trust and its shareholders (including shareholders owning large positions in the Trust).

The discussions set forth herein and in the Prospectus do not constitute tax advice, and you are urged to consult your own tax advisor to determine the specific U.S. federal, state, local and foreign tax consequences to you of investing in the Trust.

#### Taxation of the Trust

The Trust intends to elect to be treated and to qualify annually as a regulated investment company under Subchapter M of the Code. Accordingly, the Trust must, among other things, meet the following requirements regarding the source of its income and the diversification of its assets:

(i) The Trust must derive in each taxable year at least 90% of its gross income from the following sources: (a) dividends, interest (including tax-exempt interest), payments with respect to certain securities loans, and gains from the sale or other disposition of stock, securities or foreign currencies, or other income (including but not limited to gain from options, futures and forward contracts) derived with respect to its business of investing in such stock, securities or foreign currencies; and (b) interests in "qualified publicly traded partnerships" (as defined in the Code).

(ii) The Trust must diversify its holdings so that, at the end of each quarter of each taxable year: (a) at least 50% of the market value of the Trust's total assets is represented by cash and cash items, U.S. government securities, the securities of other regulated investment companies and other securities, with such other securities limited, in respect of any one issuer, to an amount not greater than 5% of the value of the Trust's total assets and not more than 10% of the outstanding voting securities of such issuer and (b) not more than 25% of the market value of the Trust's total assets is invested in the securities (other than U.S. government securities and the securities of other regulated investment companies) of: (I) any one issuer, (II) any two or more issuers that the Trust controls and that are determined to be engaged in the same business or similar or related trades or businesses or (III) any one or more "qualified publicly traded partnerships" (as defined in the Code).

As a regulated investment company, the Trust generally will not be subject to U.S. federal income tax on income and gains that the Trust distributes to its shareholders provided that it distributes each taxable year at least the sum of: (i) 90% of the Trust's investment company taxable income (which includes, among other items, dividends, interest and the excess of any net

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

short-term capital gain over net long-term capital loss and other taxable income, other than any net long-term capital gain, reduced by deductible expenses) determined without regard to the deduction for dividends paid and (ii) 90% of the Trust's net tax-exempt interest (the excess of its gross tax-exempt interest over certain disallowed deductions). The Trust intends to distribute substantially all of such income each year. The Trust will be subject to income tax at regular corporation rates on any taxable income or gains that it does not distribute to its shareholders.

The Code imposes a 4% nondeductible excise tax on the Trust to the extent the Trust does not distribute by the end of any calendar year at least the sum of: (i) 98% of its ordinary income (not taking into account any capital gain or loss) for the calendar year and (ii) 98% of its capital gain in excess of its capital loss (adjusted for certain ordinary losses) for a one-year period generally ending on October 31 of the calendar year (unless an election is made to use the Trust's fiscal year). In addition, the minimum amounts that must be distributed in any year to avoid the excise tax will be increased or decreased to reflect any under-distribution or over-distribution, as the case may be, from the previous year. While the Trust intends to distribute any income and capital gain in the manner necessary to minimize imposition of the 4% excise tax, there can be no assurance that sufficient amounts of the Trust's taxable income and capital gain will be distributed to

B-19

avoid entirely the imposition of the excise tax. In that event, the Trust will be liable for the excise tax only on the amount by which it does not meet the foregoing distribution requirement.

If for any taxable year the Trust does not qualify as a regulated investment company, all of its taxable income (including its net capital gain) will be subject to tax at regular corporate rates without any deduction for distributions to shareholders, and such distributions will be taxable to the shareholders as ordinary dividends to the extent of the Trust's current or accumulated earnings and profits. Such dividends, however, would be eligible (i) to be treated as qualified dividend income in the case of shareholders taxed as individuals and (ii) for the dividends-received deduction in the case of shareholders taxed as corporations. The Trust could be required to recognize unrealized gains, pay taxes and make distributions (which could be subject to interest charges) before requalifying for taxation as a regulated investment company. If the Trust fails to qualify as a regulated investment company in any year, it must pay out its earnings and profits accumulated in that year in order to qualify again as a regulated investment company. If the Trust fails to qualify as a regulated investment company for a period greater than two taxable years, the Trust may be required to recognize and pay tax on any net built-in gains with respect to certain of its assets (i.e., the excess of the aggregate gains, including items of income, over aggregate losses that would have been realized with respect to such assets if the Trust had been liquidated) or, alternatively, to elect to be subject to taxation on such built-in gain recognized for a period of ten years, in order to qualify as a regulated investment company in a subsequent year.

Certain of the Trust's investment practices are subject to special and complex U.S. federal income tax provisions that may, among other things: (i) treat dividends that would otherwise constitute qualified dividend income as non-qualified dividend income, (ii) treat dividends that would otherwise be eligible for the corporate dividends-received deduction as ineligible for such treatment, (iii) disallow, suspend or otherwise limit the allowance of certain losses or deductions, (iv) convert lower taxed long-term capital gain into higher taxed short-term capital gain or ordinary income, (v) convert an

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

ordinary loss or deduction into a capital loss (the deductibility of which is more limited) or (vi) cause the Trust to recognize income or gain without a corresponding receipt of cash.

If the Trust purchases common shares in certain foreign investment entities, called passive foreign investment companies ("PFICs"), the Trust may be subject to U.S. federal income tax on a portion of any "excess distribution" or gain from the disposition of such common shares even if such income is distributed as a taxable dividend by the Trust to the shareholders. Additional charges in the nature of interest may be imposed on the Trust in respect of deferred taxes arising from such distributions or gains. Elections may be available to the Trust to mitigate the effect of this tax, but such elections generally accelerate the recognition of income without the receipt of cash. Dividends paid by PFICs will not be qualified dividend income, as discussed below under "Taxation of Shareholders."

If the Trust invests in the common shares of a PFIC, or any other investment that produces income that is not matched by a corresponding cash distribution to the Trust, the Trust could be required to recognize income that it has not yet received. Any such income would be treated as income earned by the Trust and therefore would be subject to the distribution requirements of the Code. This might prevent the Trust from distributing 90% of its net investment income as is required in order to avoid Trust-level U.S. federal income taxation on all of its income, or might prevent the Trust from distributing enough ordinary income and capital gain net income to avoid completely the imposition of the excise tax. To avoid this result, the Trust may be required to borrow money or dispose of securities to be able to make required distributions to the shareholders.

Dividend, interest and other income received by the Trust from investments outside the United States may be subject to withholding and other taxes imposed by foreign countries. Tax treaties between the United States and other countries may reduce or eliminate such taxes. The Trust does not expect that it will be eligible to elect to treat any foreign taxes it pays as paid by its shareholders, who therefore will not be entitled to credits for such taxes on their own tax returns. Foreign taxes paid by a Trust will reduce the return from the Trust's investments.

### Taxation of Shareholders

The Trust will determine either to distribute or to retain for reinvestment all or part of its net capital gain. If any such gain is retained, the Trust will be subject to a corporate income tax (currently at a maximum rate of 35%) on such retained amount. In that event, the Trust expects to designate the retained amount as undistributed capital gain in a notice to its shareholders, each of whom: (i) will be required to include in income for U.S. federal tax purposes as long-term capital gain its share of such undistributed amounts, (ii) will be entitled to credit its proportionate share of the tax paid by the Trust against its U.S. federal income tax liability and to claim refunds to the extent that the credit exceeds such liability and (iii) will increase its basis in its common shares of the Trust by an amount equal to 65% of the amount of undistributed capital gain included in such shareholder's gross income.

B-20

Distributions paid to you by the Trust from its net realized long-term capital gains, if any, that the Trust designates as capital gains dividends ("capital gain dividends") are taxable as long-term capital gains, regardless of how long you have held your common shares. All other dividends paid to you

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

by the Trust (including dividends from short-term capital gains) from its current or accumulated earnings and profits ("ordinary income dividends") are generally subject to tax as ordinary income.

Special rules apply, however, to ordinary income dividends paid to individuals with respect to taxable years beginning on or before December 31, 2008. If you are an individual, any such ordinary income dividend that you receive from the Trust generally will be eligible for taxation at the rates applicable to long-term capital gains (currently at a maximum rate of 15%) to the extent that: (i) the ordinary income dividend is attributable to "qualified dividend income" (i.e., generally dividends paid by U.S. corporations and certain foreign corporations) received by the Trust, (ii) the Trust satisfies certain holding period and other requirements with respect to the stock on which such qualified dividend income was paid and (iii) you satisfy certain holding period and other requirements with respect to your common shares. Ordinary income dividends subject to these special rules are not actually treated as capital gains, however, and thus will not be included in the computation of your net capital gain and generally cannot be used to offset any capital losses. Congress has recently considered certain proposals to extend the preferential tax rates for qualified dividend income beyond 2008, but no assurances can be given in this regard.

Any distributions you receive that are in excess of the Trust's current or accumulated earnings and profits will be treated as a tax-free return of capital to the extent of your adjusted tax basis in your common shares, and thereafter as capital gain from the sale of common shares. The amount of any Trust distribution that is treated as a tax-free return of capital will reduce your adjusted tax basis in your common shares, thereby increasing your potential gain or reducing your potential loss on any subsequent sale or other disposition of your common shares.

Dividends and other taxable distributions are taxable to you even if they are reinvested in additional common shares of the Trust. Dividends and other distributions paid by the Trust are generally treated under the Code as received by you at the time the dividend or distribution is made. If, however, the Trust pays you a dividend in January that was declared in the previous October, November or December and you were the shareholder of record on a specified date in one of such months, then such dividend will be treated for tax purposes as being paid by the Trust and received by you on December 31 of the year in which the dividend was declared.

The price of common shares purchased at any time may reflect the amount of a forthcoming distribution. If you purchase common shares just prior to a distribution, you will receive a distribution that will be taxable to you even though it represents in part a return of your invested capital.

The Trust will send you information after the end of each year setting forth the amount and tax status of any distributions paid to you by the Trust. Ordinary income dividends and capital gain dividends may also be subject to state and local taxes.

If you sell or otherwise dispose of common shares of the Trust (including exchange them for common shares of another fund), you will generally recognize a gain or loss in an amount equal to the difference between your tax basis in such common shares of the Trust and the amount you receive upon disposition of such common shares. If you hold your common shares as capital assets, any such gain or loss will be long-term capital gain or loss if you have held such common shares for more than one year at the time of sale. Any loss upon the sale or exchange of common shares held for six months or less will be treated as long-term capital loss to the extent of any capital gain dividends received (including amounts credited as an undistributed capital gain dividend) by you with respect to such common shares. Any loss you realize on a sale or exchange

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

of common shares will be disallowed if you acquire other common shares (whether through the automatic reinvestment of dividends or otherwise) within a 61-day period beginning 30 days before and ending 30 days after your sale or exchange of the common shares. In such case, your tax basis in the common shares acquired will be adjusted to reflect the disallowed loss.

Current law taxes both long-term and short-term capital gain of corporations at the rates applicable to ordinary income. For non-corporate taxpayers, short-term capital gain is currently taxed at rates applicable to ordinary income (currently at a maximum of 35%) while long-term capital gain generally is taxed at a maximum rate of 15%.

Shareholders may be entitled to offset their capital gain dividends with capital loss. The Code contains a number of statutory provisions affecting when capital loss may be offset against capital gain and limiting the use of loss from certain investments and activities. Accordingly, shareholders that have capital losses are urged to consult their tax advisors.

B-21

The Trust may be required to withhold, for U.S. federal backup withholding tax purposes, a portion of the dividends, distributions and redemption proceeds payable to a shareholder who fails to provide the Trust (or its agent) with the shareholder's correct taxpayer identification number (in the case of an individual, generally, such individual's social security number) or to make the required certification, or who has been notified by the IRS that such shareholder is subject to backup withholding. Certain shareholders are exempt from backup withholding. Backup withholding is not an additional tax and any amount withheld may be refunded or credited against your U.S. federal income tax liability, if any, provided that you furnish the required information to the IRS.

### EXPERTS

The Statement of Net Assets of the Trust as of \_\_\_\_\_, 2006 appearing in this Statement of Additional Information has been audited by \_\_\_\_\_, independent auditors, as set forth in their report thereon appearing elsewhere herein, and is included in reliance upon such report given upon the authority of such firm as experts in accounting and auditing. \_\_\_\_\_, located at \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, provides accounting and auditing services to the Trust.

### ADDITIONAL INFORMATION

A Registration Statement on Form N-2, including amendments thereto, relating to the shares offered hereby, has been filed by the Trust with the Securities and Exchange Commission (the "Commission"), Washington, D.C. The prospectus and this Statement of Additional Information do not contain all of the information set forth in the Registration Statement, including any exhibits and schedules thereto. For further information with respect to the Trust and the shares offered hereby, reference is made to the Registration Statement. Statements contained in the prospectus and this Statement of Additional Information as to the contents of any contract or other document referred to are not necessarily complete and in each instance reference is made to the copy of such contract or other document filed as an exhibit to the Registration Statement, each such statement being qualified in all respects by such reference. A copy of the Registration Statement may be inspected without charge at the Commission's principal office in Washington, D.C., and copies of all or any part thereof may be obtained from the Commission upon the payment of certain fees prescribed by the Commission.

Edgar Filing: Highland Credit Strategies Fund - Form N-2

B-22

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Trustees and Shareholder of Highland Credit Strategies Fund:

We have audited the accompanying statement of assets and liabilities of Highland Credit Strategies Fund (the "Trust") as of \_\_\_\_\_, 2006 and the related statements of operations and changes in net assets for the period from March 10, 2006 (date of inception) to \_\_\_\_\_, 2006. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Highland Credit Strategies Fund as of \_\_\_\_\_, 2006, and the results of its operations and the changes in its net assets for the period from March 10, 2006 (date of inception) to \_\_\_\_\_, 2006, in conformity with accounting principles generally accepted in the United States of America.

\_\_\_\_\_,  
, 2006

F-1

HIGHLAND CREDIT STRATEGIES FUND  
STATEMENT OF ASSETS AND LIABILITIES  
\_\_\_\_\_, 2006

F-2

HIGHLAND CREDIT STRATEGIES FUND  
STATEMENT OF OPERATIONS  
For the period March 10, 2006 (date of inception) to \_\_\_\_\_, 2006

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

F-3

### HIGHLAND CREDIT STRATEGIES FUND

#### STATEMENT OF CHANGES IN NET ASSETS

For the period March 10, 2006 (date of inception) to , 2006

F-4

### HIGHLAND CREDIT STRATEGIES FUND

#### NOTES TO FINANCIAL STATEMENTS

F-5

### APPENDIX A

#### GENERAL CHARACTERISTICS AND RISKS OF STRATEGIC TRANSACTIONS

In order to manage the risk of its securities portfolio, or to enhance income or gain as described in the prospectus, the Trust will engage in Strategic Transactions. The Trust will engage in such activities in the Investment Manager's discretion, and may not necessarily be engaging in such activities when movements in interest rates that could affect the value of the assets of the Trust occur. The Trust's ability to pursue certain of these strategies may be limited by applicable regulations of the CFTC. Certain Strategic Transactions may give rise to taxable income.

#### Put and Call Options on Securities and Indices

The Trust may purchase and sell put and call options on securities and indices. A put option gives the purchaser of the option the right to sell and the writer the obligation to buy the underlying security at the exercise price during the option period. The Trust may also purchase and sell options on securities indices ("index options"). Index options are similar to options on securities except that, rather than taking or making delivery of securities underlying the option at a specified price upon exercise, an index option gives the holder the right to receive cash upon exercise of the option if the level of the securities index upon which the option is based is greater, in the case of a call, or less, in the case of a put, than the exercise price of the option. The purchase of a put option on a security could protect the Trust's holdings in a security or a number of securities against a substantial decline in the market value. A call option gives the purchaser of the option the right to buy and the seller the obligation to sell the underlying security or index at the exercise price during the option period or for a specified period prior to a fixed date. The purchase of a call option on a security could protect the Trust against an increase in the price of a security that it intended to purchase in the future. In the case of either put or call options that it has purchased, if the option expires without being sold or exercised, the Trust will experience a loss in the amount of the option premium plus any related commissions. When the Trust sells put and call options, it receives a premium



## Edgar Filing: Highland Credit Strategies Fund - Form N-2

as the seller of the option. The premium that the Trust receives for selling the option will serve as a partial offset, in the amount of the option premium, against changes in the value of the securities in its portfolio. During the term of the option, however, a covered call seller has, in return for the premium on the option, given up the opportunity for capital appreciation above the exercise price of the option if the value of the underlying security increases, but has retained the risk of loss should the price of the underlying security decline. Conversely, a secured put seller retains the risk of loss should the market value of the underlying security decline be low the exercise price of the option, less the premium received on the sale of the option. The Trust is authorized to purchase and sell exchange listed options and over-the-counter options ("OTC Options") which are privately negotiated with the counterparty. Listed options are issued by the Options Clearing Corporation ("OCC") which guarantees the performance of the obligations of the parties to such options.

The Trust's ability to close out its position as a purchaser or seller of an exchange listed put or call option is dependent upon the existence of a liquid secondary market on option exchanges. Among the possible reasons for the absence of a liquid secondary market on an exchange are: (i) insufficient trading interest in certain options; (ii) restrictions on transactions imposed by an exchange; (iii) trading halts, suspensions or other restrictions imposed with respect to particular classes or series of options or underlying securities; (iv) interruption of the normal operations on an exchange; (v) inadequacy of the facilities of an exchange or OCC to handle current trading volume; or (vi) a decision by one or more exchanges to discontinue the trading of options (or a particular class or series of options), in which event the secondary market on that exchange (or in that class or series of options) would cease to exist, although outstanding options on that exchange that had been listed by the OCC as a result of trades on that exchange would generally continue to be exercisable in accordance with their terms. OTC Options are purchased from or sold to dealers, financial institutions or other counterparties which have entered into direct agreements with the Trust. With OTC Options, such variables as expiration date, exercise price and premium will be agreed upon between the Trust and the counterparty, without the intermediation of a third party such as the OCC. If the counterparty fails to make or take delivery of the securities underlying an option it has written, or otherwise settle the transaction in accordance with the terms of that option as written, the Trust would lose the premium paid for the option as well as any anticipated benefit of the transaction.

The hours of trading for options on securities may not conform to the hours during which the underlying securities are traded. To the extent that the option markets close before the markets for the underlying securities, significant price movements can take place in the underlying markets that cannot be reflected in the option markets.

A-1

### Futures Contracts and Related Options

Characteristics. The Trust may sell financial futures contracts or purchase put and call options on such futures as an offset against anticipated market movements. The sale of a futures contract creates an obligation by the Trust, as seller, to deliver the specific type of financial instrument called for in the contract at a specified future time for a specified price. Options on futures contracts are similar to options on securities except that an option on a futures contract gives the purchaser the right in return for the premium paid to assume a position in a futures contract (a long position if the option

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

is a call and a short position if the option is a put).

**Margin Requirements.** At the time a futures contract is purchased or sold, the Trust must allocate cash or securities as a deposit payment ("initial margin"). It is expected that the initial margin that the Trust will pay may range from approximately 1% to approximately 5% of the value of the securities or commodities underlying the contract. In certain circumstances, however, such as periods of high volatility, the Trust may be required by an exchange to increase the level of its initial margin payment. Additionally, initial margin requirements may be increased generally in the future by regulatory action. An outstanding futures contract is valued daily and the payment in case of "variation margin" may be required, a process known as "marking to the market." Transactions in listed options and futures are usually settled by entering into an offsetting transaction, and are subject to the risk that the position may not be able to be closed if no offsetting transaction can be arranged.

**Limitations on Use of Futures and Options on Futures.** The Trust's use of futures and options on futures will in all cases be consistent with applicable regulatory requirements and in particular the rules and regulations of the CFTC. The Trust currently may enter into such transactions without limit for bona fide strategic purposes, including risk management and duration management and other portfolio strategies. The Trust may also engage in transactions in futures contracts or related options for non-strategic purposes to enhance income or gain provided that the Trust will not enter into a futures contract or related option (except for closing transactions) for purposes other than bona fide strategic purposes, or risk management including duration management if, immediately thereafter, the sum of the amount of its initial deposits and premiums on open contracts and options would exceed 5% of the Trust's liquidation value, i.e., net assets (taken at current value); provided, however, that in the case of an option that is in-the-money at the time of the purchase, the in-the-money amount may be excluded in calculating the 5% limitation. The above policies are non-fundamental and may be changed by the Trust's board of trustees at any time. Also, when required, an account of cash equivalents designated on the books and records will be maintained and marked to market on a daily basis in an amount equal to the market value of the contract.

**Segregation and Cover Requirements.** Futures contracts, interest rate swaps, caps, floors and collars, short sales, reverse repurchase agreements and dollar rolls, and listed or OTC options on securities, indices and futures contracts sold by the Trust are generally subject to earmarking and coverage requirements of either the CFTC or the SEC, with the result that, if the Trust does not hold the security or futures contract underlying the instrument, the Trust will be required to designate on its books and records an ongoing basis, cash, U.S. government securities, or other liquid high grade debt obligations in an amount at least equal to the Trust's obligations with respect to such instruments.

Such amounts fluctuate as the obligations increase or decrease. The earmarking requirement can result in the Trust maintaining securities positions it would otherwise liquidate, segregating assets at a time when it might be disadvantageous to do so or otherwise restrict portfolio management.

**Strategic Transactions Present Certain Risks.** With respect to Strategic Transactions and risk management, the variable degree of correlation between price movements of strategic instruments and price movements in the position being offset create the possibility that losses using the strategy may be greater than gains in the value of the Trust's position. The same is true for such instruments entered into for income or gain. In addition, certain instruments and markets may not be liquid in all circumstances. As a result, in volatile markets, the Trust may not be able to close out a transaction without incurring losses substantially greater than the initial deposit. Although the

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

contemplated use of these instruments predominantly for Strategic Transactions should tend to minimize the risk of loss due to a decline in the value of the position, at the same time they tend to limit any potential gain which might result from an increase in the value of such position. The ability of the Trust to successfully utilize Strategic Transactions will depend on the Advisor's and the Sub-Advisor's ability to predict pertinent market movements and sufficient correlations, which cannot be assured. Finally, the daily deposit requirements in futures contracts that the Trust has sold create an on going greater potential financial risk than do options transactions, where the exposure is limited to the cost of the initial premium. Losses due to the use of Strategic Transactions will reduce net asset value.

Regulatory Considerations. The Trust has claimed an exclusion from the term "commodity pool operator" under the Commodity Exchange Act and, therefore, is not subject to registration or regulation as a commodity pool operator under the Commodity Exchange Act.

A-2

### APPENDIX B

#### PROXY VOTING PROCEDURES

B-1

### Part C

#### Other Information

#### Item 25. Financial Statements And Exhibits

##### Financial Statements

Part A--None.

Part B--Statement of Assets and Liabilities. (1)

##### EXHIBITS

(a) Agreement and Declaration of Trust.(1) (b) By-Laws.(1)

-----  
(1) To be filed by amendment.

#### Item 26. Marketing Arrangements

Reference is made to the Form of Underwriting Agreement for the Registrant's shares of beneficial interest to be filed by amendment to this registration statement.

#### Item 27. Other Expenses Of Issuance And Distribution

The following table sets forth the estimated expenses to be incurred in

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

connection with the offering described in this registration statement:

Registration fee  
NYSE listing fee  
Printing (other than certificates)  
Engraving and printing certificates  
Accounting fees and expenses related to the offering  
Legal fees and expenses related to the offering  
NASD fee  
Miscellaneous (i.e. travel) related to the offering  
  
Total

Item 28. Persons Controlled By Or under Common Control With The Registrant

None.

Item 29. Number Of Holders Of Shares

As of \_\_\_\_\_, 2006

Title Of Class

-----  
Shares of Beneficial Interest

Item 30. Indemnification

Article V of the Registrant's Agreement and Declaration of Trust provides as follows:

5.1 No Personal Liability of Shareholders, Trustees, etc. No Shareholder of the Trust shall be subject in such capacity to any personal liability whatsoever to any Person in connection with Trust Property or the acts, obligations or affairs of the Trust. Shareholders shall have the same limitation of personal liability as is extended to stockholders of a

C-1

private corporation for profit incorporated under the Delaware General Corporation Law. No Trustee or officer of the Trust shall be subject in such capacity to any personal liability whatsoever to any Person, save only liability to the Trust or its Shareholders arising from bad faith, willful misfeasance, gross negligence or reckless disregard for his duty to such Person; and, subject to the foregoing exception, all such Persons shall look solely to the Trust Property for satisfaction of claims of any nature arising in connection with the affairs of the Trust. If any Shareholder, Trustee or officer, as such, of the Trust, is made a party to any suit or proceeding to enforce any such liability, subject to the foregoing exception, he shall not, on account thereof, be held to any personal liability. Any repeal or modification of this Section 5.1 shall

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

not adversely affect any right or protection of a Trustee or officer of the Trust existing at the time of such repeal or modification with respect to acts or omissions occurring prior to such repeal or modification.

5.2 Mandatory Indemnification. (a) The Trust hereby agrees to indemnify each person who at any time serves as a Trustee or officer of the Trust (each such person being an "indemnitee") against any liabilities and expenses, including amounts paid in satisfaction of judgments, in compromise or as fines and penalties, and reasonable counsel fees reasonably incurred by such indemnitee in connection with the defense or disposition of any action, suit or other proceeding, whether civil or criminal, before any court or administrative or investigative body in which he may be or may have been involved as a party or otherwise or with which he may be or may have been threatened, while acting in any capacity set forth in this Article V by reason of his having acted in any such capacity, except with respect to any matter as to which he shall not have acted in good faith in the reasonable belief that his action was in the best interest of the Trust or, in the case of any criminal proceeding, as to which he shall have had reasonable cause to believe that the conduct was unlawful, provided, however, that no indemnitee shall be indemnified hereunder against any liability to any person or any expense of such indemnitee arising by reason of (i) willful misfeasance, (ii) bad faith, (iii) gross negligence, or (iv) reckless disregard of the duties involved in the conduct of his position (the conduct referred to in such clauses (i) through (iv) being sometimes referred to herein as "disabling conduct"). Notwithstanding the foregoing, with respect to any action, suit or other proceeding voluntarily prosecuted by any indemnitee as plaintiff, indemnification shall be mandatory only if the prosecution of such action, suit or other proceeding by such indemnitee (1) was authorized by a majority of the Trustees or (2) was instituted by the indemnitee to enforce his or her rights to indemnification hereunder in a case in which the indemnitee is found to be entitled to such indemnification. The rights to indemnification set forth in this Declaration shall continue as to a person who has ceased to be a Trustee or officer of the Trust and shall inure to the benefit of his or her heirs, executors and personal and legal representatives. No amendment or restatement of this Declaration or repeal of any of its provisions shall limit or eliminate any of the benefits provided to any person who at any time is or was a Trustee or officer of the Trust or otherwise entitled to indemnification hereunder in respect of any act or omission that occurred prior to such amendment, restatement or repeal.

(b) Notwithstanding the foregoing, no indemnification shall be made hereunder unless there has been a determination (i) by a final decision on the merits by a court or other body of competent jurisdiction before whom the issue of entitlement to indemnification hereunder was brought that such indemnitee is entitled to indemnification hereunder or, (ii) in the absence of such a decision, by (1) a majority vote of a quorum of those Trustees who are neither "interested persons" of the Trust (as defined in Section 2(a)(19) of the Investment Company Act) nor parties to the proceeding ("Disinterested Non-Party Trustees"), that the indemnitee is entitled to indemnification hereunder, or (2) if such quorum is not obtainable or even if obtainable, if such majority so directs, independent legal counsel in a written opinion concludes that the indemnitee should be entitled to indemnification hereunder. All determinations to make advance payments in connection with the expense of defending any proceeding shall be authorized and made in accordance with the immediately succeeding paragraph (c) below.

(c) The Trust shall make advance payments in connection with the expenses of defending any action with respect to which indemnification might be sought hereunder if the Trust receives a written affirmation by

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

the indemnitee of the indemnitee's good faith belief that the standards of conduct necessary for indemnification have been met and a written undertaking to reimburse the Trust unless it is subsequently determined that the indemnitee is entitled to such indemnification and if a majority of the Trustees determine that the applicable standards of conduct necessary for indemnification appear to have been met. In addition, at least one of the following conditions must be met: (i) the indemnitee shall provide adequate security for his undertaking, (ii) the Trust shall be insured against losses arising by reason of any lawful advances, or (iii) a majority of a quorum of the Disinterested Non-Party Trustees, or if a majority vote of such quorum so direct, independent legal counsel in a written opinion, shall conclude, based on a review of readily available facts (as opposed to a full trial-type inquiry), that there is substantial reason to believe that the indemnitee ultimately will be found entitled to indemnification.

(d) The rights accruing to any indemnitee under these provisions shall not exclude any other right which any person may have or hereafter acquire under this Declaration, the By-Laws of the Trust, any statute, agreement, vote of

C-2

stockholders or Trustees who are "disinterested persons" (as defined in Section 2(a)(19) of the 1940 Act) or any other right to which he or she may be lawfully entitled.

(e) Subject to any limitations provided by the 1940 Act and this Declaration, the Trust shall have the power and authority to indemnify and provide for the advance payment of expenses to employees, agents and other Persons providing services to the Trust or serving in any capacity at the request of the Trust to the full extent corporations organized under the Delaware General Corporation Law may indemnify or provide for the advance payment of expenses for such Persons, provided that such indemnification has been approved by a majority of the Trustees.

5.3 No Bond Required of Trustees. No Trustee shall, as such, be obligated to give any bond or other security for the performance of any of his duties hereunder.

5.4 No Duty of Investigation; Notice in Trust Instruments, etc. No purchaser, lender, transfer agent or other person dealing with the Trustees or with any officer, employee or agent of the Trust shall be bound to make any inquiry concerning the validity of any transaction purporting to be made by the Trustees or by said officer, employee or agent or be liable for the application of money or property paid, loaned, or delivered to or on the order of the Trustees or of said officer, employee or agent. Every obligation, contract, undertaking, instrument, certificate, Share, other security of the Trust, and every other act or thing whatsoever executed in connection with the Trust shall be conclusively taken to have been executed or done by the executors thereof only in their capacity as Trustees under this Declaration or in their capacity as officers, employees or agents of the Trust. The Trustees may maintain insurance for the protection of the Trust Property, its Shareholders, Trustees, officers, employees and agents in such amount as the Trustees shall deem adequate to cover possible tort liability, and such other insurance as the Trustees in their sole judgment shall deem advisable or is required by the 1940 Act.

5.5 Reliance on Experts, etc. Each Trustee and officer or employee of

## Edgar Filing: Highland Credit Strategies Fund - Form N-2

the Trust shall, in the performance of its duties, be fully and completely justified and protected with regard to any act or any failure to act resulting from reliance in good faith upon the books of account or other records of the Trust, upon an opinion of counsel, or upon reports made to the Trust by any of the Trust's officers or employees or by any advisor, administrator, manager, distributor, selected dealer, accountant, appraiser or other expert or consultant selected with reasonable care by the Trustees, officers or employees of the Trust, regardless of whether such counsel or expert may also be a Trustee.

Insofar as indemnification for liabilities arising under the Act, may be terminated to Trustees, officers and controlling persons of the Trust, pursuant to the foregoing provisions or otherwise, the Trust has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the Registrant of expenses incurred or paid by a Trustee, officer or controlling person of the Registrant in the successful defense of any action, suit or proceeding) is asserted by such Trustee, officer or controlling person in connection with the securities being registered, the Registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act and will be governed by the final adjudication of such issue. Reference is made to Article of the underwriting agreement attached as Exhibit (h), which is incorporated herein by reference.

### Item 31. Business And Other Connections Of Investment Advisor

Not Applicable.

### Item 32. Location Of Accounts And Records

The Registrant's accounts, books and other documents are currently located at the offices of the Registrant, c/o Highland Capital Management, L.P., Two Galleria Tower, 13455 Noel Road, Suite 800, Dallas, Texas 75240 and at the offices of the Registrant's Custodian and Transfer Agent.

### Item 33. Management Services

Not Applicable.

### Item 34. Undertakings

(1) The Registrant hereby undertakes to suspend the offering of its units until it amends its prospectus if (a) subsequent to the effective date of its registration statement, the net asset value declines more than 10 percent from its

C-3

net asset value as of the effective date of the Registration Statement or (b) the net asset value increases to an amount greater than its net proceeds as stated in the prospectus.

(2) Not applicable.

(3) Not applicable.

Edgar Filing: Highland Credit Strategies Fund - Form N-2

(4) Not applicable.

(5) (a) For the purposes of determining any liability under the Securities Act of 1933, the information omitted from the form of prospectus filed as part of a registration statement in reliance upon Rule 430A and contained in the form of prospectus filed by the Registrant under Rule 497 (h) under the Securities Act of 1933 shall be deemed to be part of the Registration Statement as of the time it was declared effective.

(b) For the purpose of determining any liability under the Securities Act of 1933, each post-effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of the securities at that time shall be deemed to be the initial bona fide offering thereof.

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

C-4

SIGNATURES

Pursuant to the requirements of the Securities Act of 1933 and the Investment Company Act of 1940, the Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Dallas, and State of Texas, on the 15th day of March 2006.

/s/ R. Joseph Dougherty

-----  
R. Joseph Dougherty  
Sole Initial Trustee, President, Chief Executive  
Officer and Principal Financial Officer

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed by the following persons in the capacities set forth below on the 15th day of March 2006.

NAME	TITLE
----	-----
/s/ R. Joseph Dougherty ----- R. Joseph Dougherty	Sole Initial Trustee, President, Chief Executive Officer and Principal Financial Officer

INDEX TO EXHIBITS

None.